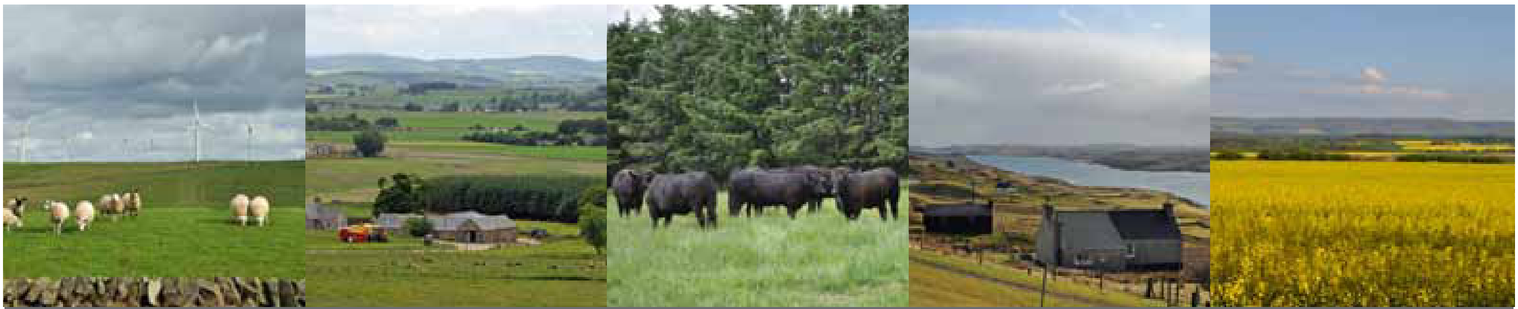
THE ROAD AHEAD **FOR SCOTLAND**

FINAL REPORT OF THE INQUIRY INTO FUTURE SUPPORT
FOR AGRICULTURE IN SCOTLAND

CHAIRMAN BRIAN PACK OBE



The Scottish Government

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The Scottish Government, Edinburgh, 2010

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Preface

Over my life I have had many interesting challenges and Chairing this Inquiry has certainly been that. Many have said that coming up with a future model for agricultural support in Scotland is an impossible task but what they actually mean is, as with any change, that not everybody will be happy with the change recommended – but change is inevitable in the post-2013 CAP. Once one accepts that fact then my objective becomes all the clearer, namely to make recommendations that are in the best interests for the future of Scottish agriculture, rural Scotland and therefore Scotland as a whole. It is my sincere hope that you agree that this report delivers the objective.

Getting to this point of making recommendations to the Cabinet Secretary for Rural Affairs and the Environment has been a remarkable journey which has been greatly helped by the wide body of stakeholders who have taken time to understand the issues and offer evidence and opinions – a sincere thanks to you all. I particularly appreciate those who attended one of the roadshow meetings held throughout Scotland in the late winter and contributed to the positive atmosphere that was a feature of the meetings.

Whilst this report is "my baby" it would have been impossible without the help of many. Firstly, my Committee of Advisors whose breadth of expertise and clear thinking provided invaluable input which helped shape the report – thanks to Wilma, Johnnie, John, Davie and Steve. Secondly, the staff of the Rural and Environment Directorate and other Scottish Government experts who provided evidence and advice to ensure I fully understood the issues – thanks for your patience, good humour and expertise. A special thanks for the Secretary to the Inquiry, John Brownlee, for his support and organisational ability, and to my two independent scribes who converted the evidence and thoughts into a logical and readable report.

It would be remiss of me not to recognise the contribution of my home team – my long suffering assistant Helen, my wife Pam, my sons and my friend who drove me round Scotland – thanks to you all and life will be less frenetic now!

Finally I would like to thank Richard Lochhead, the Cabinet Secretary, for appointing me to Chair this Inquiry. It has certainly been challenging, mostly enjoyable, and I hope to be able to look back and say very rewarding.

Brian Pack OBE

"A more sustainable agriculture: an agricultural sector that is innovative and competitive, and has food production as its primary purpose, but… also delivers a range of other benefits which help to meet the global challenges of food security, climate change, water and energy supply and biodiversity.

It is essential that Scottish agriculture continues on this journey as not only will it deliver the benefits that wider society demands but it will ensure the long term future of Scottish agriculture".

The Pack Inquiry Committee

Chairman: Brian Pack OBE

Brian Pack chaired the Inquiry. Brian is the former Chief Executive of ANM Group Ltd, Chairman of the Board of Governors of the Rowett Institute of Nutrition and Health, a member of the Aberdeen University Court and the Operating Board, Managing Director of Farmdata Ltd, an agricultural software house and director of Financial Control Services Ltd (a farmers' co-op which offers a budgeting and financial control service to farmers). Brian is a Fellow of the Royal Agricultural Society and an Honorary Member of the Institute of Auctioneers. He was awarded an OBE for services to agriculture, food and marketing in 1999.

Advisors

Brian received assistance and advice from several other key figures with expertise in a range of sectors. These members of the Committee were appointed to act as advisors. They were asked to advise and support the Inquiry Chair by attending meetings and participating in discussions; contributing their own experiences to the evaluation of agricultural support policies; facilitating the development of alternative agriculture support models available under the CAP through analysis of evidence; and by offering comment on the drafting of written submissions including the final report of the Inquiry's findings. The advisors are:

Wilma Finlay MBE – Wilma is the Managing Director of Cream O'Galloway, a farm diversification business employing 19 full-time staff and 35 seasonal staff. The farming business managed by Wilma's husband is an 830 acre tenanted dairy and livestock organic farm.

Professor John Grace FRSE – John is Professor of Environmental Biology at the School of GeoSciences in the University of Edinburgh.

Johnny Mackey – Johnny is a relatively new entrant to farming and is building up a cattle and sheep business. He is Breed Secretary for the Luing Cattle Society Ltd.

David MacLeod – Dave manages the family farm in Skye, is an Independent Rural Consultant and a member of the Board of the Crofters Commission.

Steve McLean – Steve is the Agriculture Manager for Marks and Spencer plc, responsible for livestock supply chains and for interaction between the retailer and its farmer producers.

Executive **Summary**

Executive Summary

The Inquiry

This Inquiry into future support for agriculture and rural development in Scotland was commissioned by Richard Lochhead MSP, Cabinet Secretary for Rural Affairs and the Environment in June 2009. It was established to provide advice to the Scottish Government on how support to agriculture and rural development could best be tailored to deliver the Scottish Government's purpose of "creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth". The Inquiry was chaired by Brian Pack OBE.

The Inquiry gathered evidence in a number of different ways, including: meetings with Scottish Government staff and a wide range of stakeholders; commissioning several evidence papers (available on the Inquiry website); meetings with European Commissioners and Commission officials; two public consultations, firstly in Autumn 2009, and secondly in early 2010 in response to the Inquiry's Interim Report; a series of public meetings throughout Scotland; and modelling work undertaken by the Macaulay Land Use Research Institute and the Scottish Government. The Inquiry published its short-term recommendations in June 2010. These were accepted by the Scottish Government in August 2010.

The changing context for agricultural support in Scotland

The Common Agricultural Policy (CAP) was created in the 1957 Treaty of Rome. Since then it has undergone several reforms in order to reorient it to the needs of a changing world, including a broadening to incorporate environmental and rural development measures. Much of the funding remains in Pillar 1, and is paid out to farmers and land managers in decoupled direct payments (the Single Farm Payment Scheme, SFPS).

Today there are increasing calls that the agricultural industry should be a player in addressing the significant global challenges that we face. The Inquiry uses the term 'a sustainable agriculture' to describe an industry that is moving towards meeting these challenges. This means an agricultural sector that is innovative and competitive, with food production as its primary purpose, but which is also delivering a range of other benefits helping to address these global challenges. The Inquiry highlights five key challenges: food security, climate change, water supply, energy use and biodiversity. The Inquiry also believes that the strength of rural communities is intrinsically inter-linked with a sustainable agricultural industry. It is critical that future support regimes recognise the important and increasing role of the industry in addressing these global challenges.

A number of other contextual issues are important for Scotland, including: the CAP's declining share of the EU budget as a result of the expansion of EU responsibilities into new areas; debates around the objectives and balance of funding in the CAP's two Pillars; the method of distributing Pillar 1 direct payments as the EU consensus moves towards an area based approach; and the share of the CAP budget allocated to a growing number of Member States, all with very different agricultural industries. The Inquiry notes the currently low allocation of both Pillar 1 and Pillar 2 funding in Scotland and believes that Scotland has a strong case for arguing for an increased (or at least maintained) budget in future based on the principle of equity (applied at both EU and UK level).

Support for agriculture and rural development in Scotland today

85% of Scottish agricultural land is Less Favoured Area (LFA) with land management in these areas facing difficult physical and climatic conditions. With 70% of this area consisting of rough grazing it can only really be used for extensive livestock production. Agriculture makes a significant contribution to employment and the maintenance of communities and their services in rural Scotland (particularly in remote rural areas), and through its supply chain links with other industries. Scottish farmers and land managers also play a critical role in managing the Scottish landscape and biodiversity, and thus in providing large quantities of public goods. Any future support regime must be tailored to these key Scottish concerns.

Public financial support plays a very important role in the Scottish agricultural industry, although this importance varies by sector. Pillar 1 direct payments are given to farmers mainly through the SFPS based on a historic model of allocating the funding. A small amount of money is available through the Scottish Beef Calf Scheme. Pillar 2 payments are provided through grant funding in the Scotland Rural Development Programme (SRDP). Scotland adopted an innovative approach in providing an integrated set of measures in the SRDP to deliver against the three axes of the Programme. The main measures in the SRDP are Rural Development Contracts, the Less Favoured Area Support Scheme (LFASS) and LEADER.

There are a number of concerns that can be raised about the current support regime and which have been vital in shaping the Inquiry's recommendations for the future. The main one is that using an historic approach to distributing payments makes the payments hard to justify. Pillar 1 payments are very unevenly distributed across Scotland and there is an asymmetry between Pillars 1 and 2, again raising the question of whether Pillar 1 should be reformed so as to deliver greater benefits, given its greater share of the budget. The final concern relates to Scotland's small share of the overall CAP budget and the strong argument for this to be increased in future.

Agricultural support in Scotland: where do we want to go?

The Inquiry believed it was important to identify a direction of travel, a goal and a set of priorities for reaching that goal. In doing so, the Inquiry firstly referred to a number of policy documents produced over the last ten years in Scotland. The current Scottish Government's Vision for Agriculture (2010) argues that the agriculture sector should be market based but that farming also delivers a range of public goods which should be supported by public funds and through the formation of a clear contract between farmers and society. The sector also has a role to play in contributing to the Scottish Government's purpose of increasing sustainable economic growth but, as a result of pressures on public spending, there is a need to demonstrate more precisely how Scottish agriculture makes this contribution.

The Inquiry's first public consultation emphasised a number of key considerations, including the need for: support to target only land being actively farmed or managed for the production of public benefits; schemes to be open and transparent and to support new entrants and those who currently do not receive support; and consideration of different land types when deciding how support should be distributed. The second consultation highlighted support for the Inquiry's broad principles (including the need to support active farming and to move away from historic payments) although opinions were more mixed on the specific proposals, including the use of the Land Capability for Agriculture (LCA) to distribute payments.

As a result of considering these documents and responses, and broader EU and WTO debates, the Inquiry identified a framework of characteristics within which its goal – for a more sustainable Scottish agriculture, contributing to increased sustainable economic growth for Scotland - would need to be achieved. These characteristics are: a future support regime with agricultural production at its heart which is tailored to the needs of different places but which is simple to administer. The system should be designed to work towards clear objectives, whilst being compliant with WTO requirements.

Agricultural support in Scotland: how do we get there?

The Inquiry takes the view that the current two Pillar structure can deliver against a broader range of objectives (i.e. the global challenges) and that the majority of support should be maintained in Pillar 1 in recognition of this extended role for direct payments. The Inquiry believes that this approach is the best way to ensure that food production remains at the heart of the future support regime but that agriculture becomes more sustainable and delivers against the global challenges, in turn contributing to increasing sustainable economic growth.

The Inquiry also takes the view that, as direct payments are designed to compensate producers for the increased costs of operating in a highly regulated common market with high food safety and animal welfare standards, the more active farmers who face the highest costs in meeting these requirements should receive the most direct support. Moreover, the more active farmers have the greatest potential to contribute positively to the global challenges but face the largest hurdles in doing so, thus again they should receive the most direct support.

As a result of the responses to the second consultation and of further analysis, the Inquiry reached the conclusion that using the LCA was not an appropriate method of distributing payments. Instead the Inquiry believes that dividing Scotland into LFA and Non-LFA land provides a more appropriate approach as it recognises the different opportunities, needs and challenges of farmers in these areas.

Due to the dominance of rough grazing and permanent pasture, farmers in the LFA face limited choices about what to produce. The risk of land abandonment, and associated negative economic, social and environmental consequences, in these areas is high. The Inquiry believes that farmers in the LFA should be supported by three mechanisms:

- An area payment on eligible land (defined by the Inquiry, including land in an approved environmental scheme but not woodland) as a low base payment thus minimising the disruption to the land market. Extensive grazing is paid on the equivalent area to a stocking rate minimum of 0.12 Livestock Units (LU) per hectare.
- A Top Up Fund to encourage delivery against the global challenges which recognises the ability of a business to contribute by using Standard Labour Requirements to determine the individual fund.

- Headage payments designed to stabilise cow and ewe numbers on this marginal land thereby securing the basis for the provision of public benefits. Money would be paid out on lambs and beef calves. The annual budget for each would be set at the outset.

The Inquiry proposes that farmers in the Non-LFA land, who have a range of options as to what to produce, will be supported in two ways:

- An area payment making up two thirds of support.
- A Top Up Fund payment making up one third of support, paid on an area basis.

The Inquiry believes that Scotland must move away from historic payments and that this move should occur one year post reform with the new schemes adopted in one step, primarily to avoid difficulties in administration. In the event of a phased transition, the Inquiry proposes an interim scheme, funded by a National Reserve, to give payments to new entrants who have started a business since 2003.

As a result of its proposals based on LFA/Non-LFA, the Inquiry also considered the future of LFASS. It proposes that a proportion of the current LFASS money (€25 million) remains in Pillar 2 to be targeted at a clearly defined 'Vulnerable Area', in recognition of the role this area plays in delivering a wide range of public benefits. The balance of the current LFASS funding of €45 million would be retained in Pillar 1 and paid out as an addition to the Top Up Fund.

The Inquiry also considered the future of Pillar 2 (the SRDP) more broadly, although it acknowledges the detailed analysis of this in the 2009 first stage review and the current mid-term evaluation (to report by the end of 2010). The Inquiry notes the need for flexibility in thinking about future Pillar 2 schemes and the need for ensuring that complementarities exist between Pillar 2 and any moves to achieve more with Pillar 1 money. The Inquiry notes the importance of continuing payments in Pillar 2 for economic diversification, environmental and land management measures and broader rural development schemes.

The Inquiry also notes the market and production risks faced by the farming industry, and the strategic role of agricultural policy in providing farmers with an environment in which they can more effectively engage with the risk management tools available. The Inquiry welcomes continued CAP market support aimed at providing a safety net against extreme price movements, but calls for a more flexible approach to current market intervention. It also calls for further work to be undertaken into the potential for establishing a marketing loan scheme at EU level and into the role of producer organisations in strengthening the position of primary producers.

The Inquiry acknowledges the moves taken by the EU to introduce less rigid bureaucratic procedures in administering the CAP budget but would encourage more moves to be taken in this direction. In particular, the Inquiry believes that Member States should be given more flexibility in deciding how to spend their funding allocation and that they should be allowed to roll funding forward for at least one year to ensure that money can be more effectively targeted at clearly defined outcomes.

Finally, the Inquiry offers its perspective on spending priorities in the event of a significant reduction in Scotland's CAP budget post-2013. If Pillar 2 funding is substantially reduced, priority should be given to the Vulnerable Area and to ensuring the good work done to date is not lost. The Inquiry also recommends that the results of the ongoing mid-term review of the SRDP together with the first stage review are used to inform the targeting of funding to develop a more sustainable agricultural industry. As regards cuts in Pillar 1 funding (direct payments), the Inquiry recommends that up to a 15% cut is applied pro rata across all direct payments. With a budget cut of over 15% but less than 30% the support to the Non-LFA should be cut by up to 50%, with the acceptance that savage cuts will result in little, if any, contribution to the global challenges from this area. In the event of funding cuts of over 30% the Top Up Fund for the LFA will have to absorb the balance with possible consequences for the delivery of a more sustainable agriculture.

1 Introduction

1. Introduction

This Inquiry was commissioned by Richard Lochhead MSP, Cabinet Secretary for Rural Affairs and the Environment, in June 2009. It was established to provide advice to the Scottish Government on how support to agriculture and rural development could best be tailored to deliver the Scottish Government's purpose of "creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth".

This introductory section explains the remit of the Inquiry, details the activities undertaken by the Committee to examine the options for future support, and sets out the structure of the rest of the report.

1.1 Remit of the Inquiry

Agricultural support in Scotland is to a large extent determined by European agricultural policy, which is likely to be reformed in 2013. The Common Agricultural Policy (CAP) has been subject to a long history of reform, but today new pressures on the European Union (EU) budget, issues relating to new Member States and questions about how the policy can help tackle emerging global challenges such as climate change, all suggest that the 2013 reform will be significant. Different Member States and institutions are reviewing the role of agricultural support in their countries and positioning themselves for forthcoming negotiations about the nature of future reform. In this context, the Scottish Government commissioned the Inquiry to make recommendations about what sort of support regime would be best for Scotland in order to inform their preparations for the forthcoming negotiations about the nature of European agricultural policy after 2013.

In broad terms, Richard Lochhead asked that the Inquiry *"make recommendations to the Scottish Government on how financial support to agriculture and rural development can best be tailored to incentivise delivery of the Scottish Government's purpose of sustainable economic growth, and in particular of its vision for thriving agricultural and rural sectors based on natural resource productivity, in a world increasingly recognising the need to address the challenges of climate change and biodiversity loss"*.

The specific remit of the Inquiry was to examine and provide recommendations in the following areas:

- **How Pillar 1 funds (i.e. the Single Farm Payment Scheme in Scotland) might be best distributed in future, for example between regions of Scotland and/or land types, in order to contribute to the Government's purpose and vision**

  The issues: Due to the great geographical and agricultural variation within Scotland and to the choices that have been made about how to implement the Single Farm Payment Scheme, there is a great deal of variation in the distribution of direct support. Land managers in some areas of Scotland receive much higher payments than others, primarily because the current system—while technically decoupled—still relates to the level of production in the 2000 – 2002 reference period. But is this inequality in payment levels right? Should the future support regime replicate the current distribution? Or should the future regime focus more on a wider set of deliverables, such as public goods, which could result in significant redistribution? A related question that has arisen since decoupling, and which will provide the key to making choices about the appropriate distribution of Pillar 1 funds, is: what are direct payments for?

- **The conditions to be attached to Pillar 1 payments in the future to secure public benefits commensurate with those payments, and the relationship with the Less Favoured Area Support Scheme**

  The issues: A lack of clarity about what direct payments are for has prompted questions about what society gets back for spending public money in this way. The current conditions for receipt of direct payments (cross compliance) are criticised by some for being too weak and effectively providing farmers with money with little obtained in return. A tightening of public budgets across Europe means that expenditure has to be robustly justified and so one way of ensuring the continuation of direct payments would be to strengthen the conditions associated with Pillar 1 in order to more demonstrably deliver public benefits in return for public investment. But what sort of conditions might we attach to Pillar 1 payments? Should more stringent environmental conditions be attached or would this confuse Pillar 1 and Pillar 2 payments? Should conditions be imposed that move the industry in a particular direction, for example towards more sustainable farming? But if more conditions are imposed how do we find the balance between more stringent conditions that ensure value for money and the greater bureaucracy and administration costs that would be generated?

- **The link between payment levels and farming activity**

  The issues: The decoupling of payments from production means that payment rates are no longer related to activity. It is perfectly possible for a farmer to reduce his/her farming activity to a minimal level to meet their cross compliance obligations and continue receiving support. They may continue to receive public money whilst only making a minimal contribution to economic growth or delivering minimal public benefit. Clearly, if, in general terms, it is true that the more active the farmer then the more likely they are to be delivering benefits to the people of Scotland (whether they are economic, social or environmental) some sort of link between payments and appropriate activity is desirable. Yet payments that are linked with the level of production are subject to limits under international trade agreements because they are potentially trade distorting. So how is it possible to ensure that only those that are actively farming (and thereby delivering public benefits) receive payments?

- **The situation of agricultural holdings currently outside the Single Farm Payment system, and new entrants to farming**

  The issues: Under the current historic system for allocating Pillar 1 support, payments are calculated in relation to activity in the reference period (2000 – 2002). Since people entering the farming industry since 2003 were not active in the reference period and did not qualify for the National Reserve, they do not have any 'entitlement' to direct support and, unless they buy entitlement (because entitlements are tradeable), they will not receive support through Pillar 1. This situation is criticised as unjust. A group of farmers that are highly motivated and want to get involved in the industry and who are likely to be highly active are effectively excluded from accessing the major source of agricultural support, a situation that makes it even harder for them to compete with others already established in the industry. A move away from the historic system may partially solve the problem, but the question of how best to ensure a continuing supply of new entrants in an ageing industry will remain an enduring issue.

  In addition, some agricultural land uses did not receive support in the base years and accordingly there was no historic base to allocate them direct payments, notably deer farming and potato, vegetable and fruit cultivation. Deer farmers feel particularly aggrieved since they are rearing animals for slaughter and entry into the food chain in very similar ways to those that rear cattle and sheep. Again, issues of equity and fairness are raised. Should a future support regime include these previously excluded land uses or forms of agriculture?

- **How to address the risk of a smaller Single Farm Payment budget for Scotland after 2013, taking into account the generally held expectation of severe pressure on that part of the EU budget**

  The issues: Over time the proportion of the total EU budget devoted to agriculture has gradually declined from 71% in 1984 to an estimated 33% in 2013. At the same time the number of Member States has gradually increased, meaning that the declining agricultural share of the budget also has to be shared across a growing number of recipients. New Member States are expecting to gradually reach parity within the structure of the CAP and a shift in expenditure towards the new Member States will result in declining budgets elsewhere. Add to this the global economic downturn and the current pressure to reduce public expenditure as a means of cutting Government deficits, and a smaller budget looks likely. A smaller budget subsequently raises questions about how we can do all the things we would like to do—such as address a growing list of global challenges like ensuring food security and tackling climate change. How can we achieve more with less? What are the most cost-effective ways of investing public money?

- **The future balance between Pillar 1 and Pillar 2 of the CAP in Scotland, including the role of support for transformational change to agricultural businesses, for collaboration, and for engagement between businesses in the different stages of the production chain**

  The issues: At present, financial support is delivered to Scottish farmers and land managers through two 'Pillars'. Pillar 1 constitutes direct payments that are provided as a form of business support and which are paid from European funds. Pillar 2 provides support for rural development including agri-environment, forestry, business development and community initiatives, and is co-financed by Europe and the Member State. The amount distributed through these Pillars is unequal with the majority of funds distributed through Pillar 1 in direct payments. An important current debate therefore revolves around whether this allocation is appropriate. Some argue for a gradual transfer of funds from Pillar 1 to Pillar 2 on the grounds that public expenditure through Pillar 2 will deliver public goods and is therefore more justifiable than the support provided through Pillar 1. But is that trajectory right? Or should we retain and finesse Pillar 1 payments in order to make them deliver more but at the same time be more transparent? Again the key to answering such questions will be found in the answer to the fundamental question of what are direct payments for?

- **Scottish priorities in future negotiations with the United Kingdom authorities and at EU level**

  The issues: Scottish agriculture is different to that of other parts of the UK, notably England, and requires a distinctively Scottish policy. In recent years, especially since the Scottish National Party came to power, Scottish agricultural policy has diverged from that of England, with the Scottish position being more defensive of continued direct support while the English position has tended to support a shift from direct support towards an emphasis on public goods. This divergence is potentially problematic because it is often English agricultural policy that comes to define the UK position, which could mean that Scottish interests might not be pursued. As we move towards the negotiations about the CAP post-2013, clarity about Scottish priorities will be important. What do we want to make sure we achieve in the forthcoming talks?

1.2 Approach

1.2.1 Evidence gathering

The Inquiry began in June 2009 with the gathering of evidence about the current state and importance of agriculture in Scotland and about the implementation of agricultural policy. This information was gathered through a series of meetings with a range of people including: Scottish Government staff (primarily in the Rural and Environment and the Rural Payments and Inspections Directorates); researchers based in the Scottish Government's Main Research Providers (SAC and the Macaulay Institute); and representatives from the industry, environmental NGOs and government agencies (such as the Forestry Commission, Scottish Natural Heritage, Scottish Environmental Protection Agency and Scottish Water).

The Inquiry then commissioned several evidence papers that could be placed on the Inquiry web pages so that as discussions about how best to implement agricultural support developed, everyone would have access to the same information. These papers were on the following topics[1]:

- Economic trends in Scottish agriculture (produced by the Scottish Government)
- The importance of livestock production to the Scottish economy (produced by Quality Meat Scotland)
- The Scottish arable sector (produced by the Scottish Government)
- Farming and the natural environment (produced by SNH)
- Background Paper on Forests and Woodland (produced by Forestry Commission Scotland)
- Commissioned work on the value of public goods from agriculture and the production impacts of the Single Farm Payment Scheme (undertaken by SAC)
- Overview of USA Farm Support Policy (produced by Scottish Government economists)
- Retailers perspective on climate change (produced by Marks & Spencer)
- Rural Payments and Inspections Directorate – IT issues (produced by the Scottish Government)
- Risk and risk management strategies in agriculture: an overview of the evidence (produced by the Scottish Government).

Further evidence was gathered about the debates at the European level in visits to Brussels and meetings with Dacin Cioloş and Mariann Fischer Boel (current and former Commissioner for Agriculture and Rural Development), Paulo De Castro (Chair of the European Parliament Agriculture Committee), George Lyon MEP (author of the recent European Parliament report on the future of the Common Agricultural Policy), Tassos Haniotis (Head of Agricultural Policy Analysis and Perspectives, DG Agri), Tim Render (Agriculture Counsellor at the UK Permanent

1 All of the papers can be accessed on the Pack Inquiry website: http://www.scotland.gov.uk/BrianPackInquiry.

Representation), Alec Page (Defra expert seconded to the European Commission), Andreas Lillig (Single Farm Payment Implementation, DG Agri) and Maeve Whyte (Director, British Agricultural Bureau). These meetings facilitated insight into the debates taking place on the future direction of the CAP and were useful in providing the context within which debates in Scotland will take place. Tassos Haniotis visited Scotland in September 2010 and discussed the key issues with the Inquiry. He was also shown first-hand the diversity and challenges pertaining to agricultural production in Scotland through visits to two farms, one of which was a productive, well-stocked upland farm, while the other had a large area of rough grazing and low stock numbers.

1.2.2 Public consultation

An initial consultation, which ran from September to the end of October 2009, sought views from the public and interested organisations on the key issues being addressed by the Inquiry. The questions were structured around the remit of the Inquiry and asked for views on such issues as the balance of Pillars 1 and 2, the future distribution of Pillar 1 payments and the conditions that might be attached to those payments. A total of 105 responses were received, comprising 58 responses from individuals and 47 from organisations. The responses were analysed by George Street Research and their findings were presented to the Inquiry Committee[2].

The Inquiry produced its Interim Report in January 2010 to provide insight into its thinking[3]. The Interim Report set out the challenges that we currently face and which agricultural policy must address, and it put forward a potential rationale for a future support regime along with an example of how direct payments might be distributed. This Interim Report provided the basis for a second consultation, which ran from January to March 2010. This sought further views on the more detailed proposals including a proposal for an area based approach to direct payments supplemented by a Top Up Fund. A total of 149 responses were received to this second consultation, comprising 99 responses from individuals and 50 from organisations. George Street Research again analysed the responses and presented their findings to the Inquiry Committee[4]. The online consultation was supplemented by a series of 12 public meetings across the length and breadth of Scotland. The Chairman of the Inquiry addressed all meetings (each lasting approximately two and half hours) and around 1,400 stakeholders attended. The key points from these meetings are also reported in the George Street Research Phase 2 report. Chapter 4 of this report discusses some of the key findings from the consultations which have informed the Inquiry's thinking.

1.2.3 Short-term recommendations

Although the Inquiry was asked to consider a medium to long-term question about how future support to agriculture and rural development could best be tailored to deliver the Scottish Government's purpose, the Inquiry recognised that some of the issues could potentially be addressed through currently available mechanisms to achieve change in the short-term. Consequently, the Inquiry examined the options for achieving short-term change and in June 2010

2 George Street Research (2010) Phase 1 of the Inquiry into Future Support for Agriculture in Scotland: Analysis of Evidence. Available at: http://www.scotland.gov.uk/Resource/Doc/319836/0102322.pdf.

3 The Interim Report can be accessed on the Inquiry website at: http://www.scotland.gov.uk/Topics/farmingrural/Agriculture/inquiry/interim.

4 George Street Research (2010) Phase 2 of the Inquiry into Future Support for Agriculture in Scotland: Analysis of Consultation Responses. Available at: http://www.scotland.gov.uk/Resource/Doc/319913/0102346.pdf.

presented its recommendations on the measures that could be implemented prior to 2013[5]. These recommendations were presented before the final Inquiry recommendations so as to facilitate speedy action on the part of Scottish Government if they chose to accept the proposals. The Scottish Government subsequently accepted the proposals in August 2010 and is taking action to implement them in partnership with the industry.

1.2.4 Modelling scenarios of changes to direct payments

The Interim Report highlighted the problems of the current historic system for distributing direct payments and suggested that we in Scotland are very likely to have to move towards an area based approach after 2013. The Report highlighted that any change to the current system would result in winners and losers and put forward one possible scenario for an area based system using the Land Capability for Agriculture (LCA) classification as the basis for ascribing value to land of different quality. This example was included with the simple purpose of providing one scenario that could highlight the sorts of decisions that would have to be made and the possible consequences. The Inquiry commissioned the Macaulay Land Use Research Institute to undertake some modelling work to explore the possible consequences of a range of scenarios for implementing an area based approach to distributing direct payments[6]. The modelling work provided much useful evidence in shaping the Inquiry's thinking. In particular, while the Inquiry expected that a move to an area based model would result in some redistribution of the payments, the modelling produced a redistribution which would result in quite significant consequences for the industry and which was inconsistent with the Inquiry's view of the key rationale for continuing direct payments. The work also highlighted the significant technical challenges of making area payments on the basis of the Macaulay LCA, and in particular the difficulties in accounting for spatial differences in land quality at the micro-level.

As a result, an alternative framework was required to enable the Inquiry to explore different scenarios for area payments which would be more consistent with its views on the purpose of agricultural support. Further modelling was therefore undertaken by the Scottish Government using the Farm Accounts Survey (FAS) data. The FAS data, based on a sample of around 450 farms, collects detailed financial and economic data for eight farm types - Specialist Sheep (LFA), Specialist beef (LFA), Cattle and Sheep (LFA), Cereals, General Cropping, Dairy, Lowland Cattle and Sheep and Mixed. The alternative framework uses this data as a baseline of profitability and the modelling shows the impact on profitability of scenarios which include a combination of area and other top up payments. Further details on the modelling are provided in the Appendix to this report. The Scottish Government is also currently undertaking analysis of the wider economic impact of changes to the agriculture support system, and this work will be available shortly.

5 The Scottish Government (2010) Inquiry into Future Support for Agriculture in Scotland: Short-term Recommendations. Available at: http://www.scotland.gov.uk/Resource/Doc/915/0100597.pdf.

6 The work undertaken by the Macaulay Land Use Research Institute will be available via the Pack Inquiry website shortly (http://www.scotland.gov.uk/BrianPackInquiry).

1.2.5 Structure of the report

This report has the following structure:

Chapter 2 explores the changing nature of European agricultural policy, which provides the context for this Inquiry. It is the forthcoming reform that will re-shape the Common Agricultural Policy after 2013—but which has yet to be negotiated—that provides the impetus for this Inquiry. Chapter 2 therefore details the evolution of the CAP, the new challenges that any reformed CAP must address and the debates about the nature of the forthcoming reform, with a particular focus on the budget.

Chapter 3 provides information about the nature of Scottish agriculture and agricultural and rural development support in Scotland today. If we are to develop coherent and practical ideas about the nature of future agricultural support in Scotland we must have a clear idea of the current situation so that we understand the starting point for any future change.

Chapter 4 draws on published pronouncements from the Scottish Government and other stakeholders to establish a clear goal for what we want Scottish agriculture to look like in the future and to establish a direction of travel for the industry. We have to have a clear vision of where we are heading to be able to make appropriate decisions about the best way to get there. The chapter also recognises that this goal is set, and will have to be achieved within, a framework of broad characteristics established by a variety of different actors, including the EU and WTO.

Chapter 5 sets out the Inquiry's proposals on the nature of a future support regime, given the vision and direction of travel. It provides advice on the distribution of Pillar 1 payments, the conditions that should be attached to Pillar 1 payments, how payments should relate to activity and how a new regime should accommodate previously excluded land uses, and the balance of payments between Pillars. The chapter also addresses a number of other key issues, including: the future of the Scotland Rural Development Programme (SRDP) and particularly the Less Favoured Area Support Scheme (LFASS); the importance of agricultural policy in supporting the farming industry to deal with the particular risk factors that it faces; and a plea that the EU administers the budget in a more helpful way.

Chapter 6 discusses the implications of a large reduction in the CAP budget for Scotland. The Inquiry believes that, following the equity principle, Scotland has a strong case for at least maintaining its CAP budget post-2013, thus it should not experience a large reduction in funding. However, the Inquiry was asked to consider a situation where the budget is significantly reduced and this chapter sets out its priorities and suggested approach if this is the case.

Chapter 7 returns to the Inquiry's remit and summarises the Inquiry's key messages to the Scottish Government in relation to its negotiations at both a UK and an EU level (Negotiating Points) and its advice to the Scottish Government on matters where it is expected that it will have discretion (Recommendations).

At appropriate points in the report text, the Inquiry has highlighted what it has termed its 'Negotiating Points' and its 'Recommendations' using coloured text boxes:

The Negotiating Points are issues on which the Inquiry believes that the Scottish Government should place particular emphasis in its negotiations at the UK and EU level regarding the future of agricultural and rural development support.

The Recommendations are the Inquiry's advice to Scottish Government on matters where it expects that Scottish Government will have discretion in shaping the future system.

These Negotiating Points and Recommendations are presented together in Chapter 7 of the report.

2 The changing context for agricultural support in Scotland

2. The changing context for agricultural support in Scotland

Given that agricultural support in Scotland is to a large extent determined by European agricultural policy, this chapter is devoted to detailing some of the issues at the European level. These issues and debates provide the context for any future support regime in Scotland and it is therefore important to understand the different arguments that are currently being made about the future of the CAP and where the policy might be heading.

The chapter begins by briefly sketching out the evolution of the CAP, highlighting the key issues which have guided the changes to date. It then discusses the emerging context for the post-2013 CAP, focusing on two key themes. Firstly, the role of the agricultural industry in meeting a wide range of global challenges and thus in becoming more sustainable, and secondly, likely changes in the size, structure and distribution of the CAP budget in future.

2.1 The evolution of the Common Agricultural Policy

The Common Agricultural Policy (CAP) was created in the 1957 Treaty of Rome. It was one of the first common European policies and it has played an important role in the development of the EU. Yet for all its longevity, the CAP has not stood still; it has undergone several major reforms that have sought to reorient it to the needs of a changing world. As the nature of agricultural production has changed, as the world economy has changed, and as our perception of the most pressing challenges has changed, so the policy has evolved.

2.1.1 From market intervention to direct support

Prior to the 1992 MacSharry reforms the largest share of producer support came through price support mechanisms using a system of intervention prices and export subsidies. Under the pressure of the Uruguay Round of international trade negotiations, the MacSharry reforms introduced a different approach that limited the use of price support mechanisms and instead compensated farmers in the form of direct payments that were coupled to specific commodities on a per hectare or headage basis. While receiving direct aid, farmers were encouraged to look more to the market place and to respond to the public's changing priorities.

2.1.2 From production support to producer support

The direct payments ushered in by the MacSharry reforms, while marking a significant change from the system of market mechanisms, were coupled to production. This meant that agricultural support was acting as an incentive to increase production, which, whilst positive in post-war Europe, had started to lead to large surpluses. This sort of production based support was also deemed to be trade distorting with the result that agricultural support potentially represented a stumbling block in international trade negotiations. Consequently, the EU moved to further reform agricultural support so that it was more acceptable in terms of international trade. Direct support was decoupled from production so that the support did not so immediately distort the market. Provided that land managers adhered to cross compliance measures they would be eligible for support. It was a move that was seen as freeing farmers up to produce for the market. They would no longer be responding to the policy and policymakers; they would be free to respond to market signals and to consumers.

Figure 1 shows the shifts that have occurred in the type of payments in the EU since 1993, illustrating the move away from market measures. Market measures are identified by the WTO as amber box payments, meaning that they are considered to be domestic support measures that distort production and trade. In 2000, the level of coupled – or blue box - payments was high. The blue box is referred to as the 'amber box with conditions' (i.e. this is support that would normally be in the amber box but it is placed in the blue box if it also requires farmers to limit production). In 2010, the large majority of payments for farmers (through the Single Farm Payment Scheme) are defined as green box and therefore non-trade distorting.

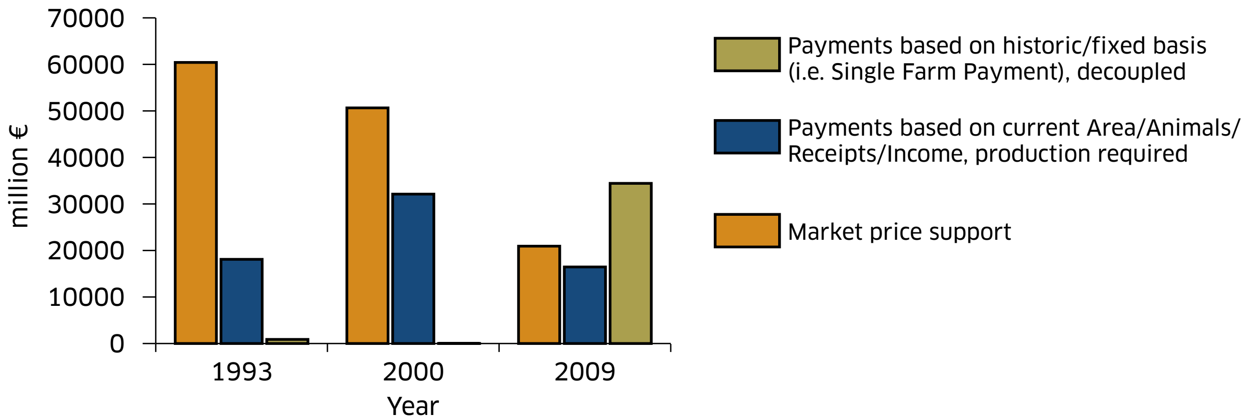

Figure 1: The shift in the type of CAP payments (1993-2010)[7]

2.1.3 From a clear agricultural focus towards agriculture and rural development

Over time the CAP has gradually been reoriented from being almost entirely focused on supporting farmers to including a wider focus on the rural economy. Originally, the focus was on supporting farm incomes through price support mechanisms and support for processing and marketing was intended to lead to further integration within the food chain and to enhance competitiveness. Gradually the focus widened to include issues such as training and development and farmer retirement. By the 1970s the Less Favoured Area (LFA) designation became the first element of the CAP with a territorial dimension. The LFA had a broad social objective of helping to keep farmers on the land as a means of helping to sustain marginal rural areas.

In 1999, however, a more explicit emphasis on rural development was ushered in by the 'Agenda 2000' reforms which divided the CAP into two 'Pillars': production support and rural development. The current objectives of rural development policy are: increasing the competitiveness of the agricultural sector; enhancing the environment and countryside through support for land management; and enhancing the quality of life in rural areas and promoting the diversification of economic activities. The Leader initiative, which supports local community activity, is included within rural development policy and funding. Although the budget associated with the second pillar of the CAP is much smaller than that for the first pillar, the establishment of a specific rural development policy represents the latest stage in the gradual widening in the objectives and focus of the CAP.

The following two figures illustrate how the CAP has changed over recent years. Figure 2 illustrates the major reforms in recent decades and the key changes that

7 Further information on the WTO boxes is available from the WTO website at: http://www.wto.org/

they have introduced. Figure 3 shows how the types of payments within the CAP have evolved in proportional terms.

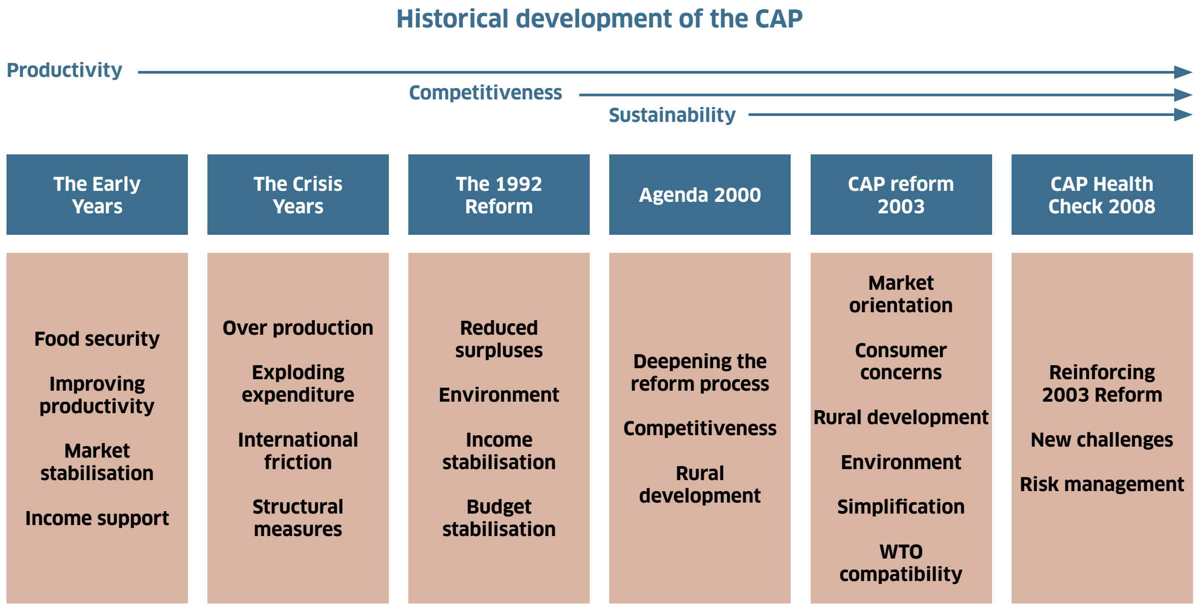

Figure 2: The changing emphasis of the CAP[8]

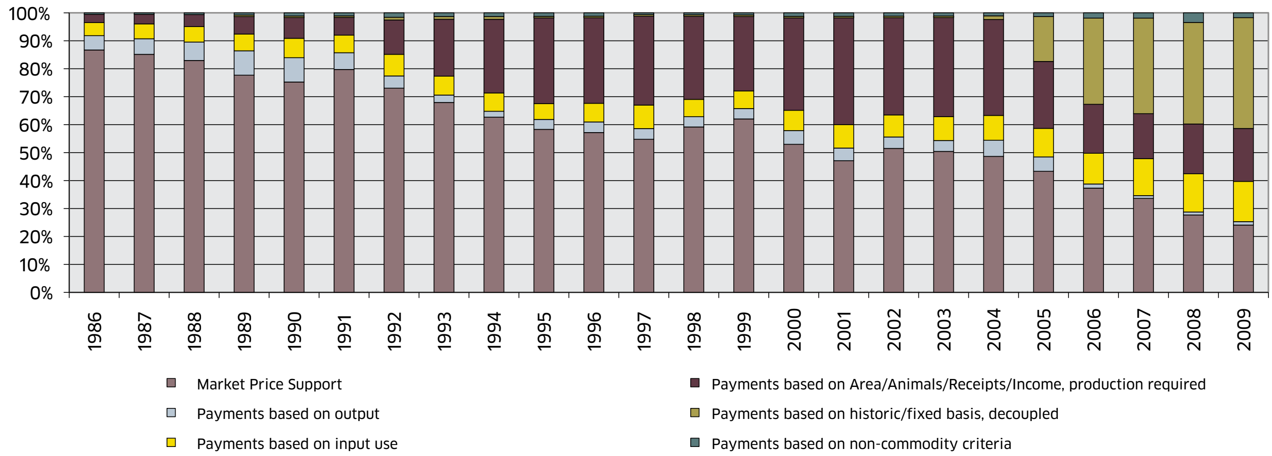

Figure 3: The evolution of the CAP[9]

2.1.4 From maximising production to promoting sustainability

Although the degree to which the CAP has incorporated an environmental and a broader rural development focus would probably be contested by some, it is clear that over time, especially with the introduction of Pillar 2 in the Agenda 2000 reforms, there has been a shift towards delivering the policy in such a way as to achieve greater sustainability (see Figure 2). The incorporation of specific environmental schemes into the CAP is one part of this shift, but the growing rural development agenda offers a wider approach to sustainability with its emphasis on social and economic sustainability in addition to environmental sustainability.

8 European Commission (2009) A reform agenda for a global Europe – reforming the budget, changing Europe, Communication from the Commission to the Council and Parliament (Brussels).

9 European Commission (2009) The CAP in perspective: from market intervention to policy innovation, Agricultural Policy Perspectives; Brief No. 1. Available at: http://ec.europa.eu/agriculture/publi/app-briefs/01_en.pdf.

The CAP has therefore evolved through a series of reforms. It has been adapted so that it has a more market oriented focus and so that it conforms to international trade rules, and it has been altered to accommodate emerging concerns about the environment and rural development. These shifts are illustrated in Figures 2 and 3 above. Despite the fact that the proportion of the CAP budget devoted to agriculture is declining, the CAP remains an important policy. While it has undoubtedly been slow to change, it has been reformed so that it better reflects the changing context within which it exists. However, the context itself has not stopped changing, as the next section discusses.

2.2 The emerging context for the post-2013 CAP

The context within which the CAP operates continues to evolve. This section of Chapter 2 discusses the key ways in which the context is evolving, dividing the discussion into two broad themes. The first theme is the extent to which agricultural support should become a mechanism to help address the significant global challenges that we face. The second theme relates to the future CAP budget, addressing several issues including the CAP budget as a proportion of the overall EU budget, the distribution of the budget between Pillars and the distribution of the budget between Member States.

2.2.1 The emerging context for the post-2013 CAP: meeting the global challenges

2.2.1.1 What are the global challenges?

Today there are increasing calls that agricultural support should become a mechanism to help address the significant global challenges that we face. The CAP Health Check of 2008 specifically attempted to alter the CAP in ways that enabled support to be targeted more effectively at the new challenges. Different people identify different challenges. Dacian Cioloş, for example, has identified seven major challenges for the CAP: food production; globalisation; the environment; economic issues; a territorial approach; diversity, and simplification. There is, however, significant agreement about the main ones and the Inquiry has chosen to separate out the challenges of implementing the CAP from the major global issues that the CAP could help address.

Before discussing the major challenges that the Inquiry believes agriculture could help to address, it is important to note that the Inquiry uses the term ‘a more sustainable agriculture’ to describe an industry that is moving towards meeting these global challenges. By using the term ‘a more sustainable agriculture’, the Inquiry means an agricultural sector that is innovative and competitive, and has food production as its primary purpose, but a sector which is also delivering a range of other benefits which help to meet the global challenges. The Inquiry highlights food security, climate change, water supply, energy supply and biodiversity as the global challenges that a sustainable agricultural sector can help to address. The Inquiry also believes that the success of rural communities is intrinsically inter-linked with a sustainable agricultural industry.

Food security – The high food prices of 2008 put the issue of food security back on the international agenda and FAO estimates that global food production needs to rise by 50% by 2030 and double by 2050 have served to re-focus minds on agricultural policy and food production. Food production will have to increase, but achieving such increases will be difficult, not least because of climate change.

Climate change – It is now widely accepted that climate change is happening, that humanity is responsible and that the consequences are potentially devastating. With regard to food production, for example, it is the poorest regions of the world with the highest levels of chronic hunger that are likely to be worst affected. But at the same time, as agriculture is a net source of greenhouse gases and also will be affected by climate change, agriculture has a role to play in mitigating greenhouse gas emissions. It must find ways of adapting to a new climatic regime.

Water supply – Globally, water security is a growing problem that has both natural and anthropogenic causes. A growing world population with rising incomes will put water resources under increasing pressure as household consumption is expected to rise. But the expected growth in the demand for food is likely to be the most important cause of pressure on water resources because much of the increase in global food production in recent years has been achieved with the help of an expansion in irrigated farming. Climate change also represents a compounding factor that will add to water management problems.

Energy supply – Around the world, many countries are facing similar energy challenges. Security of energy supply is vitally important for economic growth but most of our energy is sourced from finite natural resources that will eventually run out. In addition, our energy demand continues to rise, with world demand for energy set to rise by 40% between now and 2030, leading to greater competition for a limited resource[10]. Even if we manage to save energy, reflecting the need to reduce emissions to tackle climate change, a significant increase in demand is still likely. Issues of energy supply have significant implications for intensive food production systems and high energy prices have now been pinpointed as the prime cause of the food price rises in 2008. Nitrogenous fertiliser has been a vital element in the dramatic growth in production over the last fifty years, but its production consumes fossil fuel and therefore it will be more expensive in the future and possibly scarcer.

Biodiversity – The Millennium Ecosystem Assessment found that human actions are fundamentally, and to a significant extent irreversibly, changing the diversity of life on Earth, and most of these changes represent a loss of biodiversity. The assessment, which took place between 2001 and 2005, found that the changes in important components of biological diversity were more rapid in the past 50 years than at any time in human history and projections suggest that these rates will continue, or accelerate, in the future[11]. Despite the many initiatives to encourage action to protect biodiversity, including the Convention on Biological Diversity and pan-European activity through Natura 2000 sites, biodiversity loss continues.

Rural communities – The future of communities in rural and fragile areas across many EU Member States is intrinsically inter-linked with the future of the agricultural sector, particularly in those communities where opportunities to diversify the local economy beyond primary production are limited. A decline in activity in the agricultural sector may result in serious economic and social impacts in these communities, in terms of the knock-on impact on businesses down the supply chain and in terms of the reduced demand for local services. At the same time, current trends in the agricultural sector itself offer many new

10 International Energy Agency (2009) World Energy Outlook 2009. Available at: http://www.iea.org.

11 See http://www.maweb.org for more information.

economic opportunities for rural communities, for example in terms of the re-use of agricultural buildings for new enterprises and the take-up of renewable energy technologies.

2.2.1.2 Agriculture has a role to play in meeting the challenges

Increasingly, the CAP is being seen as a potential mechanism through which the global challenges can be addressed. The way that the land is managed can be an important factor in our ability to face up to these challenges. For example farmers and other land managers can:

- help guard against future food security issues by maintaining agricultural activity
- help tackle climate change by changing agricultural practices
- seek to reduce reliance on energy intensive inputs by adopting new technologies
- implement measures that enhance biodiversity
- manage the land in a way that helps biodiversity adapt to climate change
- manage the land in a way that helps to mitigate the impact of extreme events such as flooding, thereby reducing the impact on urban areas
- engage in renewable energy projects.

Agriculture and rural land management have a key role to play in meeting the challenges we face. The key to unlocking agriculture's potential in this regard will be designing agricultural policy which relies on support regimes and regulation to maximise the delivery of benefits to society. The balance between support and regulation is important.

2.2.1.3 The global challenges and the changing relations between farmers and society

At the same time as we point out that agriculture is part of the solution to current challenges we must also accept that the relationship between farmers and society is going to change. This is apparent if we think about the way the CAP has changed and see the focus on using agricultural policy to address global challenges as the latest phase in its evolution. Whereas the CAP started out with a very strong focus on farming and production and gradually widened to attempt to develop more environmentally friendly farming systems and to support rural areas, this new focus on global challenges views agricultural support as a means to achieve much wider ends. In future it looks as if agricultural support will not simply be about supporting farmers and the farming industry; it will increasingly be framed as a contractual relationship that encourages more sustainable farming.

This shift in thinking about agricultural support could be understood as resulting from the magnitude of the challenges we face, but it is also a result of the weakness in the justifications that are currently put forward for the amount of public money being invested in agriculture. At the moment, it can be difficult to pinpoint what the public get back for the investment of public money in agriculture and so the debate about future support has gradually shifted to focus on how public investment in the sector could help tackle major issues. Public accountability matters and the use of public money has to be robustly justified. Emphasising how agricultural and rural development funding could help us rise to the challenges we face provides a much stronger justification. After all, it would be quite wrong if public money was used to develop an industry that was at odds with the concept of sustainable economic growth.

But there are consequences of this subtle change in the way that agricultural support is framed. In particular, in future it suggests a much stronger emphasis on outcomes. We are therefore potentially moving towards a situation where the public money provided to farmers and other land managers is given to deliver a service, which would represent something of a change in the relationships between the public, governments and farmers. It suggests, as the Scottish Government has already recognised[12], a shift towards a new contract between farmers and society.

Over recent decades the structure of the CAP has evolved but there is now broad agreement that the next shifts in the CAP over the coming years must fully recognise the nature and extent of the global challenges that the industry is being asked to address. A re-thinking is required of the contractual relationship between farmers and society and thus of the ways in which support is justified and delivered, in order to achieve a more sustainable agricultural industry. A Top Up Fund as mooted in the Inquiry's Interim Report would be an ideal vehicle to deliver the wider benefits.

Inquiry Negotiating Point A: The shifts in the CAP over the coming years must fully recognise the nature and extent of the global challenges that agriculture is being asked to address.

Inquiry Recommendation 1: A Top Up Fund, as suggested in the Interim Report, has the potential to be a central part of a new contract between farming and society.

However, this re-thinking will take place in the context of significant pressure on the agricultural share of the EU budget, as discussed in the next section of this chapter. A potential decline in the budget raises even more questions about how best to spend the money. If it is decided that tackling the global challenges is important and that agriculture has a role to play, then the agricultural budget must be maintained because support is required to enable farmers to deliver these wider benefits. Difficult decisions about priorities will have to be made at the European level, with the size of the budget likely to have significant implications for any future support regime.

2.2.2 The emerging context for the post-2013 CAP: the budget

2.2.2.1 A declining share of the EU budget

It is widely accepted that the effectiveness of the CAP after 2013 will depend on the share of the EU budget which is allocated to it. Figure 4 shows how the proportion of the EU budget allocated to agriculture and rural development has gradually declined since 1985. As the EU has expanded its responsibilities – with a growing focus on a common foreign policy, security, immigration, citizens' rights, research and infrastructure – so the total budget has had to be spread across a broader number of interests. Having said this, although the proportion

12 See for example, Richard Lochhead (2009) "Shaping Scotland's Farming Future: The Need for a New Contract", Oxford Farming Conference, January 6. Available at: http://www.scotland.gov.uk/News/This-Week/Speeches/Greener/farmingfuture.

of the EU budget spent on the CAP has declined, CAP expenditure is now higher than it has ever been. The total CAP expenditure in 2010 is estimated at €57 billion, representing a 39% increase since 2000. By 2013, it is estimated that CAP spending will be over €60 billion[13].

To date, there has been little guidance as to the likely size of the post-2013 CAP budget, with the exception of the European Parliament paper agreeing that the budget must be adequate for the objectives set out for it[14]. The recent EU Conference on the future of the CAP post-2013 did not discuss the budget, and it seems to be widely accepted that the extent of the budget will be decided before the policy needs and objectives are agreed.

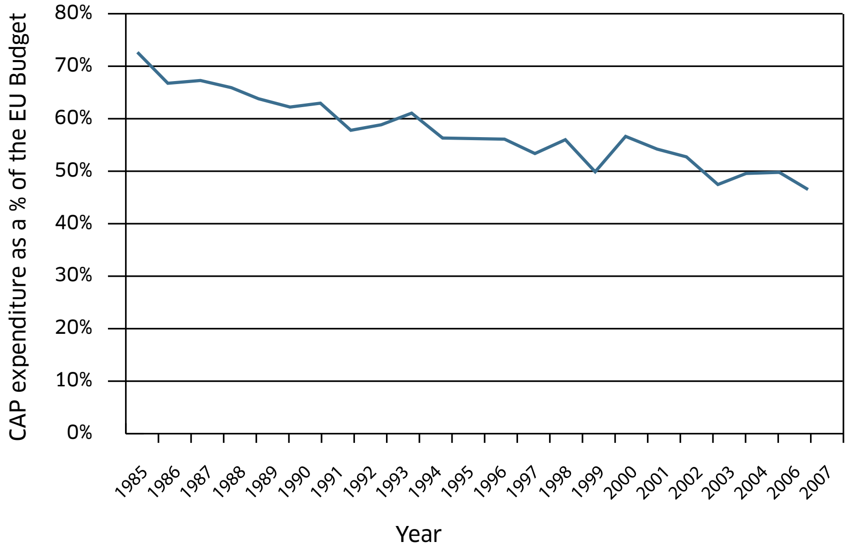

Figure 4: Percentage of CAP expenditure in EU budget[15].

> Inquiry Negotiating Point B: Agriculture has a pivotal role in tackling the global challenges, and the CAP budget must be adequate for this purpose.

2.2.2.2 Should the CAP be restructured?

In addition to questions about the size of the future CAP budget, there is also debate about the future structure of the CAP budget. At present the CAP has two Pillars. Pillar 1 provides income support to farmers through direct payments linked to cross compliance, while Pillar 2 supports the delivery of public goods from agriculture and the development of rural areas. But given the challenges that agriculture is increasingly being called upon to address, a question arises as to whether or not the current structure is appropriate. Is a different structure required? Should the future CAP move away from the two Pillar structure towards a new structure that reflects the breadth of the challenges, perhaps including a third Pillar that would be focused on climate change? Or can the

13 Agra Europe (2010) 'Rebate argument should concentrate minds', Issue AE2430 (17 September).

14 European Parliament Committee on Agriculture and Rural Development (2010) Report on the Future of the Common Agricultural Policy after 2013 (Rapporteur George Lyon), European Parliament, Brussels. Available at: http://www.georgelyon.org.uk/resources/sites/84.234.17.197-489191ad48f659.69290487/CAP+report.pdf.

15 European Commission, DG AGRI (2009) Why do we need a Common Agricultural Policy? Discussion Paper (December). Available at: http://ec.europa.eu/agriculture/cap-post-2013/reports/why_en.pdf.

current two Pillar structure be maintained, with some modifications, to deliver against these broader challenges?

While the structure of the post-2013 CAP has been raised as an issue in debates about its future, it seems that the most likely outcome is that the current two Pillar structure will remain. Speaking at a conference on the future of the CAP in July 2010, Dacian Cioloş, EU Commissioner for Agriculture and Rural Development, made it clear that he thought the two Pillar structure must remain.

"We must keep the two Pillars. But we must not let ourselves be trapped within the present set-up. The two Pillars are the two sides of the CAP and they complement each other:

the first Pillar is support for all European farmers on an annual basis which reflects quantifiable, visible results each year. It is our response to the major challenges **common** to all the Member States of the EU;

the second Pillar comprises the changes within different sectors and areas, including environmental change. It is intended to underpin our objectives, on a multi-annual programming basis, by providing clear priorities. But it must also allow enough flexibility to enable our objectives to be achieved.

Rural development policy must enable us to modernise our farms; to deploy new resources for innovation; to work towards the diversification of rural areas; to ensure stability in an agricultural sector exposed to market volatility; to provide cross-cutting solutions and to rise to the complex challenges of climate change"[16].

As such, Dacian Cioloş appears to be signalling that the challenges can be addressed through the current two Pillar structure.

16 Dacian Cioloş (2010) 'I want a CAP that is strong, efficient and well-balanced'. Speech at the 'The CAP after 2013' Conference, Brussels, 20 July. Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/10/400&format=HTML&aged=0&language=EN&guiLanguage=en.

2.2.2.3 Distribution of the budget between the Pillars

If the two Pillar structure is retained, the next question that arises relates to the distribution of the budget. At present, although the CAP apparently has a dual focus with two Pillars, 76% of the support is distributed through Pillar 1 (Figure 5). Should we, as several countries have suggested (including the UK, the Netherlands and Denmark), move away from the current emphasis on direct payments (Pillar 1) and gradually transfer support to Pillar 2 to focus on the delivery of public goods? Or should, as other countries (notably France and Germany) have argued, direct payments be retained as the vital element in supporting ongoing food production? Is it possible to modify the ways in which farmers receive Pillar 1 funding in order to ensure that it delivers more in the way of public benefits?

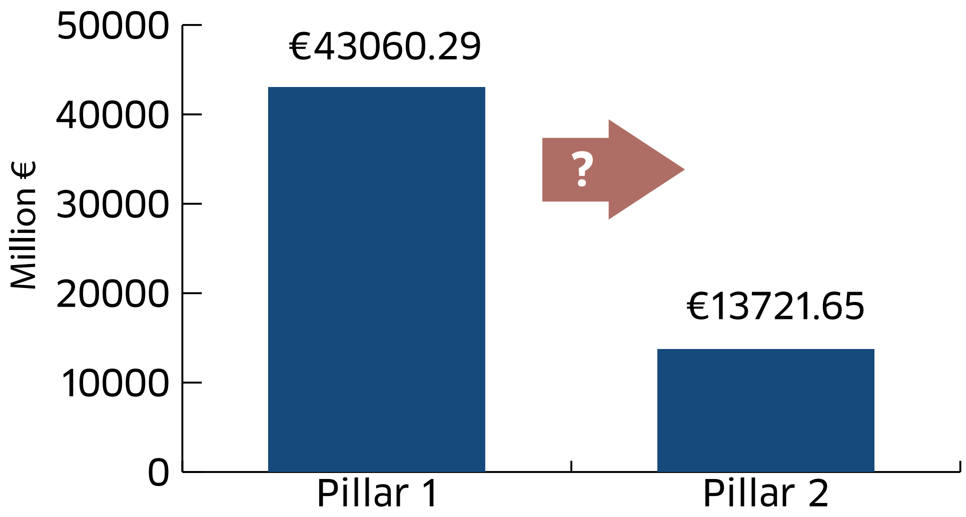

Figure 5: CAP expenditure by pillar in 2009[17]

2.2.2.4 How Pillar 1 funds are distributed

Recent reforms of the CAP have opened up the opportunity for Member States to change the way in which they distribute Pillar 1 funds, to move away from using an historic approach to an area based approach. Within the UK, the different devolved authorities opted for different methods to distribute their Pillar 1 allocation, with Scotland adopting an historic approach, which while technically decoupled, still relates payment to the level of production in the 2000-2002 reference period.

Speaking at the conference on the future of the CAP that concluded the public consultation with European citizens during 2010, Dacian Cioloş made it clear that there is a need to move away from the historic approach:

"maintaining historical criteria is no longer an option … The signposts of the past will not enable us to prepare for the future and help the sector modernise"[18].

17 AgraFacts (2010) No. 66-10 (19 August).

18 Dacian Cioloş 2010, 'I want a CAP that is strong, efficient and well-balanced'. Speech at the 'The CAP after 2013' Conference, Brussels, 20 July, Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/10/400&format=HTML&aged=0&language=EN&guiLanguage=en.

Such comments suggest that it is likely that the historic system that has been implemented in Scotland will be discontinued with area payments the most likely alternative. But agriculture is now subject to co-decision procedures that involve the Council of Ministers and the European Parliament and the latter has already approved a report from the Committee on Agriculture and Rural Development which suggests that:

"direct support should move to an area basis in all Member States within the next financial programming period; this would constitute a sufficient transition period allowing farmers and agricultural structures that are still using the historical payments system the flexibility to adapt to the changes, and to avoid too radical a redistribution of support, without prejudice to promptly achieving a balanced distribution of support amongst Member States".[19]

The European Parliament has therefore agreed that there should be a move away from the historic approach to direct payments but has signaled its desire that there be a long transition period with a complete move to area payments being made by 2020. Thus while it looks likely that there will be a move to an area payment regime, there is uncertainty about the precise detail of its implementation.

With regard to area payments in Scotland, we already know that any change to an area based system will involve a change from the current situation and a redistribution of funds. This will be especially obvious for some parts of the livestock sector, which stand to be the biggest losers. One option here, given the potential damage to Scottish agriculture of a shift to an area based system, is simply to argue that we do not want to move in that direction. But it appears that the idea of moving to an area based system has momentum within Europe and that such a move is the likeliest outcome. The key issue for Scotland therefore becomes one of trying to work out a way to accommodate the area based approach whilst meeting the needs of Scottish agriculture and also moving in the direction of travel established by the Commission and the European Parliament.

2.2.2.5 The share of the budget allocated to different Member States

A final, but critically important, debate regarding the future direction of the CAP relates to the distribution of the budget across different Member States.

It is important to note that the EU budget is financed by four revenue streams, the first and second streams being the so-called 'own resources', mainly custom duties and agricultural levies, with the third stream being based on the VAT collected in each Member State and the more recent fourth stream based on national GNP. The bulk of the funding for the EU now comes from this fourth resource which is calibrated on national GNP (in practice, Gross National Income – GNI). This element of the EU funding has progressively increased Member States' proportional contribution to the overall funds since it was introduced in the most recent radical reforms of the EU budget in 1988. It now accounts for approximately 75% of the EU's revenue and, when combined with revenue from VAT, the total proportion is some 90%.

At first sight, this would appear to be the fairest system as the richest Member States with the largest economies pay the most. However, an imbalance arises in the receipt side of the balance sheet as shown in Figure 6 which shows the EU budget balances for selected countries.

19 European Parliament Committee on Agriculture and Rural Development (2010) Report on the Future of the Common Agricultural Policy after 2013 (Rapporteur George Lyon), European Parliament, Brussels. Available at: http://www.georgelyon.org.uk/resources/sites/84.234.17.197-489191ad48f659.69290487/CAP+report.pdf.

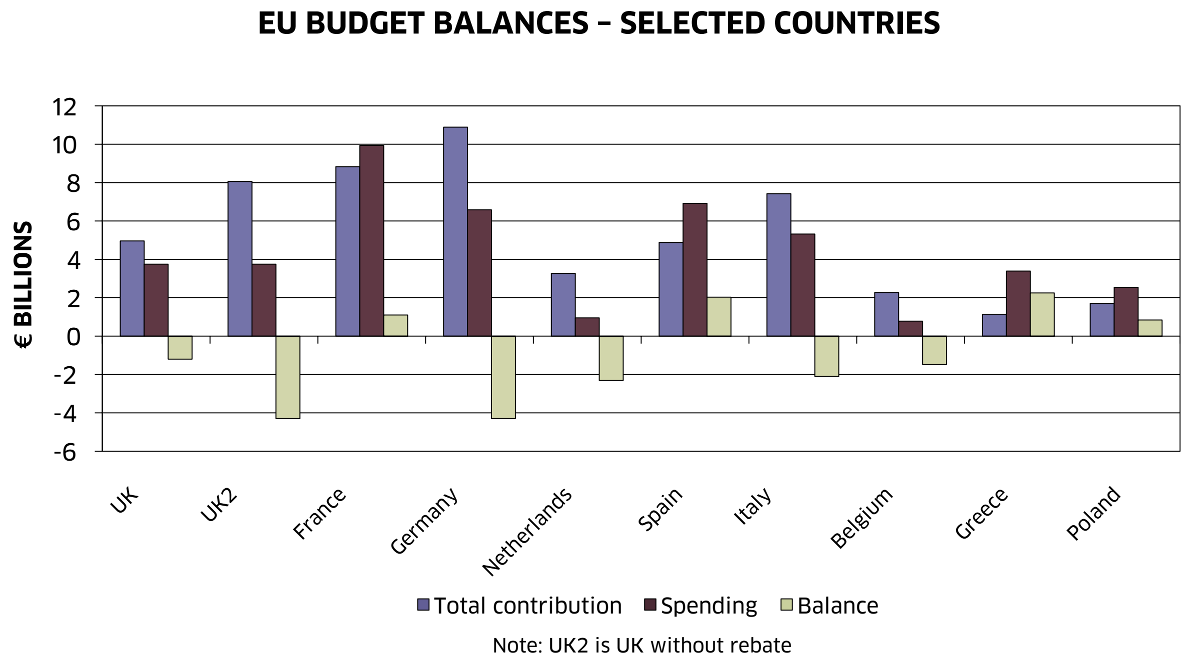

Figure 6: EU Budget Balances for Selected Countries[20]

Figure 6 identifies the role of agricultural subsidy payments in deciding who is a net contributor to the EU budget, with France and Spain for example contributing much less than the size of their economies would dictate due to their large agricultural subsidy payments. Germany is the largest contributor to the EU budget but it also receives a large amount through the CAP for its farmers. The graph shows the countries, including Ireland, Spain, Greece and Poland, which are the major beneficiaries from the EU budget. It also shows the UK's position with and without (UK2) its rebate, highlighting the UK's position as a net contributor to the EU budget.

Figure 7 shows current CAP expenditure by Member State. This graph again highlights the large CAP expenditure in France, Spain and Germany and it shows that Greece, with its relatively small olive, wine and fruit growing industries, receives almost as much from the CAP as the UK. Overall, France accounts for the largest proportion of the budget, taking 17%, while just 7 of the 27 Member States (France, Spain, Germany, Italy, UK, Poland and Greece) account for 61% of the CAP budget (Figure 7). This variation is not necessarily inappropriate because different countries have agricultural sectors of different sizes.

These budget balances, whilst giving a snapshot of the overall Member State position, identify the difficulty in moving to a more equitable distribution of single farm payments and rural development across Member States: if the Member States that contribute the most to the EU budget due to the mechanism employed receive a smaller share of future CAP finances, then their net contribution to the EU will rise substantially. This is clearly not an attractive option to any Member State in a time of financial stringency.

20 Agra Europe (2010) 'Rebate argument should concentrate minds', Issue AE2430 (17 September).

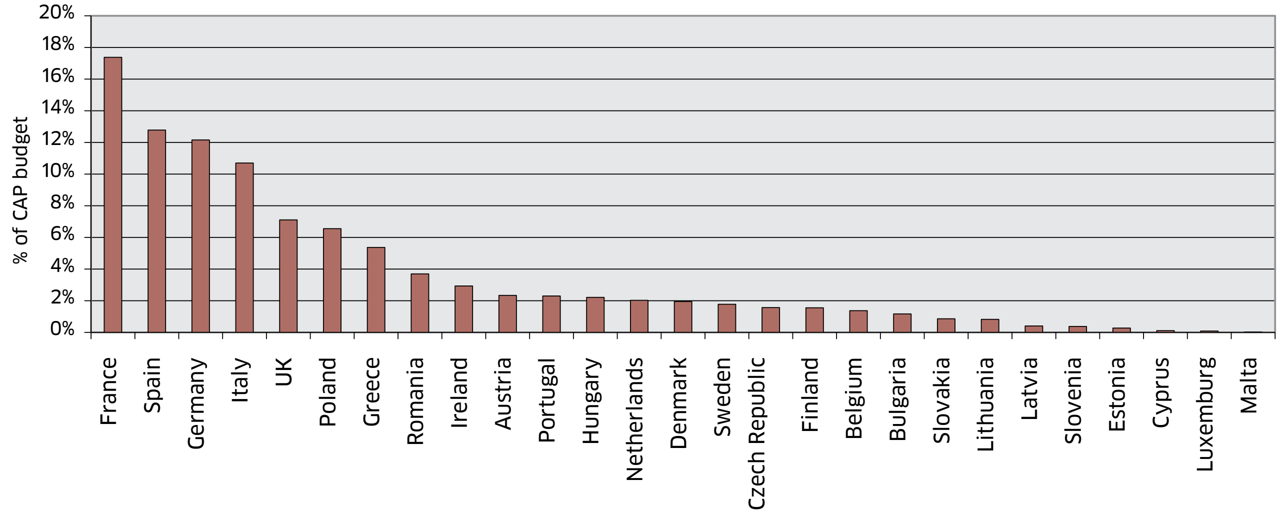

Figure 7: CAP Expenditure by Country in 2009 (Pillar 1 and Pillar 2)[21].

The following two graphs show the distribution of Pillar 1 and Pillar 2 funding across Member States. It is particularly interesting to note the distribution of funding from both Pillars within the UK.

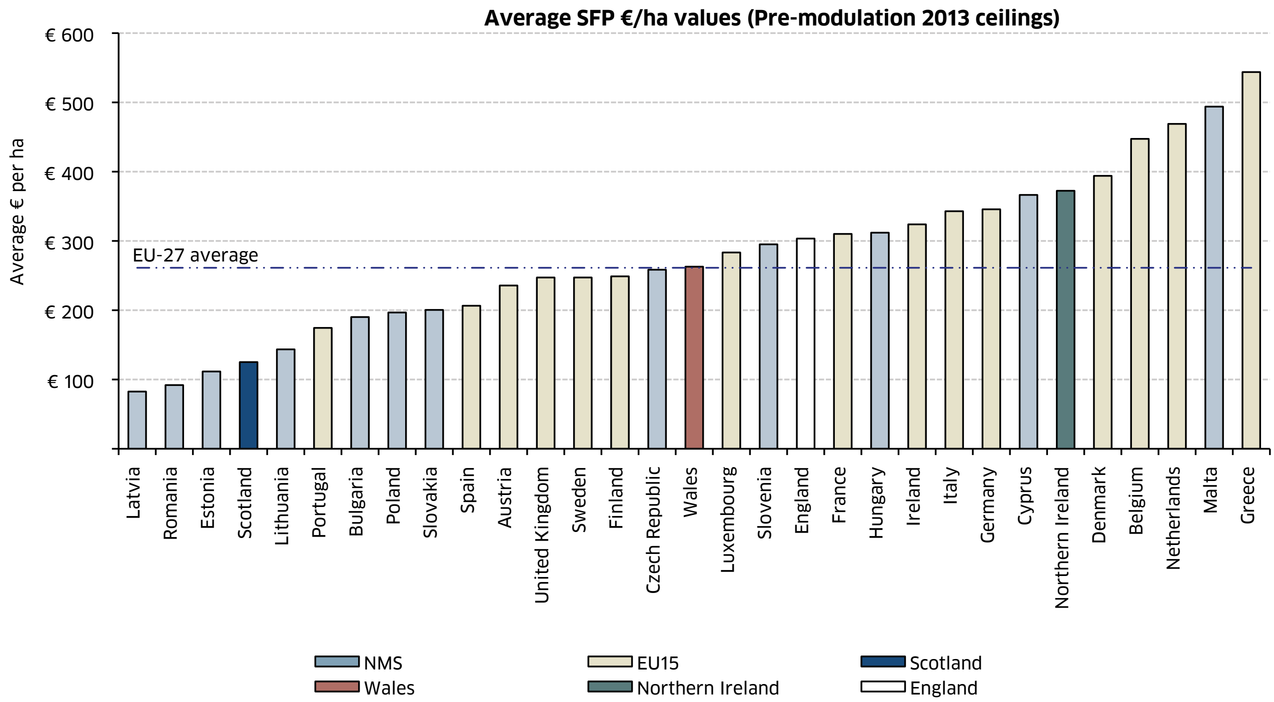

Figure 8: Current EU funded Single Farm Payment (SFP) per member state[22]

21 AgraFacts (2010) No. 66-10 (19 August).

22 European Parliament Committee on Agriculture and Rural Development (2010) Report on the Future of the Common Agricultural Policy after 2013 (Rapporteur George Lyon), European Parliament, Brussels. Available at: http://www.georgelyon.org.uk/resources/sites/84.234.17.197-489191ad48f659.69290487/CAP+report.pdf.

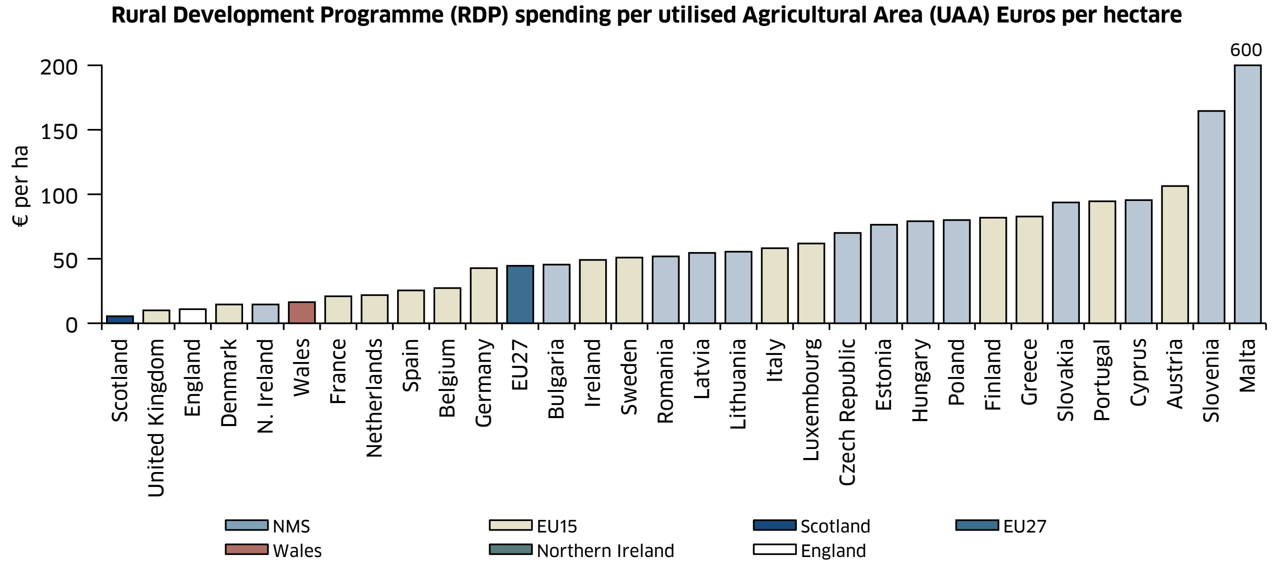

Figure 9: Current co-financed RDP per member state

Figure 8 shows that the level of Pillar 1 spending in the UK is roughly equivalent to the EU27 average, however, the graph also shows the low levels of spending currently allocated to Scotland. Scotland currently receives the fourth lowest SFPS spending level per hectare of all EU27 Member States. Scotland's allocation is an estimated €125 per hectare (including the Scottish Beef Calf Scheme) based on EU estimates of Scottish Utilised Agricultural Area (UAA) of 6 million hectares (the EU's estimate of Scotland's UAA) or €142 based on 4.6 million hectares (the Inquiry's estimate of Scotland's eligible area)[23]. In any moves towards re-allocating the Pillar 1 budget to achieve greater equity in funding across EU Member States, the UK would be unlikely to see a marked change in funding given its position so close to the EU average.

Figure 9 shows the current levels of co-financed rural development (Pillar 2) spending per EU Member State and again the variations in payment levels across Member States are clear. The level of spending on rural development in the UK as a whole is low as a result of the historically low spending on agri-environment and rural development schemes. The graph also shows that Scotland receives the lowest level of Pillar 2 spending across all Member States.

Such variation is an artefact of the historical development of the CAP, but it does raise issues of equity as we move forward. Should we move towards a more equitable distribution of support and how might that be achieved given that all the different Member States have different economic circumstances? Scotland's poor position in a UK and EU context is clear, with regard to Pillar 1 and Pillar 2 funding respectively. This currently low allocation could provide hope that Scotland gets a fairer share of EU and UK CAP funding in future. There is thus some optimism for Scotland's budget from 2014-2020 and the Inquiry takes the view that it is essential that Scotland argues for a bigger share of the overall CAP funding coming to the UK in future.

23 These figures are indicative estimates taken from Scottish Government analysis of possible allocation keys for CAP funds, and their effect on devolved authority Pillar 1 ceilings. The equivalent € per hectare figures for other parts of the UK are: €263 for Wales; €303 for England; €372 for Northern Ireland; and €247 for the UK as a whole.

Inquiry Negotiating Point C: On the basis of equity, although the UK budget would be unlikely to change significantly, Scotland should receive a larger share of the future UK Pillar 1 (Single Farm Payment Scheme) budget. The UK should argue for an increased share of the EU Pillar 2 (rural development) budget which in turn would lead to an increase for Scotland.

2.3 Conclusion

This chapter has briefly outlined the evolution of the CAP as it has moved away from price support mechanisms towards encouraging farmers to produce for the market, and as it has broadened to include environmental and rural development measures. The second part of the chapter discussed the emerging context for CAP reform post-2013 with reference to two broad themes: firstly, agriculture and its role in addressing the global challenges, and thereby becoming more sustainable, and secondly, the likely future CAP budget and the means by which it will be distributed.

It can be argued that the agricultural industry is being asked to contribute towards addressing a range of global challenges, including food security, climate change and biodiversity. This requires a different relationship between farmers and society in which there is a strong emphasis on outcomes. However, as the latter sections of this chapter explored, this is expected at a time when there are significant pressures on the CAP budget and when questions are being asked about the most appropriate ways of distributing money between Member States, Pillars and objectives. All of these questions have important implications for the shape of future support for agriculture in Scotland. The next Chapter of this report discusses the way in which agriculture and rural development support is structured in Scotland today, before Chapter 4 returns to some of the issues raised in this chapter to discuss the future vision and direction of travel for Scotland.

3 Support for agriculture and rural development in Scotland today

3. Support for agriculture and rural development in Scotland today

This chapter provides some detail about the current agricultural and rural development support system in Scotland. It starts by briefly outlining the key features of Scottish agriculture before it discusses the importance of agricultural and rural development support to Scotland and the characteristics of the main Pillar 1 and Pillar 2 support schemes. The chapter finishes by discussing the key issues raised by the current system of support payments which need to be taken into account in the design of any future support schemes.

3.1 Features of Scottish agriculture[24]

Eighty five per cent of Scottish agricultural land is classed as Less Favoured Area (LFA) and land management in these areas faces particularly difficult physical and climatic conditions. This can be compared to England with only 17% LFA. Farmers in Scotland's LFA face limited options as to what to produce because much of the land is rough grazing which can only really be used for extensive livestock production. Evidence from Quality Meat Scotland (QMS) highlights that production of milk, beef and sheepmeat accounts for between 40-50% of Scottish agricultural output with a value of approximately £1 billion[25]. Scotland is therefore disproportionately dependent on ruminant livestock farming. This reflects the land capability of Scotland and the limited alternative uses to which much of the land can be put. At the same time, it is important to note that Scotland has the great advantage of having a significant and reliable water supply which is key to ruminant meat production.

Although the direct contribution of Scottish agriculture to the economy is small (about 0.7% of Scotland's total GVA[26]), in some areas this impact is much greater. In remote rural areas, agriculture, forestry and fishing account for 17% of employment[27]. Agriculture also makes indirect contributions to the economy through its links with other industries supplying farming and industries using Scottish produce. Concerns have also been raised recently about declining livestock numbers in the hills. If farmers were to leave these areas, not only would the environmental impacts be significant, but also the social impacts, in terms of population out-migration and associated falling school rolls and lower demand for vital services.

More broadly, farmers and land managers play a significant role in actively managing the Scottish landscape and biodiversity that Scottish people and overseas tourists enjoy. Farmers therefore play an important role in delivering public goods to society, however, the non-market nature of these goods often leads to an under-supply. These agricultural public goods include: the cultural and ecological aspects of agricultural landscapes; farmland biodiversity; reduced flooding risk; soils of high functionality; water of high quality; and animal

24 Further information on the characteristics of Scotland's agricultural industry can be found in the Inquiry's Interim Report, available at: http://www.scotland.gov.uk/Resource/Doc/278281/0093386.pdf.

25 QMS (2009) The importance of livestock production to the Scottish economy. Available at: http://www.scotland.gov.uk/Resource/Doc/278281/0090717.pdf.

26 Scottish Government (2009) Economic trends in Scottish agriculture. Available at: http://www.scotland.gov.uk/Resource/Doc/278281/0090711.pdf.

27 Scottish Government (2010) Rural Scotland: Key Facts 2010. Available at: http://www.scotland.gov.uk/Publications/2010/09/17092437/0.

health and welfare[28]. Agriculture could deliver more of these public goods but government intervention and support is needed to stimulate specific activities which will enhance the provision of these goods.

Any future support regime must be tailored to these specific Scottish concerns, in particular the high proportion of LFA, and the implications this has for the way that the industry in Scotland is structured. The chapter now explores the importance of agricultural support in Scotland and describes how that support is currently structured and delivered.

3.2 The importance of agricultural support in Scotland

The CAP is the main source of support to Scottish agriculture. The Producer Support Estimate, which measures the annual monetary value of gross transfers from both consumers and taxpayers to agricultural producers (including market support and direct support), has remained relatively steady in recent years, varying from approximately £660 million to £800 million per year. However, over time, the nature of the support available has changed from being provided through market support measures to direct income support payments (Figure 10). In 2009, the industry in Scotland received £511 million in Single Farm Payments.

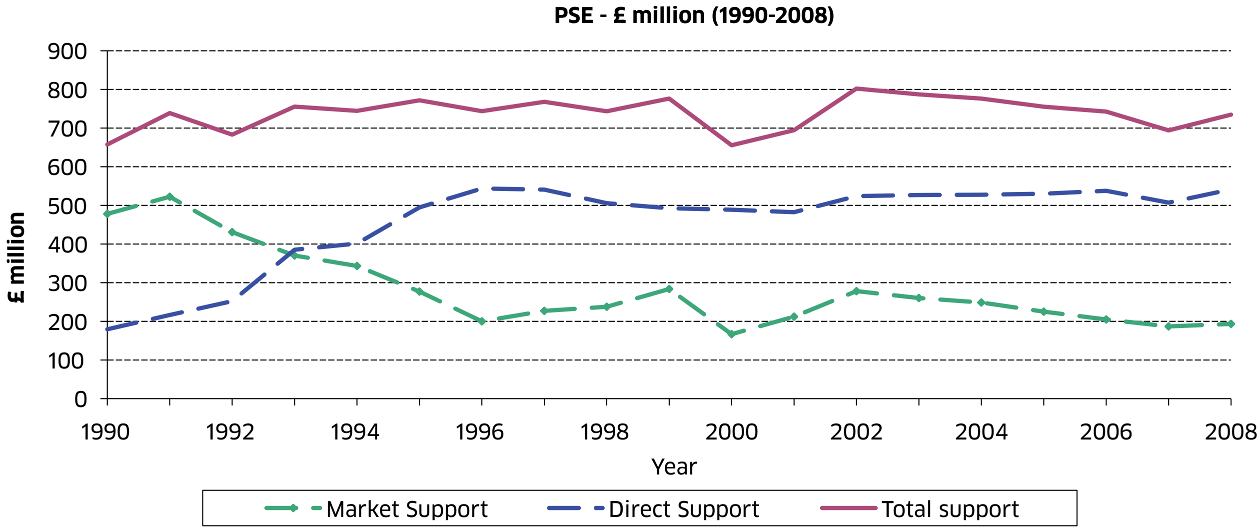

Figure 10: Trends in Producer Support Estimates for Scotland, 2000-2008[29]

Significant amounts of public money are therefore provided to farmers every year. It is this financial support that plays an incredibly important role in securing the continuation of food supply and the delivery of wider public benefits that derive from retaining farmers on the land. The importance of this support is obvious when looking at aggregate farming income data (Figure 11). The data show that in 2009, at an industry level, the Total Income from Farming (TIFF), which measures business profits plus income to workers with an entrepreneurial interest, was less than the income from direct grants and subsidies. Thus it is clear that public financial support to agriculture plays an extremely important role in the total amount of funds entering the industry.

28 McVittie, A. et al. (2009) A review of literature on the value of public goods from agriculture and the production impacts of the single farm payment scheme. Report prepared for the Pack Inquiry. Available at: http://www.scotland.gov.uk/Resource/Doc/278281/0093368.pdf.

29 Scottish Government (2009) Economic trends in Scottish agriculture. Available at: http://www.scotland.gov.uk/Resource/Doc/278281/0090711.pdf. The Producer Support Estimate (PSE) measures the annual monetary value of gross transfers from both consumers and taxpayers to agricultural producers and includes market support and direct support.

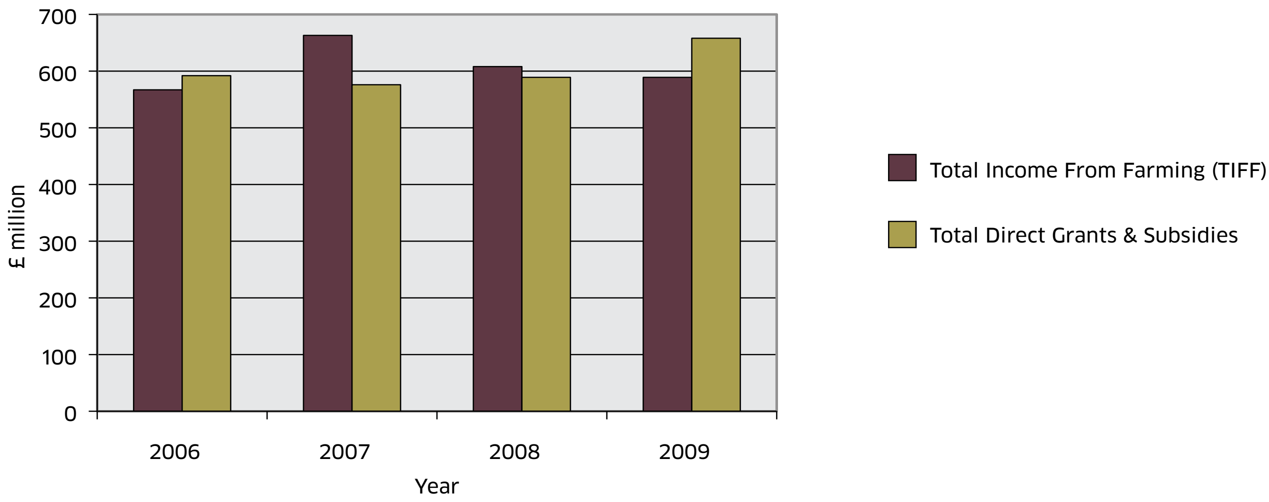

Figure 11: Aggregate Farming Income (£ Millions)[30]

Different parts of the industry are, however, more reliant on support than others. Farm Business Income (FBI) is a measure that is closely aligned to the aggregate Total Income From Farming (TIFF) measure and provides a sectoral breakdown of incomes by eight different farm types. FBI represents the return to all unpaid labour (farmer, spouse and others with an entrepreneurial interest in the farm business) and to their capital invested in the farm business. The latest FBI figures highlight a distinct variation in the degree of dependence on support (Table 1). According to these data Cereals, General Cropping and Dairy farm types are less dependent on support than LFA Sheep, LFA Beef, LFA Mixed Cattle and Sheep, Lowland Cattle and Sheep, and Mixed farm types. The Cereals, General Cropping and Dairy farm types make more money than they receive in support, but other farm types such as LFA Sheep make significantly less than they receive in public support.

Farm Type	**2008/09**			
	Business Income	**Subsidy & Payments**	**Subsidy & Payments as % of Output**	**Subsidy & Payments as % of FBI**
	£/farm	**£/farm**	**%**	**%**
LFA Sheep	16,268	29,911	50	184
LFA Beef	27,105	48,937	40	181
LFA Mixed Cattle and Sheep	26,911	56,900	41	211
Cereals	42,372	39,735	21	94
General Cropping	57,278	40,293	14	70
Dairy	78,420	36,096	10	46
Lowland Cattle and Sheep	23,338	36,306	29	156
Mixed	44,513	50,333	27	113

Table 1: Farm Business Income and direct subsidies per farm by type of farming, 2008/09[31]

30 Scottish Government (2010) Agriculture Facts and Figures 2010. Available at: http://www.scotland.gov.uk/Publications/2010/06/09152711/1.

31 Scottish Government (2010) Agriculture Facts and Figures 2010. Available at: http://www.scotland.gov.uk/Publications/2010/06/09152711/1.

3.3 The current structure of agricultural support in Scotland

The large sums of support entering the land management and rural development sectors each year are distributed through the two Pillar structure devised at the European level (Figure 12). Pillar 1 payments are funded from European funds and are intended to support farm incomes and ensure continuing food production. Pillar 2 payments are co-financed and are intended to foster the delivery of public goods. In this section the principle schemes in each Pillar are outlined before some of the current issues with these arrangements are discussed.

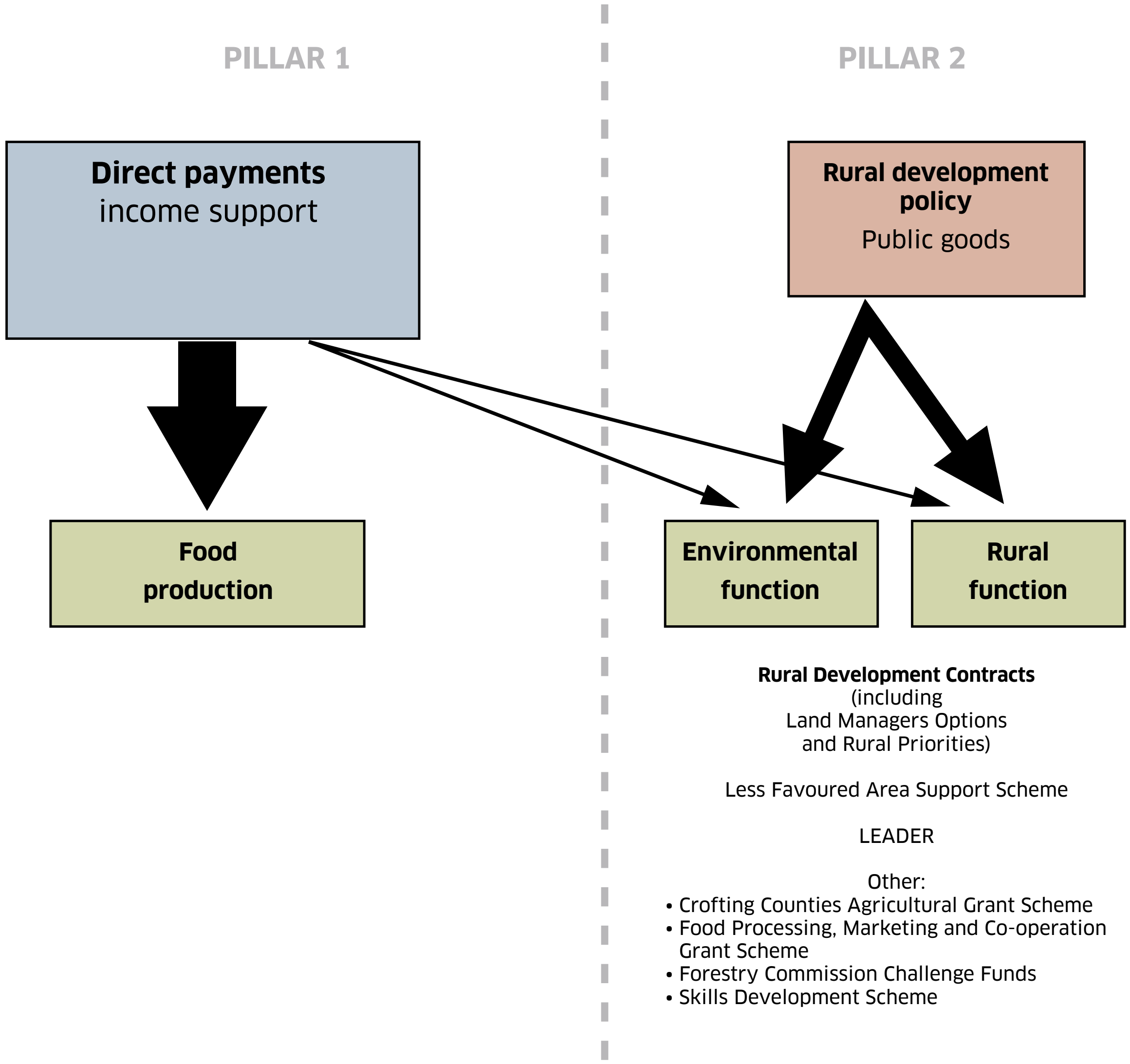

Figure 12: The two Pillar structure of the CAP. The size of the arrows represents the strength of the relationship between the type of support and the functions or purpose of the support. The size of the Pillars approximates the relative size of the budget for each Pillar in Scotland.[32]

32 Adapted from The EU Rural Development Policy 2007-2013 Factsheet. Available at: http://ec.europa.eu/agriculture/publi/fact/rurdev2007/en_2007.pdf.

3.3.1 Pillar 1 payments

3.3.1.1 Scotland's share of the Pillar 1 budget

Scotland has a total Single Farm Payment (SFP) ceiling of €647 million, of which €27.9 million is deducted in compulsory modulation and €54.2 million is deducted in voluntary modulation (i.e. giving a total modulation amount of €82 million). The £ value of Pillar 1 payments depends on the exchange rate on 30th September in any given year, although farmers can opt to receive their SFP in €.

When compared to other Member States and to other regions of the UK, as discussed in Section 2.2.2.5 (see Figure 8), Scotland receives a low level of SFP per hectare. The original allocation of SFP was based on the subsidy claims of each UK region in the reference period (as was the case with the EU15) and the move away from an historic base to area payments across the EU is expected to lead to a reallocation between Member States. In discussions with Commissioner Cioloş during the Inquiry's evidence gathering process, it became clear that this move could be termed a 'pursuit of equity'. While the UK's position is currently very close to the EU average (€247/ha and €263/ha respectively) and thus is unlikely to change markedly as a result of any reallocation across the EU to achieve equity, there is real potential for Scotland to benefit from reallocation within the UK.

3.3.1.2 Single Farm Payment Scheme

The Single Farm Payment Scheme (SFPS) was introduced on 1 January 2005. It is part of the package of reforms that sought to remove the link between subsidy and production (known as de-coupling), allowing producers to make decisions in response to market conditions, whilst maintaining environmental standards. There were a range of potential mechanisms for implementing the SFPS and the choice of model was devolved, with the UK being the only Member State to implement the scheme separately on a regional basis in England, Scotland, Wales and Northern Ireland. England chose to adopt a 'dynamic hybrid' model with a gradually decreasing historic element. Northern Ireland opted for the 'static hybrid' model with 80% of payments made on an historic basis and 20% made on an area allocation. Both Scotland and Wales opted for a wholly 'historic' model where the value of entitlements was calculated from the arable and livestock claims made by farm businesses during the reference period (2000-2002). In Scotland this model was chosen because it was a means of avoiding significant redistribution of historical payments between farm types and regions.

To be eligible for the SFPS land managers must meet a set of requirements known as cross compliance. Cross compliance is made up of a series of Statutory Management Requirements (SMRs) (existing legislative standards relating to public health, animal and plant health, environmental protection and animal welfare) and the need to maintain Good Agricultural and Environmental Conditions (GAEC).

3.3.1.3 Scottish Beef Calf Scheme

At the same time as the SFPS was implemented, Scotland chose to make use of an option available under Council Regulation (EC) 1782/2003 (Article 69) to implement a beef national envelope. This effectively involved retaining 10% of the decoupled beef payments to create a fund that would be available to encourage the supply of quality Scotch beef and deliver environmental benefits.

The Scottish Beef Calf Scheme (SBCS) payment rates are based on the number of animals claimed within the scheme year, with the first 10 animals for each business paid at double the rate.

The annual budget for the SBCS is approximately £20 million. On average, payments are made to over 8,000 claimants per annum, with an average claim of just over £2,000. In comparison, there are approximately 21,000 SFPS claimants per annum, with an average claim of around £20,000[33].

3.3.2 Pillar 2 payments – The Scotland Rural Development Programme

As already discussed in Chapter 2, over time the CAP has gradually been re-oriented from being almost entirely focused on supporting farmers to including a wider focus on rural development. The start of a more explicit emphasis on rural development in the CAP was ushered in through the 'Agenda 2000' reforms which divided the CAP into two Pillars – production support and rural development – with the latter receiving a much smaller proportion of the budget.

At the European level rural development policy for the period 2007 – 2013 focuses on three core policy objectives:

- improving the competitiveness of agriculture and forestry
- supporting land management and improving the environment and
- improving the quality of life and encouraging diversification of economic activities.

Each of these policy objectives corresponds to a thematic axis and to the core objectives in the rural development programmes (Figure 13). The three thematic axes are also complemented by a methodological axis dedicated to the LEADER approach to local level community development.

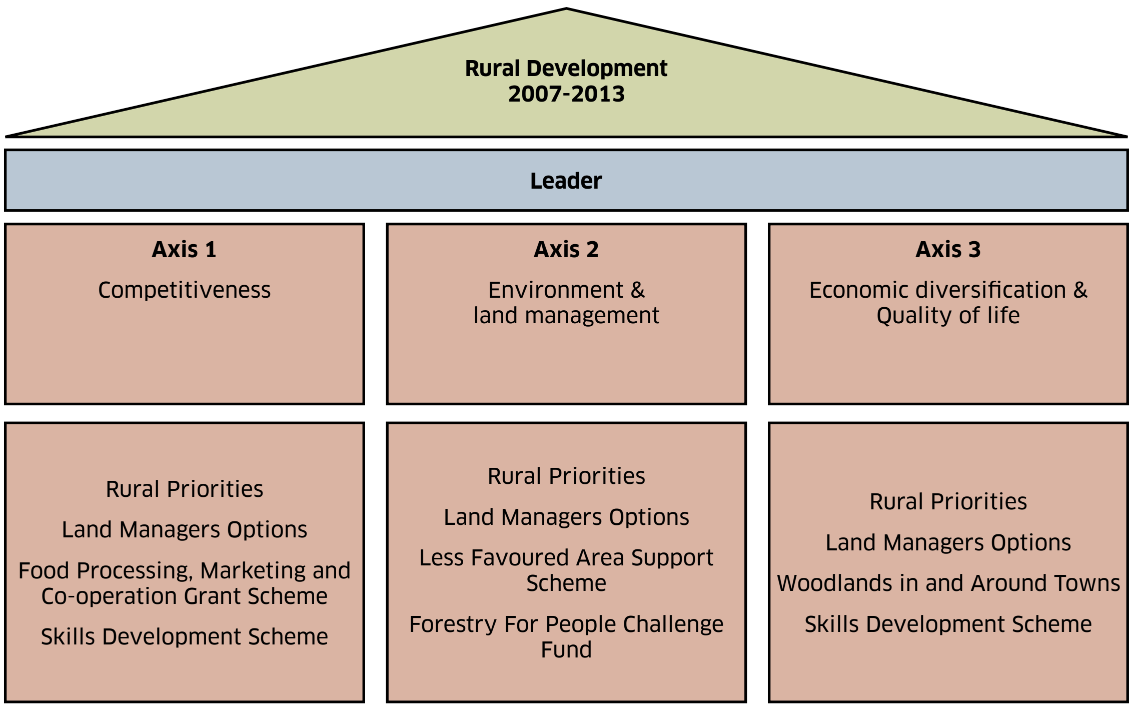

Figure 13: The structure of Pillar 2[34]

33 Analysis undertaken by the Scottish Government (2010).

34 Adapted from The EU Rural Development Policy 2007-2013: Factsheet, http://ec.europa.eu/agriculture/publi/fact/rurdev2007/en_2007.pdf.

The Scotland Rural Development Programme (SRDP) is the Scottish Government's umbrella Pillar 2 programme providing grant funding for Scotland's rural areas. The SRDP aims to provide an integrated set of measures that deliver outcomes across the three axes. The three key components of the Programme are:

- Rural Development Contracts (RDCs)
- The Less Favoured Area Support Scheme (LFASS)
- LEADER

In addition, crofting grants, non-farm-based processing and marketing grants and the Forestry Challenge Funds operate as 'stand-alone' schemes under the Programme.

3.3.2.1 Rural Development Contracts

Rural Development Contracts (RDCs) are presented as the central part of the 2007-13 SRDP. RDCs are envisaged as linking support under Pillar 1 (the Single Farm Payment) with support under Pillar 2 (the SRDP) of the Common Agricultural Policy with the aim of encouraging land managers to consider their Pillar 1 payments as a means of securing further rural development benefits, in particular to deliver or underpin actions to improve business viability.

RDCs comprise three tiers of support:

- Tier 1 is the Single Farm Payment and secures a basic level of income, environmental protection, food safety and animal welfare (funded from Pillar 1).
- Tier 2 is constituted by Land Managers Options, which provide support for the provision of economic, social and environmental improvements across rural Scotland that go beyond those provided by cross compliance under Tier 1. It is non-competitive and land managers are able to choose from a menu of options according to their particular circumstances.
- Tier 3 is Rural Priorities and is a competitive, targeted scheme, open to a wide range of beneficiaries including land managers, members of farm households, rural businesses and community groups. The focus of the scheme is on the delivery of priority outcomes, with an emphasis on collaboration to deliver integrated and/or landscape scale benefits. Priority outcomes are set at a regional level in partnership with stakeholders, but must fit within the context of the National Strategic Plan fully taking into account the requirements of the related national rural strategies.

3.3.2.2 Less Favoured Area Support Scheme

Support has been provided within the Less Favoured Area (LFA) - in future to be known as areas of natural handicap - since the 1970s. However, over time since the Scheme was introduced, its objectives have evolved, as have the methods of paying the support. For the last decade, the Scheme has operated as an area based Scheme (known as the Less Favoured Area Support Scheme, LFASS) and this will continue until at least 2013 with a current budget of around £61 million. It is interesting to compare how the objectives of the LFA scheme have changed over time:

Between 1975 and 1999, the LFA scheme was an accompanying measure to the CAP with the following three objectives:

- ensure the continuation of farming
- maintain minimum population
- conserve the countryside.

From 2000 to 2006, LFA support became part of Pillar 2 of the CAP with the following four objectives:

- ensure the continued use of agricultural land
- maintain viable rural communities
- maintain the countryside
- maintain and promote sustainable farming systems.

In the current period (2007-2013), LFA support falls within Pillar 2 of the CAP with the following three objectives:

- ensure the continued use of agricultural land
- maintain the countryside
- maintain and promote sustainable farming systems.

It is particularly noteworthy that in the current period there is no reference to the social objectives that were previously regarded as relatively important for the LFA scheme, and the accompanying guidelines are much more concerned with land abandonment. In this vein, it is interesting to note that the emphasis has shifted from the continuation of farming in these areas to one of ensuring the continued use of agricultural land. The very inclusion of LFASS under Axis 2 of the SRDP (Pillar 2) signifies that this measure is more about multifunctional farming systems and in particular, the delivery of public goods, rather than agricultural production or food supply. Multifunctional farming systems have clearly become the main rationale for continuing LFA support and are a clear example of government intervention to ensure continued provision of public goods. It is evident that supporting farming activities in LFAs provides public goods that might not otherwise be available. As a consequence, the current SRDP states that:

> *"The objective of this measure is to compensate land managers in LFAs for the particular disadvantages that they face and thereby sustain farming and crofting in these areas and the associated economic, social and environmental benefits that are dependent on continued active land management in these areas".*
>
> *"It is only through sustaining farming and crofting activity and by retaining land managers in LFAs that there can be effective uptake of agri-environmental measures and delivery of environmental benefits associated with active management of land for agricultural production".*
>
> *"LFASS has a key role in this respect by maintaining the basic underpinning agricultural and crofting capability that can promote environmental enhancement including through agri-environmental schemes under the SRDP".*

An interim scheme pending modification at the European level was in place between 2007 and 2009 and, since the EU-wide exercise to redefine LFAs will not now come into force before 2013, a further historically based scheme will run for the remainder of the programming period. In June 2009 the Scottish Government decided to increase LFASS payment rates to the Fragile and Very Fragile Areas of the Scheme by 38% (19% in 2009 and 19% in 2010). In addition, stock numbers were rebased, using 2009 data.

The Scheme has been further modified this year, subject to EU approval. These modifications ensure that the Scheme will continue to be targeted at those actively farming in LFA land. This will be achieved by moving from a single minimum stocking density to a stocking density more appropriate for the varying quality of land. In addition, from the 2011 Scheme year, claimants in the standard area of grazing category A and B will receive a 38% uplift and those farming in standard areas category C or D will see their rates increased by 5%.

It has to be remembered that with 85% of Scotland qualifying as LFA the payments are received in the majority of Scotland but within this there is an enormous variation in the degree of disadvantage experienced, hence the development of Fragile and Very Fragile distinctions. On the whole, Fragile refers to the Highlands (although there are Fragile Areas elsewhere in Scotland) and Very Fragile applies to the Islands and mainly recognises their distance from the market in terms of buying inputs and selling outputs. It is recognised that the Fragile and Very Fragile Areas deliver a disproportionate amount of public goods.

Analysis also shows the wide range in the level of payments received, reflecting the varied nature of Scottish farms (Figure 14 and Table 2). The 10% of recipients receiving the highest payments have payments that equal 46% of the total value of all LFASS payments. The top 30% of recipients account for over 75% of the total payment value. Most LFASS payments are of low value. Of the payments under £5,000, around 2,000 are the minimum payment of £385.

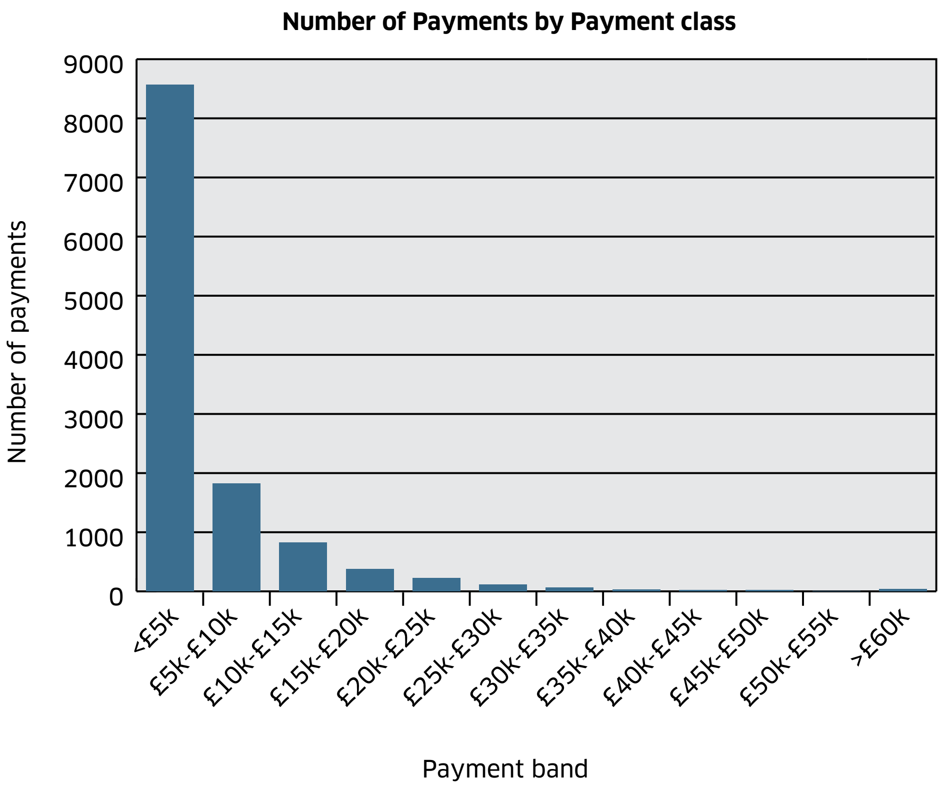

Figure 14: LFASS payments by payment class (2007)

Payment Band	Number of LFASS payments
<£5k	8,564
£5k-£10k	1,826
£10k-£15k	823
£15k-£20k	373
£20k-£25k	223
£25k-£30k	118
£30k-£35k	63
£35k-£40k	30
£40k-£45k	25
£45k-£50k	17
£50k-£55k	7
>£60k	34

Table 2: Number of LFASS payments per payment class[35]

3.3.2.3 LEADER

The LEADER initiative is a community-led approach that supports projects that meet development needs at a local level. The aim of LEADER is to increase the capacity of local rural community and business networks to build knowledge and skills, and encourage innovation and co-operation in order to tackle local development objectives. LEADER accounts for 6% of the total SRDP allocation and should deliver support of around €125 million to rural areas over the life of the Programme. It is managed by partnerships of local stakeholders (Local Action Groups, LAGs) which draw on local knowledge in assessing applications and the degree to which they meet local needs.

3.4 Issues with the current system of support payments

No system for distributing support funds is perfect. Governments have to make choices about priorities and they have to decide what they are trying to achieve with the funds available to them. Their decisions inevitably lead to winners and losers as some people find themselves either included or excluded from support schemes. Governments can therefore find themselves being criticised for pursuing the wrong priorities or classifying things in the wrong way. Equally, the context within which support is provided can change quite quickly while the mechanisms through which support is provided can be slow to change, with the result that the regime of support can look out of step with new and emerging priorities.

These sorts of issues can be seen today in the main criticisms that are made about the current support regime. The remainder of this chapter discusses these criticisms in detail as they are vital in informing the Inquiry's recommendations for the future.

35 Analysis undertaken by Scottish Government.

3.4.1 The use of the historic model makes direct payments increasingly difficult to justify

The agreement to decouple EU direct farm payments from production and introduce the SFPS was made in 2003, with implementation in Scotland in 2005. Scotland adopted the historic model, where payments are based on each farm's average annual payments for the reference period of 2000-2002. This model was adopted at the time as an interim measure on the way towards area payments and as a measure that would limit the redistribution that would occur with a move away from payments that were linked to production.

Today we still operate under this historic approach. Indeed, the Inquiry recommended that we do not move away from it before 2013 because of the potential administrative difficulties and because of the likelihood of further change. But when looking to the future (post-2013) there seems to be general agreement in the EU that we need to move away from the historic model.

One reason why the historic approach is limited as a future option is because the further we get from the reference period the harder the payments are to justify. Claimants can significantly alter their operation—perhaps reducing it to a minimal level—and still receive payment on the basis of their prior activity. The EU requirement that entitlements are tradeable can lead to indefensible uses of public funds if there are not strict rules about transfer – a situation greatly aggravated by sticking to historic entitlements 10 years after the first base year. Even if the reference period was altered ('re-basing'), the same problem would occur in a few years time. Using a reference period also creates problems for new entrants that were not operating in that time period.

The historic model has also prompted much more fundamental questions. Since payments are based on activity in the reference period and it is possible for claimants to alter their operation and continue receiving the same amount of support (provided they meet cross compliance requirements) the rationale for that support becomes less clear. When payments were made in relation to the level of production, that rationale was perfectly clear: support was aimed at ensuring food production. But now that strong link and justification has been lost and a frequently asked question is: what are direct payments for? This has been compounded by the growing emphasis on public accountability with regard to public expenditure. With pressure on public budgets, it is increasingly important to be able to offer strong justifications for the investment of public money in agriculture and rural development. The current payment regime does not straightforwardly offer that justification.

3.4.2 Pillar 1 direct payments are unevenly distributed

Prior to the introduction of the SFPS when direct payments were coupled to production, the goal was to ensure food production with the result that those farmers that were more productive in the supported sectors received more support. Due to the focus on food production, there was an asymmetry in the payment levels across Scotland, with the farmers on poorer land, usually in the North and West, receiving a lower level of support than the farmers on the better, more productive, land in the South and East.

The adoption of the historic approach to allocating direct payments implemented in 2005 effectively perpetuates this asymmetry (Figures 15 and 16). While technically decoupled, because payments are related to the average claims in the reference period, current SFPS payments reflect prior production levels with the result that farmers in some areas receive very high payments while farmers in the less productive areas receive smaller payments. But while this variation in payment rates could be justified with reference to a focus on food production, decoupling makes this justification harder to sustain.

At the same time, there has been a growing interest in the notion of public goods, with many, especially in the environmental lobby, arguing that public support should be directed at delivering these goods. This is an argument that effectively puts greater value on the land that is currently considered agriculturally marginal but which is capable of delivering high quantities of public goods, and would see a shift in the allocation of direct support from the highly productive land to the less productive land.

The very strong regional variation in payments, along with the apparent weakening of the rationale for support, raises fundamental questions about what the support is for and who should receive it. Moving forward, clarity of objectives will be crucial because once we are clear about what we are trying to achieve it will be easier to justify any variations in payment rates.

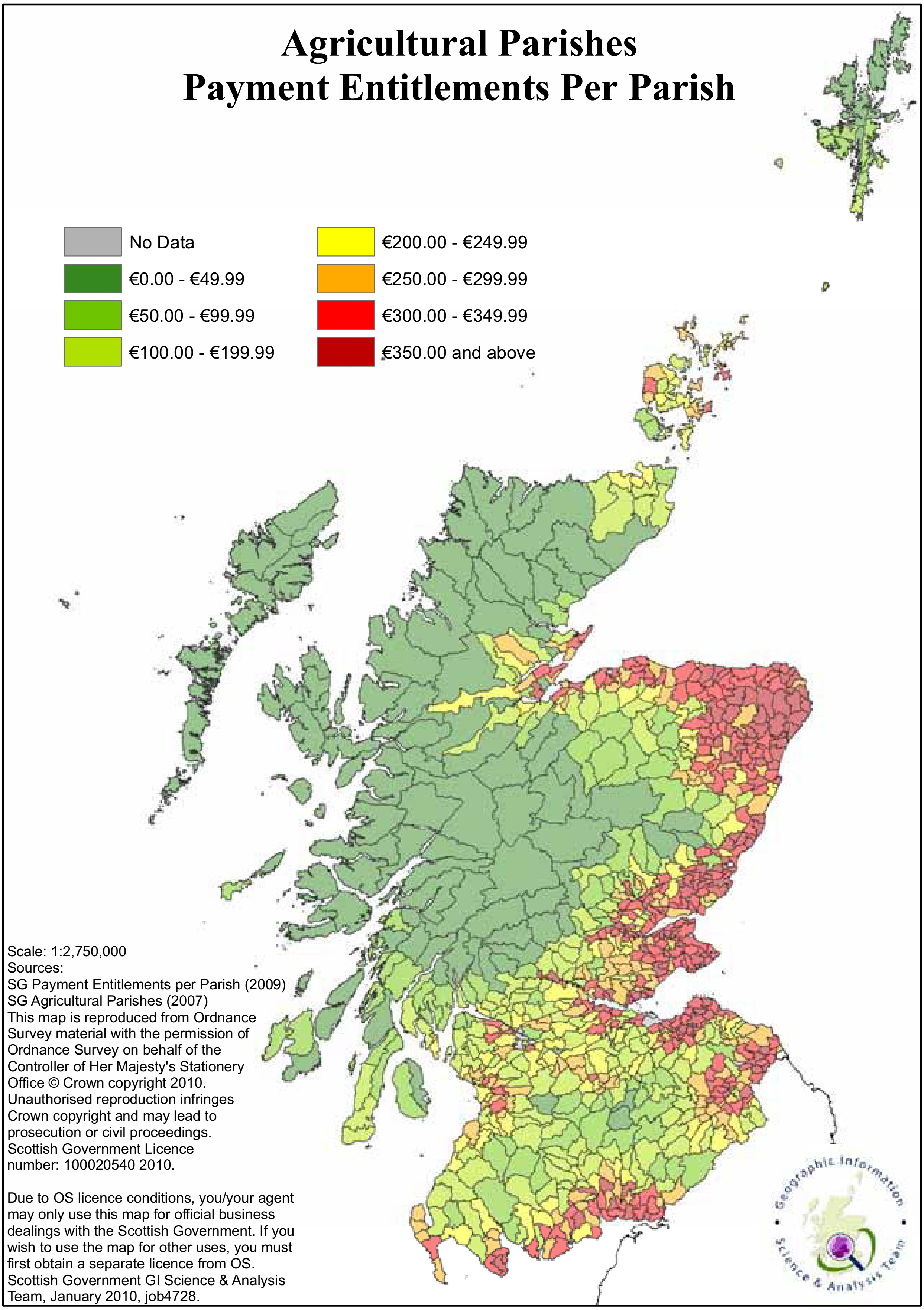

Figure 15: Average Pillar 1 payment entitlement per parish (Source: Scottish Government)

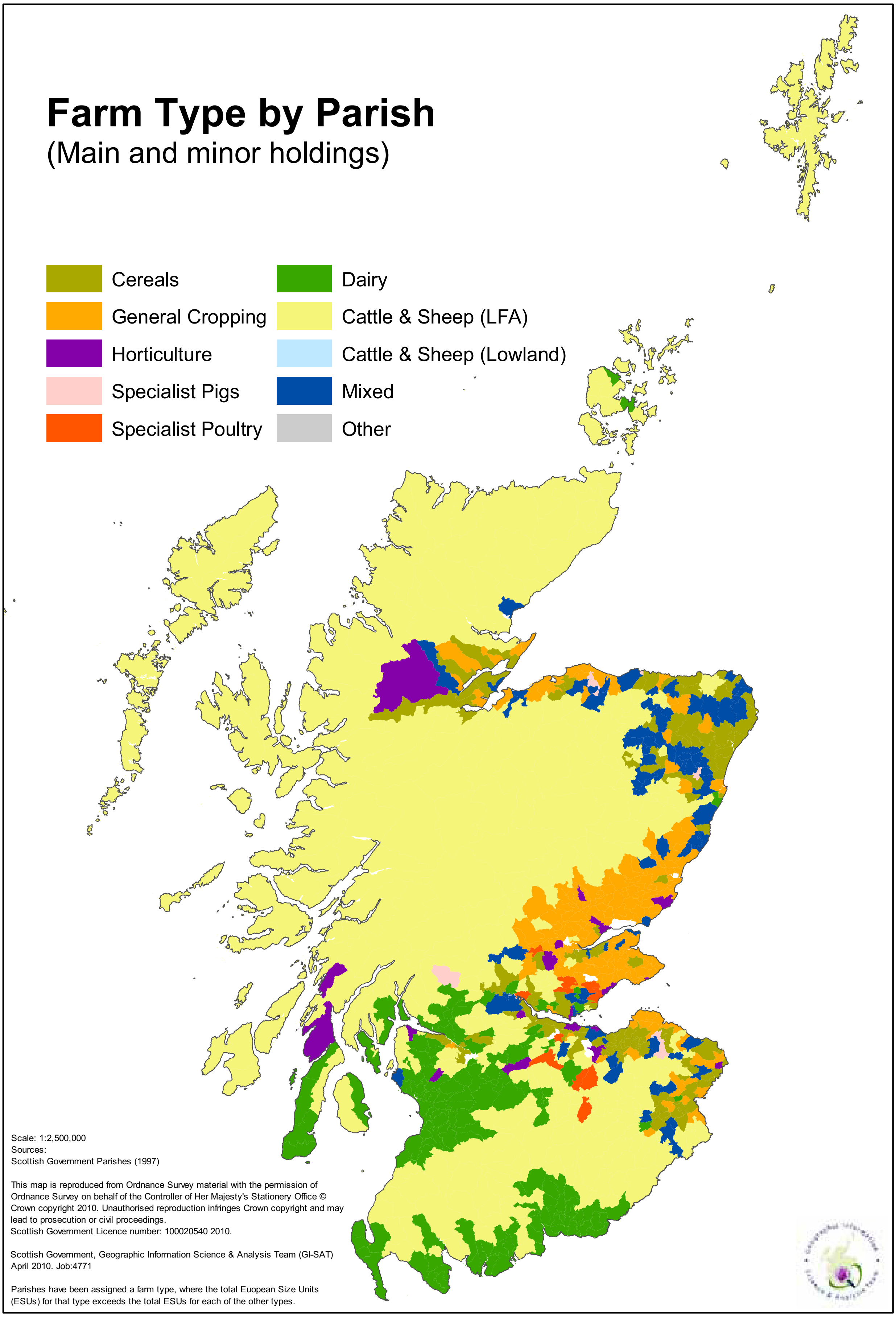

Figure 16: Farm type by parish (Source: Scottish Government)

3.4.3 There is an asymmetry between Pillars 1 and 2

Category		2005	2006	2007	2008 (2nd prov)	2009 (1st prov)
		£ million	*£ million*	*£ million*	*£ million*	*£ million*
Pillar 1	**Scottish Beef Calf Scheme**	19.001	18.478	18.689	20.502	23.574
Other Payments	**Over Thirty Months Scheme (OTMS)**	28.856	1.806			
Other Payments	**Older Cattle Disposal Scheme (OCDS)**		8.910	6.994	6.039	
	Cattle total	**47.857**	**29.194**	**25.683**	**26.541**	**23.574**
Pillar 1	**Protein Crops Premium**	0.255	0.315	0.271	0.208	0.317
Pillar 1	**Energy Crops**	0.124	0.290	0.262	0.062	0.166
	Arable Area Payments Scheme total	**0.379**	**0.605**	**0.533**	**0.270**	**0.483**
	TOTAL INCLUDED WITH COMMODITIES	**48.236**	**29.799**	**26.216**	**26.811**	**24.057**
Pillar 1	**Single Farm Payment Scheme**	399.892	399.672	404.771	443.077	511.900
Pillar 2	**Less-Favoured Area Support Scheme**	61.000	100.250	59.200	58.900	64.000
Pillar 2	**Land Management Contract Menu Scheme**	14.500	22.000	19.800	20.000	18.500
Pillar 2	**Land Managers Options**				1.189	1.974
Pillar 2	**Rural Stewardship Scheme**	12.252	20.813	24.868	17.957	18.535
Pillar 2	**Rural Priorities**					4.441
Other Payments	**Chernobyl Compensation Payments**	0.043	0.066	0.043	0.003	0.003
Other Payments	**Other Compensation Payments**			20.525		
Pillar 2	**Environmentally Sensitive Areas Payments**	8.176	6.336	5.097	5.864	2.137
Pillar 2	**Countryside Premium Scheme**	3.930	4.063	4.048	3.398	4.587
Pillar 2	**Organic Aid Scheme**	2.475	2.985	5.129	5.318	2.850
Pillar 2	**Farm Woodland Scheme**	0.540	0.438	0.489	0.475	0.400
Pillar 2	**Farm Woodland Premium Scheme**	5.133	5.178	5.092	4.347	3.400
Pillar 2	**Farmland Premium Scheme**	0.453	0.810	1.089	1.425	1.200
	TOTAL INCLUDED IN OTHER SUBSIDIES	**508.394**	**562.611**	**550.151**	**561.953**	**633.927**
	TOTAL OTHER PAYMENTS AND SUBSIDIES	**556.630**	**592.410**	**576.367**	**588.764**	**657.984**
	Total Pillar 1	419.272	418.755	423.993	463.849	535.957
	Total Pillar 2	108.459	162.873	124.812	118.873	122.024
	Total Other Payments	28.899	10.782	27.562	6.042	0.003
	Total Payments	**556.630**	**592.410**	**576.367**	**588.764**	**657.984**

Table 3: Total expenditure under main payment schemes (£ Million)[36]

36 Scottish Government (2010) Agriculture Facts and Figures 2010. Available at: http://www.scotland.gov.uk/Publications/2010/06/09152711/1.

The CAP has evolved from a policy dealing with the structural problems of the farm sector to a policy that deals with the multiple roles of farming in society and with a broader set of rural challenges. The pivotal moment in this evolution occurred with the Agenda 2000 reforms and the establishment of rural development policy as the second Pillar of the CAP. Ever since then a key question has revolved around the appropriate balance between the Pillars.

At present, the asymmetry is pronounced with the majority of support provided through Pillar 1 (Table 3) (although it should be noted that Rural Priorities spending will increase in subsequent years).

3.4.4 The CAP budget in Scotland is extremely small

For the 2007-2013 rural development programming period, Scotland was allocated a very small share of the total European funding, and when the budget for the current SRDP was set, both modulation and national money were used to boost the total. Scotland's share of the EU's rural development fund only accounted for about 8% of the total SRDP budget. A further 21% came from modulation (of which one third was compulsory modulation and two thirds voluntary modulation), and the remaining 71% from Scottish Government national finances.

Figure 9 in Section 2.2.2.5 shows rural development spending across the EU27 and highlights Scotland's disadvantage vis-a-vis other Member States and UK regions. The very low figure of €6 per hectare in Scotland is mainly a function of a low EU allocation based on the UK's historically low spending on agri-environment and other similar measures.

For the purposes of rural development spending, the EU regards Scotland's Utilisable Agricultural Area as 6 million hectares. This is higher than the area on which SFPS entitlement was made in 2004 (4.36 million hectares) and the Inquiry's calculations on future active area (4.6 million hectares). Even using the Inquiry's calculation, Scotland remains at the bottom of the table on €8 per hectare. In its 'drive for equity' the EU may address the poor allocation to some Member States and regions of Member States, including Scotland, although across Europe, the co-financing of Pillar 2 is becoming a critical issue as pressure on public spending budgets increases.

It should also be noted that in addition to its low level of Pillar 2 spending, Scotland's spending in Pillar 1 is also low when compared to other regions of the UK (as discussed in Section 3.3.1.1). Following the principle of equity, the Inquiry therefore believes that there is scope for Scotland to receive a larger share of the UK's overall CAP budget in future (see Negotiating Point C in Section 2.2.2.5).

3.5 Conclusion

This chapter of the report has discussed the key characteristics of the agricultural industry in Scotland and the way in which support is currently distributed through Pillar 1 and Pillar 2 schemes. The critical role of agricultural support in Scotland is clearly apparent but the chapter has outlined a number of issues with the current system of support payments which will need to be addressed in future. These can be summarised as follows:

It is increasingly hard to justify the use of an historic model for distributing payments: it is possible for farmers with no current activity to still be receiving payment on the basis of their activity in 2000-2002, while new entrants to farming since the reference period do not receive payments. On this basis, it is increasingly hard to argue the rationale and purpose of direct payments. Moves in the EU are towards an area based approach to distributing payments. However, in order to provide a sound justification for future payments, greater clarity is required about the purpose of these payments, who should receive them and how they should receive them.

There is an uneven distribution of Pillar 1 direct payments: using the historic system to distribute payments results in a situation where farmers in some areas receive very high payments (on the basis of high production in the reference period), while others in the less productive areas receive much smaller payments. This situation is harder to justify in an era of decoupled payments. Again, it is important to return to the question of what support is for: is it primarily for food production or for delivering wider benefits?

There is an asymmetry between Pillars 1 and 2: despite the broadening of the CAP to include a range of environmental and rural development measures, the bulk of CAP funding continues to be provided through Pillar 1 in the form of direct payments to farmers. Some Member States would argue that this asymmetry should be addressed by transferring funds into Pillar 2. However, again the Inquiry returns to the issue of the rationale for direct payments in Pillar 1. Without direct support to farmers, the wider beneficial outcomes that the industry produces would not be achieved. It is also possible that direct payments can be designed in such a way that they themselves deliver more of those beneficial outcomes.

The CAP budget in Scotland is extremely small: as shown in Chapter 2 and discussed further in Chapter 3, Scotland's spending in both Pillar 1 and Pillar 2 is exceptionally small when compared to that of other Member States. While the co-financing of Pillar 2 is becoming a more critical issue as pressure on the public spending budgets of Member States increases, it is possible that in pursuing equity across the EU, the CAP budget for Scotland may increase.

Thus far the report has established some of the key debates at EU level regarding the future shape of the CAP and has discussed the current situation with respect to agriculture and rural development support in Scotland. Chapters 4 and 5 now go on to discuss what the Inquiry believes is the direction of travel and goal for the agricultural industry in Scotland and how the Inquiry believes the goal can be achieved.

4 Support for agriculture in Scotland: where do we want to go?

4. Agricultural support in Scotland: where do we want to go?

If we want to move towards a new regime of agricultural support we need to know what we are trying to achieve and in which direction we want to take the industry. This is important because, like the current support regime, the creation of a new system of support will involve choices; it will involve the identification of priorities and the targeting of funds to achieve particular outcomes, which will, in turn, inevitably lead to a different distribution of support. The fact that the distribution of payments will change emphasises the need for us to robustly justify our choices and priorities.

Any consideration of a future agricultural support regime in Scotland must, therefore, start by identifying the direction of travel and priorities. Once we know where we are trying to get to, it will be easier to determine how to get there and it will be easier to justify the use of public money. A stronger connection between ends and means will be more robustly justifiable.

This chapter therefore seeks to identify a direction of travel for the industry. What do we want agriculture to look like in future? It starts by discussing recent publications in Scotland that have attempted to set out the direction in which Scottish agriculture should travel and by discussing the contribution of agriculture to the Scottish Government's purpose. It then discusses the key findings from the Inquiry's two consultations which provide a 'snapshot' of the ideas of many individuals and organisations on the Inquiry's broad principles and the specific proposals outlined in the Interim Report. The Inquiry worked with all of these speeches, policy documents and consultation responses to set out its goal for Scottish agriculture in future. The Inquiry recognises that this goal will have to be achieved within a framework which sets out the broad characteristics of how support mechanisms for agriculture will look in future. The chapter concludes by outlining this framework before Chapter 5 goes on to discuss the Inquiry's specific proposals to achieve the goal.

4.1 Establishing a direction of travel

4.1.1 A Forward Strategy for Scottish Agriculture

Over the last ten years there have been several official publications that attempt to set out the direction in which Scottish agriculture should travel. Shortly after devolution the then Scottish Executive established an Agriculture Strategy Steering Group including a range of stakeholders to establish a vision for Scottish agriculture and set out a strategy for how that vision could be achieved. In their report—*A Forward Strategy for Scottish Agriculture*—the Steering Group set out the following vision:

We want a prosperous farming industry, one of Scotland's success stories, which benefits all the people of Scotland. It should

- be focused on producing food and other products that the customer wants;
- play a major role in sustainable rural development and help to maintain the prosperity of our rural communities;
- be a leading player in the protection and enhancement of our environment; and
- embrace change and new opportunities[37].

37 Scottish Executive (2001) A Forward Strategy for Scottish Agriculture. Available at: http://www.scotland.gov.uk/Resource/Doc/158242/0042839.pdf.

The report was split into three main sections which focused on developing a prosperous farming industry, viewing farming as part of rural development rather than a separate sector, and how to protect and enhance the environment. The sections on rural development and the environment link with developments at the European level (where the 2nd Pillar of the CAP had been established), but the main thrust and dominant message of the *Forward Strategy* was the importance of enhancing the competitiveness of Scottish agriculture. Scottish farmers were encouraged to learn lessons from businesses in other sectors and to focus on improving their profitability.

After the implementation of decoupled payments in 2005, the *Forward Strategy* was reviewed by another stakeholder group and their report, *A Forward Strategy for Scottish Agriculture: Next Steps*[38], published in 2006, substantially reiterated much of the original *Forward Strategy*. Yet while the core message that the industry must improve its competitiveness was retained, the concept of sustainability and sustainable farming is brought more to the fore. Although it is only a very small change, the vision statement of *Next Steps* is amended to include the concept of sustainable farming. Revising the vision statement to include the concept of sustainability is telling and highlights a change in the debates about the direction for Scottish agriculture. By 2006, then, there were several strands to agricultural strategy. Scottish agriculture should become increasingly competitive; it should become more sustainable; and it should play a key role in rural development.

4.1.2 The Scottish Government's vision for agriculture

When the Scottish National Party came to power in 2007 the new administration sought to develop its own approach to Scottish agriculture with the Cabinet Secretary testing out his ideas in a series of speeches and documents. At the Oxford Farming Conference in January 2009, for example, Richard Lochhead set out his vision for agriculture. He said that his:

"vision for Scotland is to have agri-food and land-based industries which:

- Produce for the market - whether that means food, energy or other markets such as tourism
- But which also produce public goods - economic, social and environmental
- And which are appropriately regulated, not over-regulated"[39].

It was framed as a vision underpinned by the concept of "natural resource productivity", which, in the context of global financial crisis and a somewhat fractured rural land use arena, was intended to act as an organising principle that we should be trying to optimise the sustainable use of our natural resources to deliver the maximum economic and public benefit[40].

The Scottish Government subsequently published *A Vision for Scottish Agriculture* in 2010[41]. This vision aims to optimise the productive use of our natural resources and to achieve the right balance between producing for the market and delivering public goods. The vision is underpinned by four principles:

38 Scottish Executive (2006) A Forward Strategy for Scottish Agriculture: Next Steps. Available at: http://www.scotland.gov.uk/Resource/Doc/94965/0022832.pdf.

39 Richard Lochhead (2009) "Shaping Scotland's Farming Future: The Need for a New Contract", Oxford Farming Conference, January 6, 2009. Available at: http://www.scotland.gov.uk/News/This-Week/Speeches/Greener/farmingfuture.

40 Scottish Government (2009) Natural Resource Productivity. Available at: http://www.scotland.gov.uk/Resource/Doc/266446/0079744.pdf.

41 Scottish Government (2010) A Vision for Scottish Agriculture. Available at: http://www.scotland.gov.uk/Resource/Doc/302424/0094642.pdf.

1. Our agriculture sector should be market based, producing in line with consumer choices in an environment of free and fair competition.

2. However, farming also provides a range of public goods for which market mechanisms do not always exist to reward the farmer sufficiently: for example, protecting the environment, sustaining communities in remote areas and maintaining a national food producing capacity. These should be supported by public funds.

3. These public goods should also be delivered with maximum efficiency through a contract between farmers and society.

4. An appropriate level of regulation should continue to play a role in delivering public goods, using as light a touch as possible to generate the desired outcomes.

These principles were supported by four case studies that provide insight into the role that the Scottish Government sees agriculture performing. Scottish agriculture is multifunctional and performs several roles at once; it:

- Produces food
- Helps sustain rural communities
- Protects and sustains landscape and habitats
- Helps tackle climate change.

Again, the identification of these multiple roles for the agricultural industry raises questions about whether the current support system is capable of encouraging farmers to deliver these roles effectively. If not, what changes are required to produce a new support structure which would move the industry towards greater sustainability and thus towards tackling the global challenges?

4.1.3 Agriculture as part of the solution to the global challenges

In addition to the very focused pronouncements on agricultural policy in Scotland, there are also broader moves, particularly in the European arena, that help identify a direction of travel for Scottish agriculture. As highlighted in Section 2.2.1, for example, there is an expectation that agriculture should make a contribution to tackling the global challenges. This direction was established in the CAP Health Check of 2008 which specifically attempted to alter the CAP in ways that enabled support to be targeted more effectively at the new challenges.

In Scotland, moves are already being made in the direction of demonstrating the contribution that Scottish agriculture makes and of attempting to alter current practices in order to enhance that contribution. The establishment of challenging targets for reducing CO2e emissions (42% reduction in CO2e by 2020 from 1990 levels), for example, has focused minds on the need for action and the need for all sectors to make a contribution. The Scottish Government-funded ‘Farming for a Better Climate’ initiative seeks to encourage voluntary behaviour change within the industry in the hope of achieving emissions reductions without the need for greater regulation. This initiative emphasises that undertaking activity that helps reduce emissions need not be understood as a burden because there is much that can be done to reduce emissions whilst saving money and improving profitability. However, it should be noted that to achieve the reduction in emissions from agriculture set out in the Scottish Government’s Climate Change Delivery Plan[42], would require a 90% uptake of this initiative.

42 Scottish Government (2009) Climate Change Delivery Plan. Available at: http://www.scotland.gov.uk/Publications/2009/06/18103720/0.

What is clear is that further activity to help tackle climate change and address the other challenges will be required in the future. Agriculture does already contribute to our collective efforts to address these challenges—and we should not lose sight of this existing positive contribution—but in future it is increasingly likely that agriculture will have to more clearly demonstrate that contribution.

4.1.4 Agriculture as contributing to sustainable economic growth

Another development that is likely to influence the direction of travel for Scottish agriculture—not least because much Pillar 2 funding is co-financed—is the Scottish Government's clear statement of its purpose and the outcomes that it is attempting to deliver. Scottish Government's purpose is:

To focus Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth[43].

By sustainable economic growth the Government means building a dynamic and growing economy that will provide prosperity and opportunities for all, while ensuring that future generations can enjoy a better quality of life too.

To help focus on achieving this purpose the government has developed a National Performance Framework[44] that includes five strategic objectives and fifteen national outcomes. The strategic objectives are:

Wealthier and Fairer: Enable businesses and people to increase their wealth and more people to share fairly in that wealth.

Safer and Stronger: Help local communities to flourish, becoming stronger, safer place to live, offering improved opportunities and a better quality of life.

Smarter: Expand opportunities for Scots to succeed from nurture through to lifelong learning ensuring higher and more widely shared achievements.

Healthier: Help people to sustain and improve their health, especially in disadvantaged communities, ensuring better, local and faster access to health care.

Greener: Improve Scotland's natural and built environment and the sustainable use and enjoyment of it.

The National Outcomes that describe what the Government wants to achieve in the medium term are:

- We live in a Scotland that is the most attractive place for doing business in Europe
- We realise our full economic potential with more and better employment opportunities for our people
- We are better educated, more skilled and more successful, renowned for our research and innovation
- Our young people are successful learners, confident individuals, effective contributors and responsible citizens
- Our children have the best start in life and are ready to succeed

43 Scottish Government (2007) Scottish Budget Spending Review 2007. Available at: http://www.scotland.gov.uk/Publications/2007/11/13092240/0.

44 See http://www.scotland.gov.uk/Publications/2007/11/13092240/9.

- We live longer, healthier lives
- We have tackled the significant inequalities in Scottish society
- We have improved the life chances for children, young people and families at risk
- We live our lives safe from crime, disorder and danger
- We live in well-designed, sustainable places where we are able to access the amenities and services we need
- We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others
- We value and enjoy our built and natural environment and protect it and enhance it for future generations
- We take pride in a strong, fair and inclusive national identity
- We reduce the local and global environmental impact of our consumption and production
- Our public services are high quality, continually improving, efficient and responsive to local people's needs

Such objectives and frameworks are important and necessary, but the key message for Scottish agriculture is that public expenditure will increasingly be directed towards achieving results that recognisably deliver against this framework.

4.1.5 Responses to the Inquiry's consultations

As part of its evidence gathering process, the Inquiry held two public consultations. The first in Autumn 2009 sought views from the public and interested organisations on the key issues being addressed by the Inquiry. A total of 105 responses were received, with the largest number of organisational responses coming from the farming sector[45]. The second consultation ran in early 2010 in response to the Inquiry's Interim Report in which a potential rationale for a future support regime was presented. A total of 149 responses were received[46].

Detailed analysis of the responses to both consultations was undertaken by George Street Research. It is important here to discuss the key findings as they have informed the Inquiry's thinking regarding the characteristics of appropriate future support mechanisms and the guiding principles shaping those mechanisms.

Phase 1 consultation: Summary of key findings

- The need for future support schemes to support only land being actively farmed or managed for the production of public benefits (including environmental benefits and food production);
- The important role played by farming and good land management in protecting and enhancing the environment and, specifically, in mitigating the effects of climate change;

45 George Street Research (2010) Phase 1 of the Inquiry into Future Support for Agriculture in Scotland: Analysis of the Evidence. Available at: http://www.scotland.gov.uk/Resource/Doc/319836/0102322.pdf.

46 George Street Research (2010) Phase 2 of the Inquiry into Future Support for Agriculture in Scotland: Analysis of Consultation Responses. Available at: http://www.scotland.gov.uk/Resource/Doc/319913/0102346.pdf.

- A need to: move away from a historic basis for delivering support; attach some form of conditions to support schemes; have open, transparent and easy to access schemes; support new entrants and those who currently do not receive support; halt the decline in livestock numbers; consider different land types when deciding how support should be distributed; and provide early notification of any changes to support schemes.

Phase 2 consultation: Summary of key findings

- Emphasis again on the need to support active farming, move away from historic payments, support new entrants and link support payments to the delivery of public goods;
- Broad agreement on the Inquiry's principles and the objectives identified as the basis for future support, but somewhat more mixed opinions on the specific proposals, including some concerns about: the four funding streams; the example eligible area payment scheme; the proposed annual qualifying requirements; the suggestion that forest areas should be eligible for payment; and the use of the Macaulay Land Capability for Agriculture (LCA) classification;
- Highest levels of agreement with: the argument that the impact of area payments on rents is a real problem; the need for annual changes to eligible areas; and that Scotland should achieve a right to direct 15% of its National Ceiling to coupled support for permanent grass and rough grazing utilised by livestock;
- General agreement on the need for a future scheme that is as simple to administer as possible. A new scheme should not be implemented before 2014 and there should be no further transitional period. Also, some support for an interim scheme for new entrants.

4.2 Sketching out a direction of travel for Scottish agriculture

Working with these various pronouncements, speeches, policy documents and the consultation responses, the Inquiry has pieced together its goal for Scottish agriculture. However, the Inquiry recognises that this goal is set, and will have to be achieved within, a framework of broad characteristics established by a variety of actors at different levels, including the Scottish Government, the EU and the WTO. These characteristics will guide the design of the processes and mechanisms that are put in place to achieve the goal. The Inquiry has identified the following broad characteristics as important in shaping the framework within which the goal will be achieved:

- **Any future support regime must have agricultural production at its heart**

  The Inquiry takes the view that our focus must be on ensuring that we maintain a vibrant and productive agricultural sector. Producing the best high quality food we can from the land that is available to us is the primary goal of Scottish agriculture and it is in all our interests that Scottish farmers are supported to do so. But, crucially, without a productive farming sector it will be difficult to deliver the wider benefits that agriculture could provide to society, including its contribution to achieving increased sustainable economic growth for Scotland.

- **Future support schemes must be designed to work towards clear objectives so that it is clear what investment in agriculture is seeking to achieve**
  As highlighted in the Interim Report, one of the criticisms of the current system of support—voiced many times to the Inquiry in the responses to the calls for evidence—is that there is a lack of clarity about objectives. It is sometimes difficult to identify what the money going into agriculture is delivering to wider society. The Inquiry recognises, therefore, that if large sums of public money are going to be invested in the agricultural and rural development sectors, then there needs to be a robust justification for its use in this way. It will be important to ensure that any future support regime has a much stronger connection between support and the achievement of specific objectives or outcomes. Much greater clarity about what farmers and other rural land managers are delivering to society in return for public support will help achieve the Scottish Government's aim of establishing a 'new contract between farming and society'.

- **Future support schemes should be designed to deliver their objectives as simply as possible without incurring high administration costs**
  A general principle of any future support regime must be that it is efficient, with cost effective administration. Money lost in the administration of a support scheme is money that could have been invested in delivering tangible benefits to the people of Scotland. In an ideal world, a future support regime will be simple with minimal bureaucracy and low administration costs whilst being sufficiently rigorous that payments only go to active farmers and those helping to tackle the global challenges. But clearly in the real world there has to be a compromise. Ensuring that only active farmers receive support, for example, would require an annual assessment of activity, which would be bureaucratic and costly. Equally, if conditions on the receipt of financial support are introduced, a system of scrutinising compliance with the conditions or delivery of the measures subscribed to must be established. Simple systems are extremely attractive because of their small administrative costs, but simple systems might also involve a relatively simplistic means of allocating support, which could in turn be harder to justify. Thus while the aim should be introducing simple low cost schemes, the Inquiry recognises the need for farmers to play a role in tackling the many global challenges. This brings with it a need for accountability and for assessing the delivery of intended outcomes.

- **A future support regime should be tailored to the needs of different places**
  Although the goal should be to develop a simple support regime, there is such geographical variation within Scotland that a broad, one-size-fits-all approach to agricultural support (especially direct payments) is unlikely to be robustly justifiable. Some farmers have very good land and many production options, whilst others that farm poorer land are much more restricted in their choices. Consequently, we might want financial support to do quite different things in different places and the Inquiry suggests that some degree of targeting is necessary. Providing support in different ways to different farmers and land managers (for example, within and outwith the LFA) would reflect the different economic and financial situations surrounding different types of farming and would enable greater clarity about what the support was being provided for. While differentiating between different areas of Scotland as a means of tailoring support to the needs of different places does introduce a layer of complexity, the Inquiry takes the view that such an approach attempts to strike the appropriate balance between a regime that is simple and one that is more robustly justifiable.

- **Future support schemes must be WTO compliant**

  The role of agricultural support is one of the key debates in WTO trade negotiations and these talks provide an important context for any future support regime in Scotland. At present, the EU is arguing for the continuation of support (and therefore protection from international competition) on the basis that European agriculture is multifunctional (with farmers delivering quality landscapes and retaining a vibrant countryside as well as producing food). The EU suggests that without support, the very nature of the European countryside would be at risk and that support for agriculture is a way of ensuring the delivery of a wider set of benefits. This argument has largely been accepted because in recent years the debates at the WTO have focused on which forms of support are acceptable (i.e. are non-trade distorting and therefore put in the 'green box') and which are not (and therefore put in the 'amber' or 'blue box')[47]. Any future support measures will have to comply with international agreements about what sort of support is acceptable or at least work within prescribed ceilings. Payments that are coupled with the level of production are considered trade distorting, so while the Inquiry's concerns for livestock declines prompt suggestions for re-coupled payments it is clear that there will be a limit on the amount of such coupled payments allowed in future. Recent informal discussions with European officials suggest that a degree of coupled payments will be a necessary feature of the CAP post-2013.

  Given this framework and the clear purpose of the Scottish Government to achieve increased sustainable economic growth - and the key role of the agricultural industry in this – Figure 17 sets out the Inquiry's goal for the future of Scottish agriculture and its views on the principles and processes guiding the achievement of that goal. As described in Chapter 2, the Inquiry's goal is a more sustainable agriculture, meaning an agricultural sector that is innovative and competitive, with food production at its heart, but which also delivers other benefits in tackling the global challenges - food security, climate change, water and energy supply, and biodiversity.

47 Further information on the WTO boxes is available from the WTO website at: http://www.wto.org.

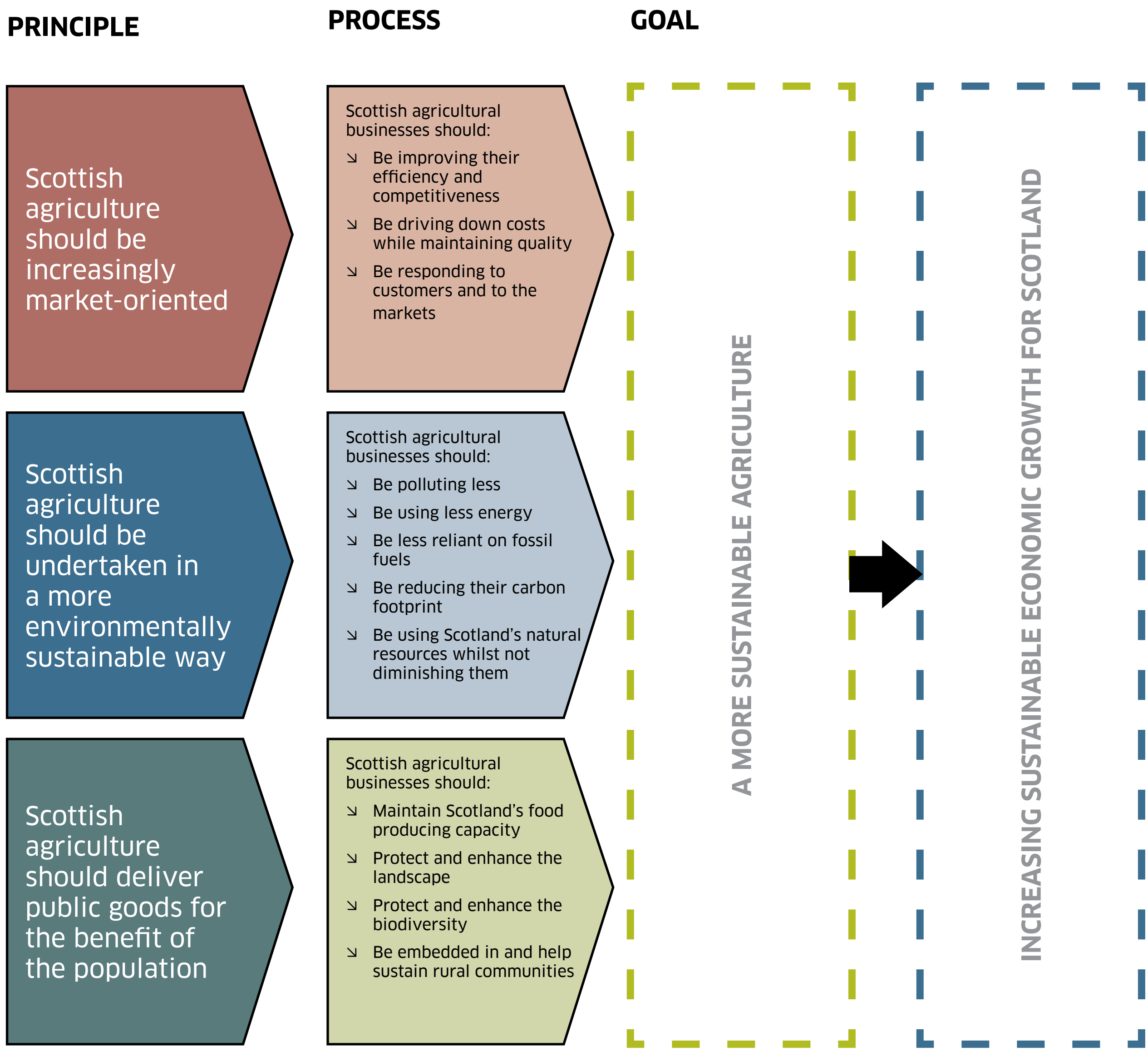

Figure 17: The Inquiry's goal for a more sustainable Scottish agriculture

This chapter has set out the Inquiry's goal of a more sustainable Scottish agriculture, based on the Scottish Government's vision for sustainable economic growth, on broader debates at the European and WTO level about the role of agriculture (as discussed in more detail in Chapter 2) and on responses to the Inquiry's own consultations. The Inquiry has identified a set of broad policy characteristics that provide the framework for the processes and mechanisms put in place to achieve the goal. Based on the identified goal and policy characteristics, Chapter 5 now sets out the Inquiry's specific proposals for the kind of support system required.

5 Support for agriculture in Scotland: how do we get there?

5. Agricultural support in Scotland: how do we get there?

Understanding where we want to go is vital for thinking about what we might want a future support regime to achieve. The next step, though, is to determine *how* we get there and it is this question of *how* that presents the difficulties. In an ideal world we would have unlimited resources and be able to achieve our goals without difficulty. Unfortunately, in a world of limited resources, choices have to be made. Where should public money be invested to achieve the greatest return and to most effectively help achieve the vision?

This section of the report details the Inquiry's proposals for a future support regime that might help Scottish Government achieve its purpose and thus to create a more sustainable agricultural industry, and the principles behind those proposals. These proposals are based on a situation in which the share of the budget coming to Scotland remains much the same as the current level.

Based on the discussion in the previous chapters, the Chapter starts by setting out the Inquiry's perspective with regard to the number of Pillars and the distribution of support between those Pillars. It then details the Inquiry's recommendations for a more appropriate distribution of direct payments across Scotland, based on Scotland being divided into LFA and Non-LFA land. The Inquiry proposes that there should be tailored payment schemes operating in the LFA and Non-LFA reflecting the different needs, opportunities and choices of farmers operating in these two areas. The Inquiry strongly believes that this offers a more justifiable and robust direct payment system under Pillar 1. The Chapter then goes on to discuss a range of other issues, including the timing of changes and the recommendations with regard to new entrants, the future of LFASS and the SRDP, and the Inquiry's perspectives on the need for continued market support as a result of the unique risks facing the agricultural industry, and on the administration of the budget.

5.1 The structure of future support: the principle

5.1.1 The number of Pillars

Some of the current debates around the future of the CAP have focused on the structure of the support Pillars, with some arguing for a change from the current two Pillar structure. The Inquiry has followed the arguments over the last few months and whilst there is no clear decision on how the future Pillar structure will look, there are some signposts. Both the European Parliament's report[48] and the view of the Agriculture Commissioner suggest that the future CAP will have two Pillars, but with a broader role for Pillar 1.

The Inquiry also takes the view that the current two Pillar structure can deliver against a broader range of objectives without being restructured; in short, the current structure provides us with the tools to address the global challenges. The Inquiry therefore suggests that the Scottish Government should argue against radical change and in favour of a continuation of the current two Pillar structure.

Inquiry Negotiating Point D: The current CAP structure of two Pillars should be maintained.

48 European Parliament Committee on Agriculture and Rural Development (2010) Report on the Future of the Common Agricultural Policy after 2013 (Rapporteur George Lyon), European Parliament, Brussels. Available at: http://www.georgelyon.org.uk/resources/sites/84.234.17.197-489191ad48f659.69290487/CAP+report.pdf.

5.1.2 The distribution of support between the Pillars

If we assume that there will be a CAP post-2013 with two Pillars, then the next question to arise relates to how support should be distributed between the two Pillars. As explained in Chapter 2, there is asymmetry between the Pillars with the majority of support provided through Pillar 1 in the form of direct payments. The key question therefore is, should the future support regime retain this emphasis on Pillar 1 or should there be a move towards parity between Pillars or an emphasis on Pillar 2?

An over-riding principle relating to the current two Pillars which the Inquiry supports is that Pillar 2 is co-financed by the EU and by Member States, whilst Pillar 1 is entirely made up of European money. In order to ensure that we have a common agricultural policy across all Member States, the dominant financing has to be from Pillar 1 with Pillar 2 enabling a member state to direct money within an overall European framework to specific territorial needs. The Inquiry recognises that this will be at odds with the objectives of those Member States which are the main financiers of the EU, including the UK. These States will wish to shift the future emphasis to Pillar 2, with co-financing thereby reducing the demand for Pillar 1 money, particularly given the strong argument for achieving equity as regards direct payments across all Member States.

The Inquiry acknowledges that direct payments are a blunt policy instrument and that there is a lack of clarity about their objectives under the current support regime. The agricultural industry is also being asked to address a much wider range of challenges, therefore, if the CAP is to continue to adapt to deliver its founding principles in a manner relevant to the current economic environment and future challenges for agriculture and wider European society, new directions for support need to be introduced. The Inquiry has identified these challenges as creating a more competitive and innovative industry, which has food supply as its primary purpose, but which also delivers a range of other benefits including securing water and energy supplies, maintaining and enhancing biodiversity and reducing carbon emissions.

Traditionally it would be assumed that such objectives should be dealt with under Pillar 2 where outcome-directed support is found. However, the Inquiry's view is that this is an outdated attitude and if the CAP is to help farmers in addressing the new challenges for the benefit of wider society, it is necessary to see an extension of Pillar 1 to target these new requirements on a cross EU basis with common support. The Inquiry believes strongly that agricultural production deserves and can justify direct support due to its critical role in food supply and in providing a base for the production of public goods which society expects, but for which market mechanisms do not exist. However, the Inquiry believes it is necessary, in these times of stringency in public expenditure across Europe, to have a wider range of expected outcomes against which payments can be made accountable. Following this logic means that some activity currently under Pillar 2 would be part of Pillar 1 in future (the Inquiry's detailed recommendations with regard to the future of Pillar 2 in Scotland (the SRDP) are discussed in Section 5.6).

Given the extended role of Pillar 1 in future, it is important that its budget is maintained at the current proportion plus the compulsory modulated funds (see the argument set out under LFASS in Section 5.5). The Inquiry recognises the importance of the unique funding measures available under Pillar 2. It believes strongly that its budget (apart from the LFASS adjustment) must be at least maintained, but that Pillar 2 should get a direct budget allocation rather than relying on modulation.

While the Inquiry has argued here that Pillar 1 must take a wider role in the CAP post-2013 in order to justify the maintenance of current support levels, it does not retract from its view that the most important reason for support is to produce food and maintain a vibrant agricultural industry. Reduced food production in Scotland makes us more vulnerable to world food security issues and without a vibrant industry the wider benefits will not flow.

The Inquiry has received evidence on Scottish farm incomes (see Figure 11 in Chapter 3) and notes that for most farm types, the subsidy support that farmers receive is greater than their farm income. It is likely that any major change in direct support will result in business failure and widespread reduction in agricultural activity. The Inquiry believes strongly that greater benefits will be delivered for society and farming if direct payments are maintained at approximately current levels with higher demands placed on the farmers that receive them, than if future direct payments are smaller and schemes to improve the environment are available in the successor SRDP.

The Inquiry has reached this position for several reasons which can be traced back to the issues and policy characteristics highlighted in earlier chapters. These can be summarised as follows:

- The fundamental belief that any future support regime must have agricultural production at its heart as the primary purpose of Scottish agriculture is, and always should be, food production. Direct payments have a vital role to play in maintaining a vibrant, productive and sustainable agricultural sector which itself is vital to the delivery of the wider benefits that address the global challenges. However, given the wide variety of benefits that Scottish agriculture is being asked to provide it is vital that the objectives of, and justifications for, support are clear. It is also vital that any future support regime is compliant with international agreements about the nature of acceptable support.
- A future support regime should involve minimal bureaucracy. The benefit of the current arrangement is that the majority of Pillar 1 support is distributed through a relatively simple mechanism: financial support gets to farmers without too much bureaucracy. Pillar 2 funds distributed through the SRDP are more focused and targeted at delivering specific outcomes, but the majority of these monies can only be accessed through competitive, and therefore more bureaucratic, schemes. Any transfer of support from Pillar 1 to Pillar 2 is likely to be accompanied by an unwelcome increase in bureaucracy.
- At the same time as being as simple to administer as possible, the future support system should be tailored to the needs of different places, recognising the varying needs and opportunities of farmers.
- Investing public money in agriculture in a way that helps to improve the sustainability of the industry and to maintain productive agricultural activity, which, in turn, contributes to wider economic activity, is the best way of contributing to the Scottish Government’s purpose of increasing sustainable economic growth. That is, the Scottish Government’s purpose will more readily be achieved by maintaining direct payments and maintaining food production and other public benefits, than by transferring support to Pillar 2 for the delivery of public goods.

The Inquiry is very aware of the disappointment that many will feel that it is not recommending that the Pillar 2 budget should be increased at the expense of Pillar 1. Equally, the Inquiry is aware that even if direct payments are maintained, there is still a need to more clearly explain what direct payments are being provided for, and there is a need for recipients to more clearly demonstrate how they are contributing to achieving high level objectives. As such, the Inquiry is keen to find ways of making sure that Pillar 1 payments much more clearly deliver against the global challenges and are more clearly delivering public benefit, whilst at the same time providing the essential support to farm businesses.

The Inquiry acknowledges the feeling within the industry—expressed at the roadshows and in responses to the consultation on the Interim Report—that a major requirement of any future support mechanism must be simplicity and minimal bureaucracy. But the Inquiry believes that a balance must be found and that the prize of maintaining basic support whilst being able to focus farmers' attention on delivering more for less, without creating a bureaucratic nightmare in Pillar 2 is well worth the effort. Using Pillar 1 funds which are financed by Europe and allocated to Member States as direct payments to incentivise the achievement of desired outcomes should justify a light touch in administration as the opportunity to create Member State financial advantage is minimised (see further discussion on this issue in Section 5.8). The Inquiry's suggestions for a more robustly justifiable Pillar 1 scheme are set out below.

Inquiry Negotiating Point E: The direct payments budget should be maintained at its current level, but Pillar 1 payments must more clearly deliver public benefits by delivering against the global challenges.

5.2 Distribution of direct payments within Scotland: the principle

At present, there is a high degree of variation in payment levels between farm types and geographical areas. The farmers on poorer land, usually in the North West and the uplands, receive a lower level of support than the farmers on the better, more productive, land in the South West, East and North East. The question therefore arises as to whether or not a future support regime should replicate such asymmetrical distribution. How should payments be distributed? Should the most or least productive receive higher levels of support? Or should support be determined by the delivery of public goods?

This issue prompts strongly diverging opinions, especially between environmentalists and agriculturalists. The assertion in the Interim Report that a future agricultural support regime should have agricultural production at its heart produced diametrically opposing responses. The environmental lobby rejected the view that the most productive farms should get the highest payments and instead argued that the farmers on the poorer land who tend to have lower incomes and have greater capacity to produce public goods (which does not include food), should get the highest direct payments.

In order to arrive at a position on this issue, the Inquiry finds it useful to return to the issue that lies at the heart of any consideration of future agricultural support, namely what the support is for. Once we are clearer about what direct support is for, we will be better able to justify any particular distribution.

The Inquiry takes the view that direct payments are designed to compensate producers for the added costs of operating in a highly regulated common market with high standards of food safety, animal welfare and environmental protection. A long term production industry like agriculture needs a financial cushion against market price and production uncertainty if it is to invest and adapt for the future to protect and grow production capacity. Direct support maintains farmers' incomes and therefore plays a key role in sustaining the wider benefits that can be derived from managed land.

Our most productive (active) farms, having high output, incur higher costs from operating in a highly regulated common market with high standards of food safety and animal welfare and potentially run higher risks from price and yield variability (this is discussed in more detail in Section 5.7). These higher costs can be illustrated in a variety of ways. For example, higher livestock numbers will mean higher costs for the farmer of meeting animal welfare, traceability and environmental standards. It therefore follows that the most active farms should receive the most direct aid.

In addition, direct payments represent a mechanism through which the EU can address the major challenges common to all the Member States. Providing support to agriculture in the form of direct payments is a way of maintaining an active and productive sector that can deliver wider benefits to society. We need a vibrant agriculture if we are to deliver against the global challenges and it is an indisputable fact that our most productive (active) farms have the greatest potential to contribute whilst having some real hurdles to overcome. Again, if the more active are more likely to deliver positive outcomes with respect to the global challenges, it follows that the more active farms should receive the most direct aid.

The Inquiry received very few representations as to the introduction of a ceiling on individual business payments but it is concerned that the EU Commission are once again considering a cap on payments. However, following the principles established above for the distribution of direct payments, the introduction of an arbitrary ceiling would make no sense. The Inquiry is also mindful that a cap on individual business payments would lead to the creation of many new businesses to ensure that all eligible areas received full annual payments. Any attempt to exclude new businesses would lead to an unhelpful situation where new entrants were not covered. Accordingly the Inquiry recommends that no ceiling on payments is introduced.

Inquiry Negotiating Point F: The introduction of a cap on individual business payments should be resisted on the basis that it would be at odds with the justification for the payments. If a cap was introduced it would prove ineffective as those businesses likely to be affected would be split into multiple businesses. Any attempt to prevent new business could have serious repercussions on genuine new entrants.

Inquiry Recommendation 2: The highest payments should go to the more active farmers. These are the individuals who have the greatest potential to deliver sustainable agriculture - and therefore sustainable economic growth – but who also face the greatest challenge in doing so.

5.3 Distribution of direct payments within Scotland: implementation

Assuming that the first two major points are accepted—namely that the majority of funds should remain in Pillar 1 and that the more active should continue to receive higher levels of support in recognition for delivering on the global challenges—the next issue to address relates to the detail of how future support will actually be distributed through Pillar 1. It is here that we must address the issue of how to make Pillar 1 payments more justifiable and directed towards specific objectives while remaining simple and light touch.

In the Interim Report, the Inquiry examined some of the detail of a future Pillar 1 scheme. The Inquiry took as its starting point an acceptance that there will be a move away from the historic system towards an area based approach to direct payments (although the timing of such a move and whether or not there is a phasing in of the new approach, is, as yet, unknown). The Inquiry also acknowledges that a move to an area based system will result in a redistribution of support with the more agriculturally productive in the historic reference period, particularly those with a greater emphasis on livestock, being the group most likely to be negatively affected, especially if they have maintained their activity.

The Interim Report highlighted that there are a range of potential options for implementing area payments—such as introducing a flat area payment that applied in the same way everywhere or breaking Scotland down into regions, each with a different area payment rate—but focused on a scheme that related payment rates to land capability. In line with the principle that the more active should receive higher levels of support, the Interim Report set out an example of an area based scheme with the higher payment rates associated with land of high quality. In addition, the Interim Report suggested that the area payment should be divided into an area payment and a Top Up Fund (with a proportion of two thirds to one third), with the Top Up Fund being used to achieve transformational change in the industry by linking the provision of support to the adoption of certain practices to enhance competitiveness and sustainability.

Following responses to the Interim Report and further consideration of the issues, the Inquiry has reached the conclusion that while such an approach has its merits, it must be possible to develop a smarter direct payments regime; one that more clearly delivers against the vision for Scottish agriculture. Whilst there was broad support in the Phase 2 consultation for the principles and objectives defined as the basis for future support, including the need for support to be targeted, responses highlighted a number of concerns with the proposed approach, including the payment rates set and the use of the LCA classification to allocate area payments. The Macaulay work confirmed the difficulties of using LCA as a basis for allocating payments (see the Appendix for more information on the modelling work undertaken).

In response to the points raised and to additional analysis, the Inquiry therefore suggests a broader approach based upon Scotland being divided into Less Favoured Area (LFA) and Non-Less Favoured Area (Non-LFA). This is outlined below.

Inquiry Recommendation 3: Future direct payments should be distributed in Scotland on the basis of distinguishing LFA and Non-LFA land. This means that payments can be more clearly targeted and thus are more easily justifiable.

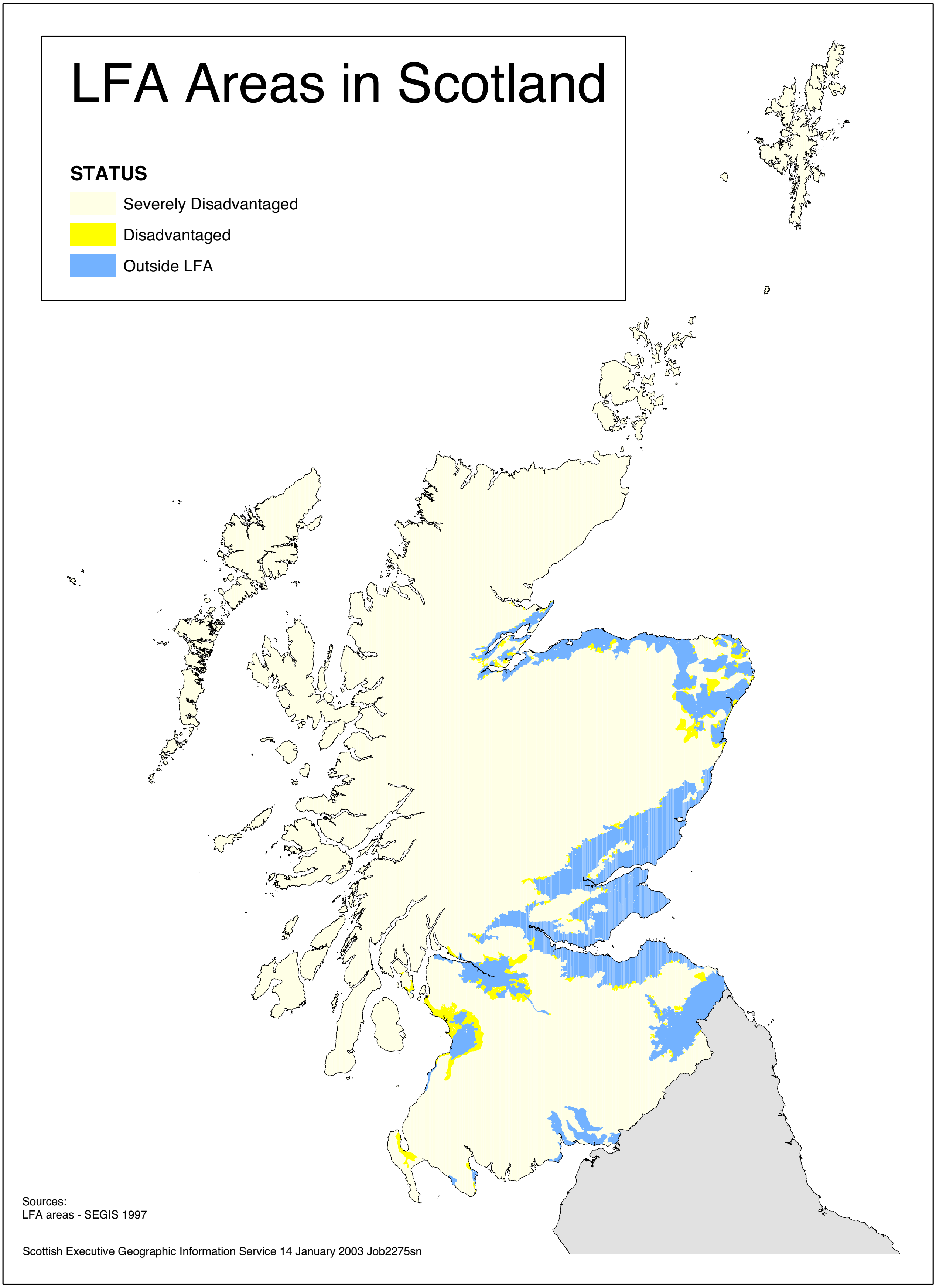

Figure 18: LFA areas in Scotland

5.4 Towards a smarter system of distributing direct payments

5.4.1 An approach based on the LFA designation

The Inquiry takes the view that in order to achieve the vision for Scottish agriculture and a workable support regime, we need to take a more differentiated approach. The various visions and strategies for Scottish agriculture set the direction in very general terms, but there is a great deal of variation across Scotland in terms of quality of land, types of farming and structure of the industry. Broad visions do not necessarily acknowledge that different areas can contribute to the achievement of our vision for agriculture and Scottish Government objectives in different ways. Some areas can produce a great deal of food. Other areas might produce food but also deliver more in the way of public goods. A blanket approach to direct payments would therefore not necessarily be the best way of achieving the goals for Scottish agriculture or the Scottish Government's purpose.

As such, the Inquiry suggests that in thinking about any future support regime we have to think about differentiating between broad land types and potentially developing different support mechanisms that target the needs of these different areas. Some areas have good quality land and lots of options, other areas have poorer quality land and few options. We therefore need a mechanism for differentiating between these areas in order to target support most effectively.

The Inquiry suggests that the LFA designation provides one way of distinguishing between types of farming with different needs, opportunities and choices. The LFA is proposed because it is a recognised designation across Europe and because the area is already mapped and the boundaries already established (albeit there is currently an EU led initiative to redefine the LFA under "areas of natural handicap designation"). The designation divides Scotland into two distinct areas:

- **LFA farming**

  The LFA accounts for 85% of Scotland. While there is some rotational cropping in this area, the land use is predominantly permanent grass and rough grazing with the result that the majority of LFA farms have a limited choice of enterprise options. In the majority of places ruminants are the only effective means of producing food and suckled calf production is particularly important. This form of production produces meat whilst also delivering a wide range of public goods. Unfortunately, it is also a form of production that is recognised as an uncompetitive way to produce beef, meaning that without support it would disappear with negative impacts on Scotland's economic growth and the delivery of public goods, not to mention Scotland's reputation for producing a quality beef product[49].

  The LFA includes 'areas of high natural handicap' which have similar characteristics to the main LFA but are distinguished as suffering from extreme natural handicap (e.g. island locations). These areas, under an appropriate management regime, are capable of achieving high levels of multifunctionality, including biodiversity, carbon sequestration and food production leading to economic activity, and therefore deserve additional support (see the discussion of the future of LFASS in Section 5.5).

49 For more information on this issue please see: QMS (2009) The importance of livestock production to the Scottish economy, Report to the Brian Pack Inquiry (November). Available at: http://www.scotland.gov.uk/Topics/farmingrural/Agriculture/inquiry/background/livestock

- **Non-LFA farming**

  Land lying outwith the LFA is good quality (categorised in the LCA classification as 1, 2, 3.1 and some 3.2), and occupies 15% of Scotland's land mass. This land can be used to grow a wide range of crops including rotational grass and has the highest yield potential with the greatest returns to inputs. Farmers on this better land have choices as to what to produce and how to produce it and have a greater opportunity to contribute to Scotland's economic growth. Consequently, production choices should be based on market realities and not support schemes.

The Inquiry recommends a differentiated approach to direct payments that distinguishes between LFA and Non-LFA because each area faces different challenges and the farmers have different options. By differentiating between these types it should be possible to develop tailored support schemes that more specifically target the needs of each area. Greater targeting in this way will make it easier to justify the payments because those payments will be more closely focused on particular issues.

5.4.2 Allocating direct payments on the basis of these categories

5.4.2.1 Support for LFA farming

Given that the LFA is dominated by permanent grass and rough grazing where the only choices are which ruminant to use and how many, and given the well documented low profitability of farming in the LFA (in particular single suckled calf production), the outcome of a pure area based payment for this class of land is easy to predict. A simple area based payment system would decimate our productive upland and hill units. The risk of land abandonment with this class of land is high with the consequential loss of food production capacity, amenities and the negative impact on rural communities.

The temptation is to try to stick with the existing historic payment system or to attempt to create an updated historic system based on livestock numbers in the absence of subsidy data. It is clear from the EU that an updated but historic system will not be acceptable and continuing with our current historic system - that was introduced as an interim measure - is neither a defendable use of public money nor good for a progressive Scottish agriculture.

The challenge is therefore to identify a means of targeting future support to our more productive upland and hill farms (in order to recognise the greater challenges they face in achieving such higher levels of production), and at the same time ensuring that the farmer is the beneficiary of the support rather than the landlord either via resuming tenanted land or increasing rents.

The Inquiry therefore proposes that land within the LFA is supported by a mixture of three mechanisms: an area payment, a Top Up Fund and headage payments.

Inquiry Recommendation 4: LFA land should be supported by a combination of three mechanisms: area payments, Top Up Fund and headage payments.

Area Payments

In the LFA, the direct payment based on area is designed to provide a single low base payment to avoid the necessity of grading the land to reflect a range of payments, with the main support coming from the other two mechanisms (the Top Up Fund and headage payments). A low per hectare payment should minimise the disruption to the land market, particularly the tenanted sector, predicted by many as a consequence of a move to area payments. The area payment requires the eligible land on which the payments will be made to be identified. Eligible land is land which grows crops or supports domestic livestock (including farmed deer). It is envisaged that the area of land supporting a stocking rate below a level thought appropriate for the payment will be scaled back to an area which achieves the minimum acceptable stocking rate. Land involved in an approved environmental scheme will be eligible. Following overwhelming support to exclude trees in the Consultation following the Interim Report, the Inquiry has decided that woodland will not be eligible and therefore will require its own incentives under Pillar 2.

The Inquiry is committed to the principle that the area of Scotland paid on annually adjusts as stocking increases or decreases the area eligible. The concept is an eligibility criteria for the land receiving payment ensuring that all supported land has activity. Using a minimum stocking rate to decide if land not growing crops is eligible for payment should ensure that rents are not increased in the LFA - as they would likely be if an area payment was introduced on bare land with no requirement for a farmer/crofter. Whilst this system will result in some bureaucracy for both applicants and Government, with stocking being declared and checked annually, it is nonetheless considered the best way to avoid the current anomalies and ensure that direct payments only go to active farmers. Paying on Scotland's total UAA would dilute payments from those proposed, resulting in a loss of effectiveness.

Inquiry Negotiating Point G: It is essential that future EU regulations recognise that eligibility criteria are required to assess land qualifying for direct payments. These criteria should be decided on an objective basis by Member States. They should include, in the case of land stocked below the minimum, the ability to scale back to an area that achieves the minimum.

Inquiry Recommendation 5: Land eligible for direct payments is all land growing crops, land involved in an environmental scheme or land supporting livestock with a minimum stocking rate deciding the area eligible.

Top Up Funds

At the time of the Interim Report, the Inquiry felt that area payments alone would not constitute a viable future farm support system for Scotland and as a result introduced the concept of a Top Up Fund. Discussions and further analysis have confirmed this view and therefore the Inquiry is convinced that Top Up Funds should be a significant part of support in the LFA.

Top Up payments using Pillar 1 money are designed to incentivise transformational change to develop farming systems which produce food in a competitive way, but which also address the global challenges and deliver important public benefits. These payments should be directed at producing more with less (i.e. increasing output while reducing fossil fuel usage, carbon emissions and environmental damage - particularly water pollution). It is essential that Scottish agriculture continues on this journey as not only will it deliver the benefits that wider society demands but it will ensure the long term future of the industry.

The concept of a Top Up Fund is new and it is one which requires development as to how it is to apply, with the key being light touch as regards audit requirement. In the first instance it is unlikely that specific outcomes (e.g. carbon emissions per unit) would need to be specified; more a commitment on the part of a business to develop a plan for change, although further work is required here to identify which 'hooks' would be appropriate in the Fund. It is possible that industry self policing (e.g. Farm Assurance schemes) will play a part in ensuring the high level commitment is delivered, thereby reducing the burden on the Rural Payments and Inspections Directorate (RPID).

The Inquiry is minded that an area basis would not be an appropriate way of distributing Top Up Funds. Instead, the most appropriate way to match payment levels to relative contributions is to use Standard Labour Requirements (SLRs). Using this approach provides a proxy for measuring the ability of a business to contribute to the objective of more sustainable food production, and the extent of the challenge faced in so doing. Standards do exist now for labour requirements for various enterprise types[50] but further research will be required before 2013 to update, refine and test them against actuals, in particular to capture economies of scale. An amended Single Application Form (SAF) should enable SLRs to be calculated accurately on an annual basis.

It is critical that the Top Up Fund paid out to businesses in the LFA on the basis of their SLRs is seen clearly for what it is – namely a payment in exchange for the business playing its part in ensuring agriculture is part of the solution to the global challenges. These were identified in Chapter 2 as the security of food, energy and water, tackling climate change and enhancing biodiversity. It is very difficult to imagine how, in WTO terms, this payment could be judged as providing a positive trade advantage to the recipients and therefore is anything but 'Green Box'. The Top Up Funds would be paid in return for a business committing to embark on a programme to improve its sustainability and thereby deliver food production whilst helping to satisfy the global challenges. In short, the payment based on the SLR of a business reflects the activity that the business commits to undertake in contributing to the challenges currently facing the industry, and indeed society more broadly.

50 For Standard Labour Requirements for a range of enterprise types, see Defra (2010) Definitions of Terms used in Farm Business Management. Available at: http://www.defra.gov.uk/foodfarm/farmmanage/advice/documents/def-of-terms.pdf.

The fund to finance these payments will be part of the total direct payments payable to the LFA. They are, therefore, Pillar 1 monies distributed on a different basis than area. The Inquiry believes that to support food production and to incentivise farmers and compensate them for the increased costs of developing more sustainable farm businesses using the area farmed in the LFA would be a poor basis of allocating support. This is because the payments are unlikely to reflect their ability to contribute given the wide variation in the productive capacity of the land and an equally wide range in the way it is utilised.

The Inquiry sees the Top Up Fund being used as described above as a key to the future development of the European rural area and hence of Scotland. Developing the right measures for such a scheme is an enormous task requiring a very wide input from stakeholders. These measures must produce a positive outcome without posing an impossible burden on farm businesses. It is important that measures are proportional to the fund available to the business.

Inquiry Negotiating Point H: The concept of allocating some direct subsidy payments to deliver public benefits – including the security of food, energy and water, tackling climate change and enhancing biodiversity – with payment levels (for the LFA only) based on the Standard Labour Requirements of a business is new to the EU. The European Commission and Parliament and the WTO need to fully understand and accept their rationale and purpose.

Inquiry Recommendation 6: A proportion of Pillar 1 funding should be used to create a Top Up Fund to encourage transformational change: in short, a more sustainable agricultural industry which contributes towards tackling the global challenges. In the LFA this money should be allocated on the basis of the Standard Labour Requirements of a business.

Inquiry Recommendation 7: An expert group should be established to work on the methodology to be applied for establishing the eligibility for the Top Up Fund. The over-riding principle must be that this is a positive process that farmers and land managers can fully engage with to the benefit of their business and wider society. It is envisaged that web based applications and industry self-policing will be part of the solution.

Headage Payments

The Inquiry fully supports the principle identified by the European Commission that in certain situations, coupled payments are the only way to ensure certain desirable outcomes are achieved, and that some very undesirable consequences are avoided (for example, the disappearance of crofting or starving Scotch beef processors of raw material). The Inquiry believes that, due to Scotland's uniqueness with regard to the extent of permanent pasture and rough grazing, it should have greater leniency than the currently implied ceiling of 3.5% for Scotland as a region of the UK, a member state with a 3.5% ceiling. Given the UK (and particularly England's) dislike of coupled payments, there is no chance of the UK breaching the ceiling (assuming that it is not increased in the reforms) even if Scotland went to 15%. The Inquiry believes that it would be right to argue for increased budgetary ceilings for regions of Member States where the consequences of decoupling are more acute.

The primary aim of the coupled payments in the LFA would be to stabilise cow and ewe numbers on marginal land thereby securing the basis for delivering public goods, recognising the challenges of maintaining livestock production on this land and avoiding the risk of land abandonment. It is considered essential that headage payments do not encourage the keeping of breeding stock solely to collect the subsidy cheque as happened pre-decoupling, particularly with ewes. It would be essential that the total budget for each type of coupled support was set at the outset.

The current Scottish Beef Calf Scheme (SBCS) provides the evidence that paying on offspring is an administratively simple way of ensuring production. The Inquiry's proposal is to pay on calves with at least 75% beef genetics over thirty days of age and lambs over two months at a headage rate that should make the enterprise profitable with reasonable production efficiency.

While the traceability level in cattle ensures the security of a beef calf scheme, the same (at this time) cannot be said for lambs. If a reliable way of only paying once on lambs cannot be identified the idea of a lamb scheme should not be pursued.

The Inquiry believes that additional encouragement should be provided for smaller cow herds (under 40) with even higher headage payments for very small herds recognising the significant contribution that they make to the maintenance of crofting and to biodiversity. The Inquiry also believes that the coupled support for beef calves in the LFA should be extended to include calves with 50% beef genetics (i.e. Dairy x Beef calves) at a flat rate. Not only will this provide a small element of support to LFA dairying but it will also act as an incentive to produce better quality beef from the dairy and reduce the waste of calves thereby making a positive contribution to sustainable agriculture – food security with lower carbon emissions.

Inquiry Negotiating Point I: Given the extent of permanent pasture and rough grazing in Scotland, the importance of cattle and sheep production to the Scottish economy and the high risk of land abandonment, it is essential that Scotland's ceiling on coupled payments for the post-2013 period is 15% of total Scottish direct payments.

Inquiry Recommendation 8: A more targeted SBCS should be established paying higher rates per head for smaller herds (under 40 cows) and even higher rates for very small herds (under 15 and under 5 cows). The graduated rates should be paid on calves over 30 days of age with 75% beef genetics but calves with 50% beef genetics should be eligible for the flat rate payment. The basic rate should be much higher than the current SBCS. The total annual budget for this scheme should be fixed at the outset.

Inquiry Recommendation 9: A lamb headage scheme should be developed, with a flat rate payment on all lambs born on the holding of birth after 60 days of age. However, it is essential that such a scheme has integrity (i.e. that it only pays on lambs born in the eligible area and only once per head). If traceability has not advanced such that this integrity is guaranteed then a scheme should not be implemented. The total annual budget for this scheme should be fixed at the outset.

5.4.2.2 Support for Non-LFA farming

Since land outside the LFA is of a good quality and provides the farmer with a wide range of options, it is farmers in the Non-LFA that will be in the best position and most able to be market oriented and therefore fit the EU model of area payments.

While a market downturn might result in land being fallowed (as happened in 2010 with spring barley) there is little danger of this land being abandoned. The support regime should therefore seek to encourage production based on market economics, although a level of support is still required to compensate the farmer for the costs of operating in the common market and to mitigate the effects of market volatility. Given that Non-LFA land provides choice as to what form of agricultural production is followed, the Inquiry believes that it is not in the best interests of agriculture nor wider society for production subsidies (livestock headage payments) to be available for this category of land. The sooner that enterprises and production systems are chosen for their financial viability and wider public benefit, the more sustainable our farming on Non-LFA land will be.

It is therefore proposed that land outwith the LFA receives support in two ways: an area payment and a Top Up Fund to incentivise delivery against the global challenges (with a distribution of two thirds area payment and one third Top Up Fund). In the case of Non-LFA farmers, the Top Up Fund will be paid on an area basis as it is believed that with highly productive land the area farmed is the best indicator of their potential contribution to more sustainable agriculture. The Fund will have the same aims and operate in a similar fashion to that outlined in the previous section on LFA farming, albeit will be paid on a different basis.

Both the straight area payment and the Top Up Fund will only be paid on land which supports agricultural activity or which is part of an approved environmental scheme.

Inquiry Negotiating Point J: For Non-LFA land to qualify for area payments it has to support agricultural activity or be part of an approved environmental scheme.

Inquiry Recommendation 10: The Non-LFA region of Scotland should receive direct support on an area basis with two thirds straight area payment and one third Top Up Fund. The Top Up Fund would be focused on developing a more sustainable agriculture as with the LFA Top Up Fund.

5.4.2.3 The conditions to be attached to direct payments

Under the current Single Farm Payment (SFP) system all land controlled by a claimant is subject to cross compliance and any breach of this incurs penalties which are taken in the form of deductions to subsidy receipts as laid down in the regulations. Cross compliance consists of various Statutory Management Requirements (SMRs) and Good Agricultural and Environmental Conditions (GAEC) - the extent of which is limited to adhering to the principles stated in the Regulation.

Various suggestions have been made that in the post-2013 CAP much more use should be made of GAEC regulations to force a greening of the CAP, or using the Inquiry's terminology, to encourage the Scottish farming industry to address the global challenges. However, the Inquiry's view is that this is a route fraught with difficulties. The question can be asked as to whether the required standards will be at a minimum leading to little improvement or whether they will create real difficulties for some types of farming in some Member States. The psychological barrier of a penalty based system to the achievement of real progress should not be underestimated.

Accordingly, the Inquiry has ruled out the use of more stringent GAEC standards as a means of improving the environmental credentials of European farming. Instead it believes that much more can be achieved by getting industry buy-in to the development of a more sustainable agriculture. The key will be the framing of commitments required in return for maintaining the direct payment budget via the Top Up Fund. Therefore it is envisaged that cross compliance and GAEC will continue very much as now but the definition of what would be considered to be a breach should be reviewed. In particular, the current Scottish GAEC rules state that some negative practices do not count as a breach if the damage can be rectified by the end of the following growing season; this rule should be re-considered in the light of experience. The calculation of penalties also needs to be reviewed, particularly with regard to simple mistakes in traceability.

Inquiry Negotiating Point K: Cross compliance, particularly GAEC, should not demand more of farmers than it currently does. The penalty system should be overhauled to ensure that it is proportionate.

Inquiry Recommendation 11: The Scottish Statutory Instrument that currently exempts breaches of GAEC that can in theory be rectified by the end of the following growing season should be reviewed in the light of experience.

5.4.2.4 The timing of change

The Inquiry has already noted that the historic approach to making direct payments must be changed. The current historic system – introduced as an interim measure in 2005 – is not appropriate for a progressive Scottish agriculture and makes justification of the payments received by farmers very difficult.

If the scenarios outlined above can be achieved as an outcome of the CAP reform, there is no reason to delay their implementation as, unlike a simple area based system, their impact should be good for Scottish agriculture and for Scotland. Accordingly, the Inquiry sticks with the view expressed in its Interim Report, that the new system should be introduced as soon as possible after the European negotiations are complete. The Inquiry expects that, as in previous reforms, it will take some time after the completion of negotiations for the new systems to be ready, and this might mean that the existing historic SFP has to continue for one year with the new system adopted in one step thereafter (i.e. in 2014 at the earliest). The efficient implementation of the new system will be very dependent on the development of the new IT systems as highlighted in the Inquiry's short-term recommendations[51]. Given the extent of the change from the existing simple SFP system to the much more targeted proposed scheme, it is very difficult to envisage a phased introduction that would not further disrupt the industry and be very difficult to administer.

In the event that EU rules require a phased changeover, the Inquiry believes that the method adopted should be similar to the approach adopted in Germany in that the phasing should be connected to the payment rate rather than the system (i.e. rather than phasing out one system and phasing in another over a period of years). The new value of the payment should be established and then steps to reach this figure calculated. However, the Inquiry believes that phasing of the support package for the LFA is not possible.

Inquiry Recommendation 12: The change from the current historic base for the SFPS to the Inquiry's approach outlined here should take place as soon as possible after the European negotiations are complete. This may mean that the existing system has to continue for one year with the new system adopted in one step thereafter (i.e. in 2014 at the earliest).

51 The Scottish Government (2010) Inquiry into Future Support for Agriculture in Scotland: Short-term Recommendations. Available at: http://www.scotland.gov.uk/Resource/Doc/915/0100597.pdf.

5.4.2.5 New Entrants

Given the commitment of the Scottish Government (confirmed by their acceptance of the Inquiry's short-term recommendations) to put new entrants on an equal footing as soon as possible after 2013, plans need to be laid in the event of a long phased changeover. The recommended route for paying SFPS would give new entrants equality one year after the CAP was reformed and, therefore, no other action would be required.

In the event of a more protracted change to an area based SFPS, it would be essential that the post-2013 CAP regulations enable Scotland to create a National Reserve to fund a new entrants scheme. The scheme would be aimed at legal entities which, by 2010, had started a farm business since 2003 and had not been allocated entitlement. The 2010 cut off is proposed to ensure that a plethora of new businesses on paper are not started, to benefit from an allocation of entitlement from the National Reserve. It is accepted that genuine new starts will be disadvantaged by having a date by which a business had to be started (2010) to be awarded entitlements but without this the scheme would be unworkable.

The Inquiry recommends that the National Reserve is funded by top slicing high per hectare value entitlements. Under any change from paying entitlements on a historic base it is envisaged that payments per hectare that are well above the norm will not be maintained. The precise value per hectare where the cut off will apply will require detailed calculations of the budget required but is likely to be around €600 per hectare.

Inquiry Negotiating Point L: The new EU regime post-2013 must allow Member States to create a National Reserve if required for new entrants by top slicing entitlements on an objective basis.

Inquiry Recommendation 13: If the change to a new regime is going to be a protracted process, all legal entities who started in business since 2003 and before 2010 and were not awarded entitlement should be allocated entitlement from the National Reserve, in order to provide parity. The National Reserve should be created by top slicing high per hectare value entitlements – possibly over €600.

5.4.3 Implementing the desired method of allocating direct payments

The Inquiry has identified the structure for the allocation of direct payments post-2013 in Scotland, and the principles behind that structure. It is important that the discussion around the future of agricultural support in Scotland concentrates on this structure and its underlying principles and the win-win for Scottish farming and society.

However, the Inquiry does recognise that farmers are individuals with responsibility for their own business and for the household associated with that business. As a result the possible size and structure of their direct payments in future is a matter of real concern to them. The Inquiry recognises that much of the assessment of the future will be based around calculating the difference between the current SFPS and the figures generated by any new proposals. The Inquiry believes that such an approach is flawed as it relies on an assumption that the current payment is the correct one to achieve European and Scottish Government objectives, and those of wider society.

It is also important to note at this stage that there is a long way to go in terms of the negotiating process at Scottish, UK and European levels before any new payment methods are implemented. Moreover, maintaining the status quo is not an option, and the Inquiry believes that, in this context, it has come up with a set of proposals which will result in a stronger more sustainable agricultural industry in Scotland. Despite these caveats, however, the Inquiry offers a model for allocating Scotland's current budget (post-modulation) according to its recommended support structure:

Non-LFA land

Area Payments:	€200 per eligible hectare
Top Up Fund:	€100 per eligible hectare

LFA land

Area Payments:	€30 per eligible hectare
Top Up Fund:	€6400 per Standard Labour Requirement

Headage Payments:

Scottish Beef Calf Scheme (SBCS)

At least 75% beef genetics:	Numbers	€ per head
	1-5	220
	6-15	190
	16-40	165
	40+	135
50% beef genetics:	All	135

Scottish Lamb Scheme(SLS)	Numbers	€ per head
	All	8

Using the figures above and the best available estimates of the numbers of stock and area involved, Figure 19 shows the allocation of the total budget to the LFA and Non-LFA and the recommended support structure for each area.

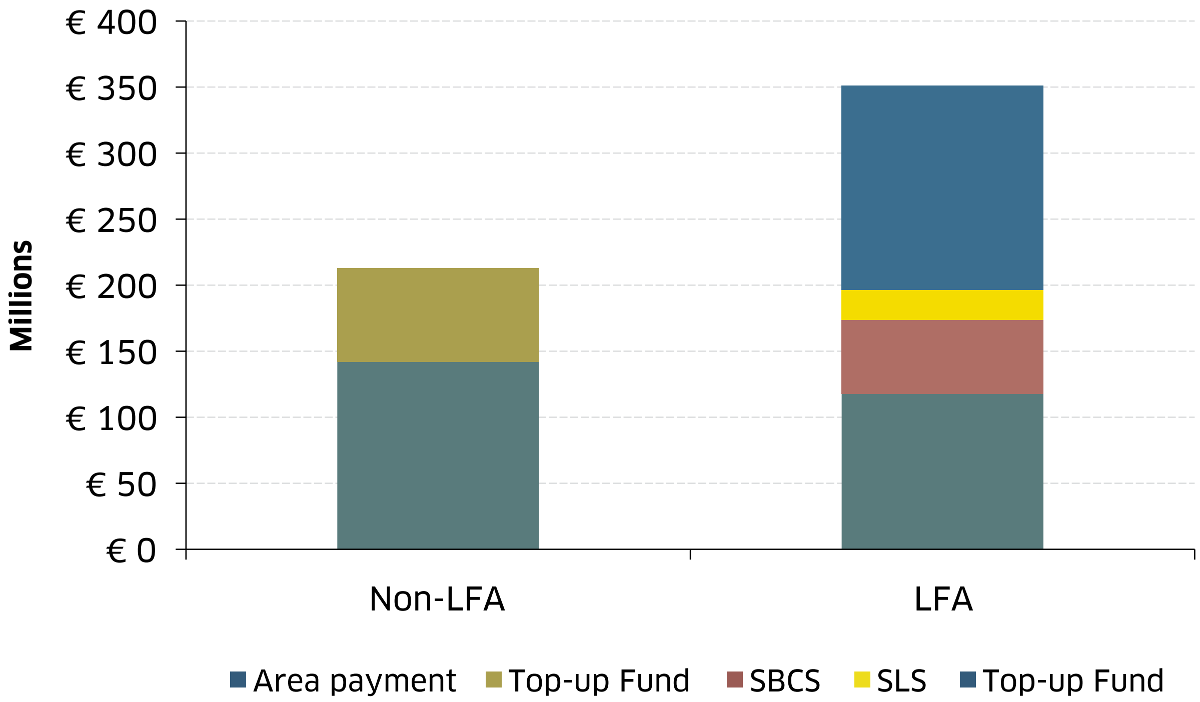

Figure 19: The Inquiry's allocation of the budget to Non-LFA and LFA and the proposed support structure

In presenting this model, the Inquiry also notes a number of key issues that must be considered:

Actual Values of Support - It is essential that readers see the values above for what they are – namely the Inquiry's view of the relative significance of the different elements of support and the split of the budget between the LFA and Non-LFA regions assuming a budget equivalent to the existing one. It is the rationale for the support and relative importance of the elements that should form the basis for discussion and not the absolute values.

Eligible Area - Area payments will only be paid on land that is agriculturally active (including approved environmental schemes). Agricultural activity is defined as growing crops, including rotational grass, producing food using the land (e.g. outdoor pigs) or utilising permanent pasture and rough grazing for domestic grazing livestock (including farmed deer) to a minimum of 0.12 livestock units (LU) per hectare. This is the figure suggested in the Interim Report which was widely discussed at the public meetings. On balance, this is considered to be the appropriate base to use.

Where the land is stocked but at a lower rate than the 0.12 LU per hectare, the area paid on will be scaled back to an area that equates to a stocking rate of 0.12 LU per hectare. The total area declared on the Single Application Form (SAF) will be subject to cross compliance.

The LFA/Non-LFA boundary – In practice, Scotland does not split conveniently into the two distinct land types, as there are farms comprising both LFA and Non-LFA land, and seasonal lets confuse this picture further. Whilst it is not the intention of the Inquiry to describe a detailed working system, it believes that it must provide some pointers as to how it will apply.

The treatment of the area based element of the annual direct payment is straightforward in that payments should correspond to land classification (i.e. Non-LFA and LFA). The land will have to be on the claimant's Single Application Form and in their control for 183 days.

The challenge arises with the headage payments and the calculation of SLRs to ensure that they only apply to activity carried out on LFA land. To this end it is envisaged that new systems will need to be developed to provide easily checkable information on livestock grazing. This information will also be required to assess land eligibility under the stocking rate requirement.

Cropping farms in the LFA – There are a number of mainly cropping farms in the LFA and their range of choices as to how to farm more competitively, means that they are better suited to the suggested Non-LFA support structure. The Inquiry suggests that these farms should be offered a one-off option to be treated as a Non-LFA farm from that point onwards. The previous land use pattern would have to support that it is a cropping farm through the SAF and the Integrated Administration and Control System (IACS).

Inquiry Recommendation 14: Mainly cropping farms (supported by previous years SAF & IACS) in the LFA should be given a one off opportunity to drop their LFA designation.

Impact assessment – The Inquiry has been able to draw upon economic modelling carried out by the Macaulay Institute and by Scottish Government, which is summarised in the Appendix. The analysis demonstrates how the LFA based approach is a better fit with the needs of Scottish agriculture than the approach illustrated in the Interim Report. However, the modelling carried out has not, in the time available, been extended to look at possible behavioural changes resulting from the changes in support and profitability, and knock on effects on land use and the environment. Nor has the modelling considered the proposed changes to LFASS. The Inquiry considers that Scottish Government should undertake further work to analyse these impacts before finalising its position.

Inquiry Recommendation 15: Further modelling work should be undertaken to look at possible behavioural changes resulting from the changes in support and profitability, and the knock on effects on land use and the environment. This work should include the impact of the proposed change to the LFASS.

5.5 The Future of the Less Favoured Area Support Scheme (LFASS)

The Inquiry's proposed method of delivering direct payments in Scotland in the post-2013 period relies on dividing Scotland into two regions, namely LFA and Non-LFA. This raises the question of the future of LFASS, and particularly whether it should be dealt with under Pillar 1. Whilst one can present an argument as to why the majority of LFA support needs can be provided by a properly targeted Pillar 1, this does beg the question as to what happens to the funds currently held in Pillar 2 support schemes.

Currently in Scotland, of the €105 million EU money in Pillar 2, some €82 million comes from modulated funds (both voluntary and compulsory) out of Pillar 1. Effectively therefore, a proportion of the current LFASS budget is funded from

Pillar 1. It makes sense that in future budget periods, money is allocated to the purpose intended – i.e. to Pillars – rather than having to rely on a vehicle like modulation to finance Pillar 2.

The Inquiry recommends that €45 million of the total LFASS budget (currently in Pillar 2) is paid out under Pillar 1 direct payments as a supplement to the Top Up Fund in the LFA region. This would add approximately €1,800 to the current Top Up Fund of €6,400 per SLR.

This leaves €25 million in Pillar 2 to be directed at the areas suffering extreme handicap as the areas at greatest risk of land abandonment – hereafter referred to as 'the Vulnerable Area'. A reduction in agricultural activity in these areas could result in large-scale negative economic, environmental and social impacts.

The Inquiry believes that the Vulnerable Area eligible for this support needs to be carefully defined. The defined area will include all of the current Very Fragile Area (i.e. all of the Islands) plus part of the Fragile Area. In defining the area, the objective will be to identify areas within the current Fragile designation which suffer from disadvantage due to natural handicaps, similar to that endured by the Very Fragile Area. There is good precedent from elsewhere in Europe (including Sweden, Italy and Germany) for defining the Vulnerable Area based on bio-physical criteria such as: an exposed, maritime climate; poor soils with high rainfall; high salinity; a predominance of small fragmented units; extreme remoteness; steep slopes and a high altitude; and a predominance of rugged land with very limited in-bye.

There is no doubt that such a Vulnerable Area is capable of achieving high levels of multifunctionality – biodiversity, amenities, carbon sequestration and food production, leading to essential economic activity – under the appropriate management regime. But, given that this area suffers from much more extreme natural handicap than the remaining LFA, it requires increased public support to ensure it survives to deliver the many public goods expected of it. It is therefore proposed that only the Vulnerable Area qualifies for support under Pillar 2 funding and that this funding is very much aimed at maintaining the type of very extensive farming systems that are the backbone of the delivery of the public goods in these areas. It is proposed that this supplement is paid on an area basis using the area established for direct payments (i.e. it would be additional to the base area payment).

As this additional funding for Vulnerable Areas comes from the co-financed Pillar 2, the Inquiry is content that the necessary funding will be available to ensure the public benefit potential is realised.

Inquiry Negotiating Point M: Modulation to create rural development funding should not be a feature of EC Regulations post-2013. The budget should be allocated to the objective intended. €45million currently modulated to Pillar 2 should stay in Pillar 1 to deal with the LFA (areas of natural handicap) as an area payment.

Inquiry Negotiating Point N: The rules must allow a Member State to designate an area or farm systems that can receive special aid due to the vulnerability of the area or farm systems to abandonment. This aid would be co-financed in Pillar 2.

Inquiry Recommendation 16: A new Vulnerable Area, including all of the current Very Fragile Area and some of the Fragile Area, should be defined. Definition should be on the basis of bio-physical criteria such as: an exposed maritime climate; poor soils with high rainfall; high salinity; a predominance of small fragmented units; extreme remoteness; steep slopes and a high altitude; and a predominance of rugged land with very limited in-bye. This Vulnerable Area would receive an additional area payment from the special aid fund (i.e. the balance of the LFASS budget remaining in Pillar 2).

5.6 The future of the Scotland Rural Development Programme (SRDP)

As described in Section 3.3.2 of this report, the SRDP forms Pillar 2 of the CAP in Scotland and is co-financed by the EU and the Scottish Government. Rural development support is targeted particularly at the delivery of public goods and, as such, is outcome focused support. The SRDP is an ambitious programme of support as it brings together a real mix of previous schemes and it includes rural communities and organisations as beneficiaries, in addition to farmers and their families. When launched, the SRDP was viewed as very innovative in terms of both the measures that it covers and the funding application processes involved. The Inquiry believes that it is important that the problems encountered in applying the SRDP schemes should not limit future ambition and innovation. The Inquiry is aware that the absence of an appropriate IT platform at the time of the launch of the Programme was a major limitation. It hopes that the lessons regarding the importance of having such a platform in place in order to deliver such an innovative Programme have been learned.

The main emphasis of the SRDP is on improving business viability, enhancing biodiversity and the landscape, improving water quality, tackling climate change and supporting thriving rural communities. As outlined in Chapter 3, Pillar 2 is characterised by three axes, complemented by a methodological axis dedicated to the LEADER approach. Scotland took the approach of providing an integrated set of measures designed to deliver outcomes across the three axes. Measures in the SRDP are delivered through a number of schemes, with the three main schemes being Rural Development Contracts, LFASS and LEADER. Other schemes include the Crofting Counties Agricultural Grant Scheme, the Food Processing, Marketing and Co-operation Grant Scheme, Forestry Commission Challenge Funds and Skills Development Scheme.

The Inquiry recognises the importance of the SRDP to rural Scotland and concurs with its broad objectives which, if applied effectively, should make a real difference to Scotland's rural businesses and communities. However, a major piece of work would be required by the Inquiry in order to enable it to provide meaningful commentary about a future rural development scheme for Scotland, including an objective assessment of the current scheme and how it has performed, particularly in terms of how effective it has been in achieving its objectives.

Completely independently of this Inquiry, a mid-term evaluation of the SRDP has commenced and it will report by 31st December 2010. This evaluation is being carried out to satisfy European Commission regulation number 1978/2005. The European Commission has set the following objectives for this mid-term evaluation:

- To assess the degree of utilisation of resources, the effectiveness and efficiency of the programming, its socio-economic impact, and its impact on the Community priorities
- To review the goals of the Progamme and aim to draw lessons concerning rural development policy
- To identify the factors that contributed to the success or failure of Programmes' implementation and the identification of best practice
- To propose measures to improve the quality of the Programme and its implementation.
- The evaluation must accord with the guidelines for mid term evaluations, set out by the European Commission.

This project, in addition to the first stage review carried out by Peter Cook[52] in early 2009, will provide the evidence base required to make informed comments about the future direction and budget for rural development in Scotland. Therefore the Inquiry has opted to focus most of its attention on the future of Pillar 1. The main exception to this is the Inquiry's proposal for the future of Pillar 2 LFASS (which makes up a large proportion of SRDP spending), which was considered in the context of the proposal to distribute Pillar 1 funding in different ways, using the LFA/Non-LFA classification to divide Scotland. The proposal shifts support (with some of the budget) for the main LFA land to Pillar 1 leaving only the area of severe natural handicap (the current Very Fragile Area plus some of the Fragile Area, termed the Vulnerable Area by the Inquiry) to be supported under Pillar 2.

However, in the context of its broader proposals for Pillar 1 and the rationale for them, the Inquiry wishes to make a number of comments with respect to the future of the SRDP.

The first point to note is in relation to the need for flexibility in Pillar 2 to allow Member States more freedom to achieve the priorities most appropriate for them, using the methods that are most appropriate for their situation. The Inquiry acknowledges the moves that the EU is making in this direction but would encourage further efforts to minimise the bureaucracy and rigidness associated with Pillar 2 (for example, through the axis structure) to encourage innovative ideas for projects.

A related point is to note the innovative approach taken by Scotland to deliver support through cross-axis rather than discrete schemes. Peter Cook's report contained some (short and long term) recommendations for improving the way in which these schemes are delivered and the Inquiry would support these. The Inquiry also notes the approach taken by Scotland to provide a relatively long list of options to potential applicants. Whilst this is commendable in that it offers a great deal of choice, it does mean that some options have low take-up rates and thus their value-for-money can be questioned. The Inquiry's instinct is that there should be fewer measures with higher payments attached to each with a minimum payout (perhaps £1,500).

Secondly, it is important to note that one of the overriding principles guiding the Inquiry's proposals with regard to Pillar 1 is the need to achieve more with the money that is given to farmers and land managers through direct payments. The

52 Cook, P. (2009) Scotland Rural Development Programme, First Stage Review, P&L Cook and Partners (May). Available at: http://www.scotland.gov.uk/Resource/Doc/197434/0082253.pdf.

intended outcome is to develop more sustainable food production with additional activity in the form of achieving environmental - water, energy, climate change, biodiversity - benefits (i.e. addressing the global challenges). Given that farmers are being asked to undertake such additional activities through their Pillar 1 payments, it is important to think about the complementarities between Pillar 1 and Pillar 2 payments in future.

Thirdly, it is important to note the importance of capital grants measures available in Pillar 2 to assist in improving the competitiveness and diversification of the agricultural industry, particularly in the context of future pressures on the Pillar 1 (direct payments) budget. The Inquiry recognises that those farmers operating in Non-LFA parts of Scotland have more opportunities to improve their competitiveness and market orientation, but that more encouragement may be required for farmers operating in LFA land where opportunities for diversifying and responding to market shifts may be more limited.

Fourthly, the Inquiry recognises the importance of Pillar 2 (mainly Axis 2) measures designed to improve the environment and land management. The importance of Scotland's environment and biodiversity cannot be under-estimated and, given the direction of travel towards supporting farmers to deliver greater public benefits, it is vital that this support continues in Pillar 2, notwithstanding the need to ensure complementarity in priorities and approaches with the proposed Pillar 1 Top Up Fund. Decisions regarding specific schemes (related to woodland, for example) need to be taken by appropriate authorities (Forestry Commission Scotland in this case), in the context of agreed Scottish Government targets, debates regarding climate change adaptation and mitigation, and debates regarding the future of land use in Scotland[53]. More broadly, the question remains as to whether future agri-environment schemes should be highly targeted (for example, in terms of focusing on SSSIs only with strict conditions attached) or broader in terms of their coverage (for example, funding an entry level scheme in which all are eligible but for which the requirements are lowered). The first stage review report highlighted a potential gap at entry level and the Inquiry would very much support the view that a "key principle must be the involvement of as many land users as possible in environmental improvement". The Inquiry would be keen to see the future SRDP develop new ways of achieving a much wider uptake of environmental improvement schemes.

Fifthly, the Inquiry recognises the importance of funding for the economic diversification of rural areas and for community-led projects through the LEADER approach. It is vital that alongside payments to farmers for food production and for the provision of other public goods, funding is available to other rural actors (including individuals, businesses and community groups) to pursue the economic and social development of their local areas. Based on its knowledge and experience of LEADER programmes (an Inquiry committee member is currently a LAG member and the Inquiry Chairman was a LAG Chairman for LEADER II), the Inquiry believes that greater use of the LEADER approach could be made in future SRDPs. However, the Inquiry also shares Cook's view that there must not be duplication of measures nor inconsistencies between LEADER and other delivery mechanisms.

53 See the recently launched Draft Land Use Strategy for Scotland. Available at: http://www.scotland.gov.uk/Publications/2010/09/23100015/0

Inquiry Negotiating Point O: Member States need greater flexibility in Pillar 2 to provide them with freedom to target the priorities most appropriate to them, using the most suitable methods for their situation.

Inquiry Recommendation 17: The problems encountered in applying the SRDP should not limit future ambition and innovation. Rather they emphasise the necessity of having IT systems fit for purpose and available at the outset when implementing new schemes.

Inquiry Recommendation 18: The future SRDP should have more emphasis on a broad and shallow approach to agri-environment schemes to ensure there is a much wider uptake.

Inquiry Recommendation 19: The LEADER delivery mechanism should have a greater role to play in the future SRDP, but there must be clarity between the different delivery mechanisms.

5.7 The Inquiry's perspective on market support

In addition to setting out its recommendations for the support system going forward, and the principles on which that support system is based, the Inquiry would also like to offer its perspective on the issue of market support. In its Interim Report, the Inquiry noted the lack of effective support for market prices and it welcomed contributions to the consultation on this challenge but in the event there was little meaningful forthcoming.

Accordingly, the Inquiry commissioned a review of literature conducted by the Scottish Government[54] and notes that the variable nature of the economic and physical environment affecting agricultural production means the farming industry faces significant challenges in dealing with a wide range of risk factors, including the weather, markets, animal and plant health and the changing economic and policy environment. Although some of these risk factors are in common with other industries, the Inquiry finds that many are unique to farming and agricultural policy has an important role to play in helping the industry deal with them. As noted in the Inquiry's Interim Report, issues around risk and risk management in agriculture are becoming increasingly important as we move into an era of increased volatility in agricultural commodity markets. In addition, projections for extreme weather events and increased risk of plant and animal diseases with climate change further highlight the future challenges for the agricultural industry when it comes to risk management.

The Inquiry acknowledges that current arrangements under the CAP already have a positive impact on the risk environment affecting EU agriculture – primarily through market support instruments and direct payments stabilising prices and farm incomes. It recognises the need for more targeted policy measures to address the various risk factors affecting the industry and notes the interest in yield risk insurance, futures markets and mutual funds. This is a view that was also strongly echoed in responses to the Inquiry's consultation.

54 Scottish Government (2010) Risk and risk management strategies in agriculture: an overview of the evidence (August). Available at: www.scotland.gov.uk/BrianPackInquiry.

The Inquiry recognises that risk factors and attitudes towards risk are specific to farm businesses and thus a blanket approach to managing risk through policy will not always be the most efficient way of dealing with the challenge. Thus, the Inquiry does not suggest that agricultural policy becomes the sole mechanism for addressing risks in agriculture. It merely acknowledges the strategic role that policy has to play in providing an environment that enables more farmers to engage with the wide range of risk management tools that are available.

From its review of risk management in agriculture, the Inquiry finds that lack of information on a range of risk factors in agriculture presents a challenge for the efficient working of some of the risk management tools. Second, it finds that not all farmers have a sufficient understanding of how the different risk management tools operate. Further, use of some of the tools (e.g. futures markets) incurs significant costs, which can be a factor inhibiting their use – especially by small farm businesses. Against this background, the Inquiry identifies the need for policies to address some of the institutional factors inhibiting growth in the use of economic and financial tools for managing risks.

In its Interim Report, the Inquiry recognised that the lack of effective market price support exposes farmers to greater market volatility which can be a source of significant difficulties for the industry. While the Inquiry welcomes continued CAP market support aimed at providing a safety net against extreme price movements, it also calls for a more flexible approach to current market intervention. Further, as it will take time for private markets for risk management tools to expand, the Inquiry recommends that other policy mechanisms for managing price risk should be made available to EU farmers in the meantime. In particular, the Inquiry notes that a marketing loan scheme introduced at EU level would provide farmers with a mechanism for bridging cash flow gaps should they wish to withhold their produce in response to short term falls in prices, thus expanding the existing use of private storage in managing market risks. The Inquiry offers this as an idea worthy of further work to establish how such a scheme might work and its likely effectiveness in stabilising markets in the face of short term shocks and thus in protecting farm incomes from short term falls in prices.

Finally, the Inquiry notes that the fragmented nature of the EU agricultural industry into small businesses means that many farms will face cost barriers when it comes to the use of some of the market-based risk management tools. The Inquiry therefore recommends measures to facilitate small businesses coming together to share costs arising from the use of some of the market-based instruments. It sees the growth and strengthening of producer organisations across all sectors of EU agriculture as an important step to achieving this goal. Such measures would also contribute to improving the competitiveness of EU agriculture by strengthening the overall position of primary producers through measures to improve transparency in agricultural markets and power when building other contractual relationships along the supply chain. This is particularly important given the increasingly complex agri-food supply chain relationships now confronting the farming industry.

Inquiry Negotiating Point P: The provision of safety-net intervention should continue and be developed to become a more effective tool in preventing price collapses.

Inquiry Negotiating Point Q: A pan-European project should be carried out to establish the effectiveness and costs/benefits of a marketing loan scheme. This would bridge cash flow gaps in the event that producers withhold their produce from the market in response to short term price falls.

Inquiry Recommendation 20: Financial and regulatory assistance should be provided to help strengthen producer organisations to ensure they become a more effective part of the supply chain and they are not overly hampered by competition rules.

5.8 The role of the EU in administering CAP funds

The Inquiry believes that a critical over-arching issue which must be addressed in considering the future of any agricultural support system is the administration of the budget.

The CAP has gone through a long period of continuous change in order to ensure that it has a shape that is relevant to the challenges agriculture faces right across Europe. The 2013 reforms will once again produce a slightly different shape to the CAP to ensure that it is relevant to farmers and wider society. However, over time, it would be reasonable to say that the administration of the CAP from an EU perspective has become more detailed and more restrictive. It is the view of the Inquiry that this ever-increasing bureaucracy is gradually throttling the policy innovation that is so essential to the development of the diverse EU of 27 Member States.

Whilst it is relatively easy to accept that the level of detail to which the EU audit process works is too intricate, it is more difficult to identify the cause. In discussions with officials both in Scotland and in Brussels, the Inquiry concludes that the ever-increasing level of detail required in the audit process is a result of the requirements of the European Court of Auditors. From a political perspective, the attractiveness of detailed auditing is easy to see. However, it is the Inquiry's view that a much larger mesh to check conformance is essential if Europe is not to strangle itself and impose impossible burdens on Member States' administrations.

Another worrying aspect of the current system is that the overall budget for the CAP is drawn up on the basis of a percentage of Member State funding being disallowed due to breaches that are identified in the audit process. With the current financial discipline there is little spare budget to cope with the need for any one off market support that might arise. Disallowed funds are relied on to finance these unexpected requirements to keep expenditure within the budget. Whilst the Inquiry accepts that European funds should be applied to the purpose for which they were intended, it is essential that a proportional approach is taken to checking and reclaiming money. The Inquiry believes that this must be based on a cost-benefit analysis, where if the cost of ensuring almost total adherence is way above the perceived benefit, a different approach should be taken. It is the Inquiry's position that the EU must change its approach to audit if a reformed CAP is to be more outcome driven.

The difficulties in introducing and then administering the SRDP are widely appreciated, but what seems to be less appreciated is the extent to which these difficulties are driven by the highly inflexible approach of the European administrators. On introducing the SRDP, Scotland took a very ambitious approach with the emphasis on delivery mechanisms for a wide range of objectives rather than the narrow axis basis set out at European level, and under which accounting procedures are framed. This mis-match immediately creates problems for Scotland particularly given that the IT systems were not well developed when the scheme was introduced.

The Inquiry believes that once the EU has agreed what the common policy should be, with suitable allowances for territorial differences within Member States, then Member States should be given more discretion to ensure that the money is used for the purpose for which it is intended with only a high level overseeing role for the EU central administration. Such an approach is vital if Europe is to ensure that future support mechanisms cope with the diversity across and within Member States. The Inquiry welcomes recent early signs that the EU recognises the need for more flexibility and less rigid bureaucratic procedures in the future CAP, and would encourage further moves in this direction as reform progresses.

Given the role of Pillar 1 in providing the essential underpinning to ensure that Europe has a sustainable agricultural industry, the Inquiry believes that once the allocation to a Member State has been agreed, then that money should be used in the Member State. Using this approach removes the temptation to look for disallowances for budget balancing purposes. It also ensures that the Member States have a suitable incentive to ensure that funds are used not only to achieve the EU's objectives, but also the Member States' sub-objectives within those. Currently the incentive is to spend all of the money in the budget year otherwise the money is lost. If Europe is to show that it is committed to outcome-focused support, then the ability to roll funding forward for at least one year (or possibly for two years, as in the Rural Development Programme) is essential. Given the complexity and diversity of an EU with 27 Member States, it is also essential that the EU operates to at least a 10% tolerance level or preferably limits based on assessment of risk. Individual Member States will operate systems that ensure they stay within this tolerance, but also set their own internal tolerance levels to ensure that the accuracy of public expenditure falls within their national targets.

Inquiry Negotiating Point R: The EU should continue on its journey of less bureaucracy and greater flexibility in administering CAP funds:

- Ceilings for errors which lead to non-conformance must be set much higher than currently. 10% is seen as a reasonable margin for error
- Disallowance of Member State funding should not be an integral part of annual budgeting
- A proportional approach based on cost/benefit analysis of audit measures should be adopted
- Unspent Pillar 1 funds should be allowed to be carried forward by the Member State to at least the next budget year.

5.9 Conclusion

This chapter has presented the Inquiry's detailed proposals for a new support scheme for Scottish agriculture. The chapter started out by establishing two clear principles guiding the structure of future support. Firstly, that the CAP should retain two Pillars and that Pillar 1 should continue to be the most significant in terms of resources but that the Pillar 1 money should be directed towards ensuring that farmers deliver a much wider range of benefits for society. Secondly, that as direct payments exist to compensate producers for the higher costs associated with operating in a common market, the more productive (active) farms which face the highest costs of meeting such standards but which also have the highest potential to contribute positively to delivering the global challenges, should receive the highest payments.

The Inquiry proposes that the LFA/Non-LFA classification should be the basis on which payments are distributed in Scotland and that, in recognition of the different challenges and opportunities facing farmers in these two areas, different payment schemes should operate in each. Farmers in the LFA should be supported by three mechanisms: area payments, a Top Up Fund and headage payments. Farmers in the Non-LFA should be supported in two ways: area payments and a Top Up Fund. Although it would be paid out on a different basis in the two areas, the Top Up Fund has the same aim of achieving transformational change in the industry (i.e. tackling the global challenges) and delivering a more sustainable agriculture that produces food.

The Chapter has also set out the Inquiry's proposals for the conditions to be attached to direct payments and for the timing of change, with the Inquiry arguing strongly that the changes should all be adopted in one step, one year post reform. If this is not possible, the chapter has also set out the Inquiry's proposal for a new entrants scheme funded by a National Reserve. The chapter has also set out the Inquiry's model for how these schemes could be implemented, although it strongly encourages stakeholders to focus on the principles and suggested schemes at this stage, rather than on the model suggested.

The chapter has discussed the future of LFASS – arguing that the principle role of supporting the LFA should be subsumed into Pillar 1 leaving a smaller, more targeted LFASS in Pillar 2. The chapter goes on to deal with the SRDP more broadly and finally details the Inquiry's perspectives with regard to the need for market support in recognition of the risks faced by the industry and with regard to the administration of the CAP budget in future.

The chapter has also set out the Inquiry's main recommendations on matters where the Inquiry expects that Scottish Government will have discretion and the suggested negotiating points for the Scottish Government in discussions at UK and EU levels.

6 The implications of a large reduction in funding for Scotland

6. The implications of a large reduction in funding for Scotland

As outlined in Chapter 2, the Inquiry believes that Scotland should argue for a larger share of the overall Pillar 1 funding coming to the UK in the 2013-2020 period. Similarly Scotland would expect to gain if the EU looks for equity in the allocation of rural development funding across Member States (the UK receives the lowest budget on a per hectare basis). The Inquiry would expect the Pillar 1 budget to be maintained given the increasing demands that are being placed on farmers to act in a truly multifunctional way to meet the global challenges. However, the Inquiry recognises the immense pressure on public budgets due to a number of factors which may mean a reduction in support to agriculture and rural development in future. These factors include the growth in the number of EU Member States and the associated need to spread funds more thinly, and the global financial downturn and associated efforts by governments to reduce national deficits. Such a reduction would severely dent the ability of the Scottish Government to meet its objective of sustainable economic growth. It would also make the target of 'more for less' more difficult to attain and severely limit the ability of the agricultural sector to help tackle the global challenges. Depending on the severity of the cutbacks Scotland's very food security could be endangered.

This chapter outlines the Inquiry's guidance as to how the money should be allocated in the event of large reductions in the money available in the next funding period.

6.1 Reduction in Pillar 2 funding

A cutback in Pillar 2 funding for rural development would be most unfortunate. It will slow down the progress being made on improving the competitiveness and environmental credentials of agriculture and endanger the ongoing development of renewable energy sources and the projects to help diversify farm income and to encourage tree planting. A reduced budget for Pillar 2 would also have a negative impact on the wider rural community, bearing in mind that its coverage is not limited to the farming sector.

A reduced SRDP budget will require greater targeting of funding at those measures considered to have the greatest impact on developing a more sustainable agricultural industry contributing to Scotland's sustainable economic growth. The results from the current mid term review, together with those from the first stage review completed in early 2009, should inform the choice of schemes and measures.

The Inquiry recommended that mainstream LFA support is provided as direct farm payments in Pillar 1 but that areas of specific natural handicap, referred to as the Vulnerable Area, continue to receive co-funded support under a more targeted Pillar 2 scheme. Given that the main argument for supporting these areas is to avoid the high risk of abandonment and the loss of public goods (particularly the maintenance of fragile communities) it would be foolhardy for Scotland to reduce support and set off a chain of irreversible actions. One such action might be the loss of active crofting to Scotland, which the Inquiry believes is unthinkable. Accordingly, the Vulnerable Area should be given priority for scarce funds.

Equally, some priority will need to be outlined for the reduced funds to ensure that the good work done to date is not lost and instead is used as a platform for future development (for example, it would be wrong to lose units that have fully converted to organic whilst encouraging new conversions).

The Inquiry also believes that it will be essential to provide funding for legacy schemes from the 2007-2013 period. Based on the carry over in 2007, this could well be in the order of €300 million, although this will depend on activity over the next two years, and in particular the outcome of the Spending Review which could force the Scottish Government to cut its commitment to the joint funding of the SRDP.

With respect to capital grants, this is likely to be an area that would incur fairly large cuts. The Inquiry acknowledges that in an environment of fierce competition for public funds, it is difficult to put forward convincing arguments for large capital grants for transformational change in agriculture and for community projects.

6.2 Reduction in Pillar 1 funding

The Inquiry's belief is that the industry could adjust albeit with difficulty – some sectors more than others – to an overall cutback in the direct payments to Scottish agriculture of 15%. However, there would be an inevitable loss in the public benefits produced, including a loss of food production. As the data showed in Table 1 (Section 3.2) some farms, and particular farm types, are unprofitable without subsidies.

In arriving at the mechanism for providing future support to Scottish agriculture (as outlined in Chapter 5), it was recognised that Scotland naturally divided into three categories for future support. These are: our better land which does not suffer from natural handicap (Non-LFA land); land that suffers from natural handicaps (LFA land); and land that suffers from more extreme natural handicap, namely altitude and distance from market, particularly due to an island location (termed the Vulnerable Area by the Inquiry). The Inquiry has identified that Scotland's Non-LFA land has considerable choice in terms of what it produces and how, with decisions driven by market forces with a low or even zero chance of land abandonment. In contrast, the large area of land in Scotland with natural handicap (LFA) relies on ruminants to convert its considerable area of rough grazing and permanent pasture into food, and has little choice as to what to produce. There is a high possibility of land abandonment in this area. However, properly supported, this land can make a substantial contribution to sustainable economic growth.

The third area of Scotland - namely that with extreme natural disadvantage, in particular Scotland's island locations (the Vulnerable Area), requires support for the public goods that it can deliver, not least the maintenance of remote and fragile communities and of landscape with the likelihood of large scale abandonment without such support. Using this division of Scotland and remembering our goal of sustainable economic growth it becomes clear where future scarce public support should be directed.

In Chapter 5, it was argued that Scotland's most productive land has more to contribute in terms of food security, but faces greater exposure to increased regulation and price volatility and potentially larger challenges in improving its sustainability, and more scope to deliver against global challenges. Thus it was argued in order to ensure a fair distribution of agricultural support in Scotland, this land should receive higher rates of support. However, in a situation of large-scale budget cuts, this area, with little or no chance of land abandonment and the greatest chance of adjusting to less support, must shoulder a disproportionate share of the cuts. Accordingly with a cut of over 15% in the total Pillar 1 budget, additional reductions in payments should be focused on this land class first. It is believed that this area could accommodate an additional Pillar 1 budget reduction of 15% (that is, 30% in total) with a 50% cut in its support budget (that is area payment plus Top Up Fund). This would leave some compensation for farmers to maintain their farm in good environmental and agricultural condition leaving the business to carry the costs of increased regulation and to provide a cushion against price volatility. However, if the budget reduction could not be accommodated by even a 50% cut in the payments, then the funding to the LFA would need to be cut.

As the concept of using direct payments to encourage farm businesses to help deliver against the global challenges and improve sustainability was based on the maintenance of the current budget it is believed that major cutbacks in Non-LFA support would rule out the delivery of outcomes additional to food production in this area.

At budget cuts of over 30% the support to the LFA must be reduced above the 15% across the board cut. With this area consisting of over 70% rough grazing the Inquiry believes that the coupled payments in the form of the Scottish Beef Calf Scheme and the Scottish Lamb Scheme must be maintained at 85% of the rates mooted in the report (that is, only incur the 15% across the board cut). It is acknowledged that this would effectively mean that these schemes therefore make up a larger proportion of the total as a result of the reduction in the budget and may struggle to qualify under the maximum support permitted. Given that the other major source of support for the LFA is applied through the Top Up Fund mechanism, it is this Fund that will have to take the final cut to balance the overall budget. That is, if Pillar 1 funding is cut by more than 30% the Top Up Fund for the LFA will have to absorb the additional cut. Depending on the severity of the cut, this may mean an inevitable loss in the important outcomes sought through the Top Up Fund.

Inquiry Recommendation 21: In the event of a large budget reduction in Scotland's Pillar 2 funding:

- The results from the current mid term review and from the first stage review completed in early 2009 should be used to inform the targeting of funding to develop a more sustainable agricultural industry
- Priority should be given to funding for areas of specific natural handicap, that is the Vulnerable Area
- Priority needs to be outlined for the reduced funds to ensure that the good work done to date is not lost
- Funding for capital grants should incur fairly large cuts.

Inquiry Recommendation 22: In the event of up to a 15% cut in Pillar 1 funding, the reductions should be spread evenly over all direct payments. If the cuts are greater than 15% but less than 30%, the Non-LFA support should be cut by up to 50%. If the Pillar 1 budget is cut by more than 30% then the Top Up Fund for the LFA will have to bear the balance of the cut.

7 Recommendations to the Scottish Government

7. Recommendations to the Scottish Government

The final chapter of the report returns to the remit of the Inquiry, which was set out in detail in Chapter 1, and summarises the Inquiry's key recommendations and negotiating points.

In broad terms, Richard Lochhead asked that the Inquiry *"make recommendations to the Scottish Government on how financial support to agriculture and rural development can best be tailored to incentivise delivery of the Scottish Government's purpose of sustainable economic growth, and in particular its vision for thriving agricultural and rural sectors based on natural resource productivity, in a world increasingly recognising the need to address the challenges of climate change and biodiversity loss"*.

The specific remit of the Inquiry was to examine and provide recommendations in the following areas:

- How Pillar 1 funds (i.e. the Single Farm Payment in Scotland) might be best distributed in future, for example between regions of Scotland and/or land types, in order to contribute to the Government's purpose and vision
- The conditions to attached to Pillar 1 payments in the future to secure public benefits commensurate with those payments, and the relationship with the Less Favoured Area Support Scheme
- The link between payment levels and farming activity
- The situation of agricultural holdings currently outside the Single Farm Payment system, and new entrants to farming
- How to address the risk of a smaller Single Farm Payment budget for Scotland after 2013, taking into account the generally-held expectation of severe pressure on that part of the EU budget
- The future balance between Pillar 1 and Pillar 2 of the CAP in Scotland, including the role of support for transformational change to agricultural businesses, for collaboration, and for engagement between businesses in the different stages of the production chain
- Scottish priorities in future negotiations with the United Kingdom authorities and at EU level

Based on evidence-gathering from a wide range of sources and discussions with relevant stakeholders, the Inquiry has identified its goal for a more sustainable Scottish agriculture and its proposals for a future support scheme that will achieve this goal.

The Inquiry has put forward two sets of recommendations. The first set is 'Negotiating Points' for the Scottish Government to pursue in its negotiations at UK and EU level regarding the future of agricultural and rural development support. The second is a set of 'Recommendations' providing advice to the Scottish Government on matters where the Inquiry expects that the Scottish Government will have discretion in shaping the future system. The two sets of recommendations are summarised in this final chapter of the Report.

The Inquiry's Negotiating Points:

A. The shifts in the CAP over the coming years must fully recognise the nature and extent of the global challenges that agriculture is being asked to address (page 27).

B. Agriculture has a pivotal role in tackling the global challenges, and the CAP budget must be adequate for this purpose (page 28).

C. On the basis of equity, although the UK budget would be unlikely to change significantly, Scotland should receive a larger share of the future UK Pillar 1 (Single Farm Payment Scheme) budget. The UK should argue for an increased share of the EU Pillar 2 (rural development) budget which in turn would lead to an increase for Scotland (page 35).

D. The current CAP structure of two Pillars should be maintained (page 65).

E. The direct payments budget should be maintained at its current level, but Pillar 1 payments must more clearly deliver public benefits by delivering against the global challenges (page 68).

F. The introduction of a cap on individual business payments should be resisted on the basis that it would be at odds with the justification for the payments. If a cap was introduced it would prove ineffective as those businesses likely to be affected would be split into multiple businesses. Any attempt to prevent new business could have serious repercussions on genuine new entrants (page 69).

G. It is essential that future EU regulations recognise that eligibility criteria are required to assess land qualifying for direct payments. These criteria should be decided on an objective basis by Member States. They should include, in the case of land stocked below the minimum, the ability to scale back to an area that achieves the minimum (page 74).

H. The concept of allocating some direct subsidy payments to deliver public benefits – including the security of food, energy and water, tackling climate change and enhancing biodiversity – with payment levels (for the LFA only) based on the Standard Labour Requirements of a business is new to the EU. The European Commission and Parliament and the WTO need to fully understand and accept their rationale and purpose (page 76).

I. Given the extent of permanent pasture and rough grazing in Scotland, the importance of cattle and sheep production to the Scottish economy and the high risk of land abandonment, it is essential that Scotland's ceiling on coupled payments for the post-2013 period is 15% of total Scottish direct payments (page 77).

J. For Non-LFA land to qualify for area payments it has to support agricultural activity or be part of an approved environmental scheme (page 79).

K. Cross compliance, particularly GAEC, should not demand more of farmers than it currently does. The penalty system should be overhauled to ensure that it is proportionate (page 79).

L. The new EU regime post-2013 must allow Member States to create a National Reserve if required for new entrants by top slicing entitlements on an objective basis (page 81).

M. Modulation to create rural development funding should not be a feature of EC Regulations post-2013. The budget should be allocated to the objective intended. €45million currently modulated to Pillar 2 should stay in Pillar 1 to deal with the LFA (areas of natural handicap) as an area payment (page 85).

N. The rules must allow a Member State to designate an area or farm systems that can receive special aid due to the vulnerability of the area or farm systems to abandonment. This aid would be co-financed in Pillar 2 (page 85).

O. Member States need greater flexibility in Pillar 2 to provide them with freedom to target the priorities most appropriate to them, using the most suitable methods for their situation (page 89).

P. The provision of safety-net intervention should continue and be developed to become a more effective tool in preventing price collapses (page 90).

Q. A pan-European project should be carried out to establish the effectiveness and costs/benefits of a marketing loan scheme. This would bridge cash flow gaps in the event that producers withhold their produce from the market in response to short term price falls (page 91).

R. The EU should continue on its journey of less bureaucracy and greater flexibility in administering CAP funds:

- Ceilings for errors which lead to non-conformance must be set much higher than currently. 10% is seen as a reasonable margin for error
- Disallowance of Member State funding should not be an integral part of annual budgeting
- A proportional approach based on cost/benefit analysis of audit measures should be adopted
- Unspent Pillar 1 funds should be allowed to be carried forward by the Member State to at least the next budget year (page 92).

The Inquiry's Recommendations:

1. A Top Up Fund, as suggested in the Interim Report, has the potential to be a central part of a new contract between farming and society (page 27).
2. The highest payments should go to the more active farmers. These are the individuals who have the greatest potential to deliver sustainable agriculture - and therefore sustainable economic growth – but who also face the greatest challenge in doing so have the greatest potential to deliver (page 69).
3. Future direct payments should be distributed in Scotland on the basis of distinguishing LFA and Non-LFA land. This means that payments can be more clearly targeted and thus are more easily justifiable (page 70).
4. LFA land should be supported by a combination of three mechanisms: area payments, Top Up Fund and headage payments (page 73).
5. Land eligible for direct payments is all land growing crops, land involved in an environmental scheme or land supporting livestock with a minimum stocking rate deciding the area eligible (page 74).

6. A proportion of Pillar 1 funding should be used to create a Top Up Fund to encourage transformational change: in short, a more sustainable agricultural industry which contributes towards tackling the global challenges. In the LFA this money should be allocated on the basis of the Standard Labour Requirements of a business (page 76).
7. An expert group should be established to work on the methodology to be applied for establishing the eligibility for the Top Up Fund. The over-riding principle must be that this is a positive process that farmers and land managers can fully engage with to the benefit of their business and wider society. It is envisaged that web based applications and industry self-policing will be part of the solution (page 76).
8. A more targeted SBCS should be established paying higher rates per head for smaller herds (under 40 cows) and even higher rates for very small herds (under 15 and under 5 cows). The graduated rates should be paid on calves over 30 days of age with 75% beef genetics but calves with 50% beef genetics should be eligible for the flat rate payment. The basic rate should be much higher than the current SBCS. The total annual budget for this scheme should be fixed at the outset (page 78).
9. A lamb headage scheme should be developed, with a flat rate payment on all lambs born on the holding of birth after 60 days of age. However, it is essential that such a scheme has integrity (i.e. that it only pays on lambs born in the eligible area and only once per head). If traceability has not advanced such that this integrity is guaranteed then a scheme should not be implemented. The total annual budget for this scheme should be fixed at the outset (page 78).
10. The Non-LFA region of Scotland should receive direct support on an area basis with two thirds straight area payment and one third Top Up Fund. The Top Up Fund would be focused on developing a more sustainable agriculture as with the LFA Top Up Fund (page 79).
11. The Scottish Statutory Instrument that currently exempts breaches of GAEC that can in theory be rectified by the end of the following growing season should be reviewed in the light of experience (page 79).
12. The change from the current historic base for the SFPS to the Inquiry's approach outlined here should take place as soon as possible after the European negotiations are complete. This may mean that the existing system has to continue for one year with the new system adopted in one step thereafter (i.e. in 2014 at the earliest) (page 80).
13. If the change to a new regime is going to be a protracted process, all legal entities who started in business since 2003 and before 2010 and were not awarded entitlement should be allocated entitlement from the National Reserve, in order to provide parity. The National Reserve should be created by top slicing high per hectare value entitlements – possibly over €600 (page 81).
14. Mainly cropping farms (supported by previous years SAF and IACS) in the LFA should be given a one off opportunity to drop their LFA designation (page 84).
15. Further modelling work should be undertaken to look at possible behavioural changes resulting from the changes in support and profitability, and the knock on effects on land use and the environment. This work should include the impact of the proposed change to the LFASS (page 84).

16. A new Vulnerable Area, including all of the current Very Fragile Area and some of the Fragile Area, should be defined. Definition should be on the basis of bio-physical criteria such as: an exposed maritime climate; poor soils with high rainfall; high salinity; a predominance of small fragmented units; extreme remoteness; steep slopes and a high altitude; and a predominance of rugged land with very limited in-bye. This Vulnerable Area would receive an additional area payment from the special aid fund (i.e. the balance of the LFASS budget remaining in Pillar 2) (page 86).

17. The problems encountered in applying the SRDP should not limit future ambition and innovation. Rather they emphasise the necessity of having IT systems fit for purpose and available at the outset when implementing new schemes (page 89).

18. The future SRDP should have more emphasis on a broad and shallow approach to agri-environment schemes to ensure there is a much wider uptake (page 89).

19. The LEADER delivery mechanism should have a greater role to play in the future SRDP, but there must be clarity between the different delivery mechanisms (page 89).

20. Financial and regulatory assistance should be provided to help strengthen producer organisations to ensure they become a more effective part of the supply chain and they are not overly hampered by competition rules (page 91).

21. In the event of a large budget reduction in Scotland's Pillar 2 funding:

    - The results from the current mid term review and from the first stage review completed in early 2009 should be used to inform the targeting of funding to develop a more sustainable agricultural industry
    - Priority should be given to funding for areas of specific natural handicap, that is the Vulnerable Area
    - Priority needs to be outlined for the reduced funds to ensure that the good work done to date is not lost
    - Funding for capital grants should incur fairly large cuts (page 97).

22. In the event of up to a 15% cut in Pillar 1 funding, the reductions should be spread evenly over all direct payments. If the cuts are greater than 15% but less than 30%, the Non-LFA support should be cut by up to 50%. If the Pillar 1 budget is cut by more than 30% then the Top Up Fund for the LFA will have to bear the balance of the cut (page 97).

Appendix: Assessment of the Impact of Pillar 1 Payment Scenarios on Farm Businesses

From an early stage the Inquiry was of the view that a country-wide, purely area-based approach to Pillar 1 support would not meet Scotland's needs. In the Interim Report it set out for consultation one illustration of an approach intended to better address those needs, which used the Macaulay Land Capability for Agriculture (LCA) system as a means of differentiating between types of land and, to an extent, levels of agricultural activity.

After that consultation, the Inquiry was able to commission the Macaulay Institute to model the impact of this and other scenarios on farm support payments at individual farm level. Full details of this analysis will be published shortly.

Not surprisingly, the analysis showed that any new scenario would be likely to result in very significant changes to the distribution of farm payments. However this work did not look at the impact of such changes on farm profitability, nor on further knock-on impacts like changes in land use and effects on the environment.

The Inquiry therefore commissioned Scottish Government analysts to carry out further modelling, using data from the Farm Accounts Survey (FAS), to look at impacts on income and profitability. The FAS collects detailed financial and economic data for eight farm types: Specialist Sheep (LFA); Specialist Beef (LFA); Cattle & Sheep (LFA); Cereals; General Cropping; Dairy; Lowland Cattle & Sheep; and Mixed. It is important to note that the FAS is a sample survey that is not representative of all Scottish farm businesses. The results using this data do however provide a good indicative assessment of how changes to farm support would impact on farm profitability.

LCA-based scenario

The scenario set out in the Interim report included payment rates equivalent to those shown in Table A1. Note that for the purposes of modelling it has been assumed that all farms make maximum use of their possibilities under the Top-Up Fund, payments for which are included in these rates.

Macaulay LCA	Interim Report Payment rates
Class 1 to 5.1	€ 246.84
Class 5.2 to 5.3	€ 85.44
Class 6.1 to 7	€ 28.48

Table A1: Payment rates for the Interim Report LCA-based scenario

Table A2 shows how this scenario would impact on total Pillar 1 support for each of the farm types, and Table A3 shows how these changes in support would impact on Farm Business Incomes (FBI).

	Baseline Pillar 1 Support	New Pillar 1 Support	Change in Pillar 1 Support	
			Amount	% of Baseline Pillar 1 Support
Specialist Sheep (LFA)	£18,957	£22,506	£3,549	19%
Specialist Beef (LFA)	£37,435	£26,412	-£11,022	-29%
Cattle & Sheep (LFA)	£39,734	£41,542	£1,808	5%
Cereals	£36,583	£20,830	-£15,754	-43%
General Cropping	£37,828	£22,640	-£15,188	-40%
Dairy (LFA)	£36,614	£24,079	-£12,535	-34%
Dairy (Non-LFA)	£29,267	£15,609	-£13,657	-47%
Lowland Cattle & Sheep	£31,849	£18,756	-£13,093	-41%
Mixed (LFA and Non-LFA)	£49,669	£25,030	-£18,155	-42%

Table A2: Impact of LCA-based Interim Report Scenario on Pillar 1 support

	Baseline FBI	New FBI	% Change in FBI
Specialist Sheep (LFA)	£16,268	£19,817	22%
Specialist Beef (LFA)	£27,105	£16,082	-41%
Cattle & Sheep (LFA)	£26,911	£28,719	7%
Cereals	£42,372	£26,618	-37%
General Cropping	£57,278	£42,090	-26%
Dairy (LFA)	£88,475	£75,940	-14%
Dairy (Non-LFA)	£58,391	£44,733	-23%
Lowland Cattle & Sheep	£23,338	£10,245	-56%
Mixed (both LFA and Non-LFA)	£44,513	£26,357	-41%

Table A3: Impact of LCA-based Interim Report Scenario on Farm Business Income

The tables above show that the generally more intensive farm types, which would have received high entitlements under the historic-based system, would see their payments reduce, while those with more land and a lower level of intensity would see increases. This general trend is, of course, to be expected under any change from the historic-based system to an area-based or mixed system.

However, the Inquiry considered that these figures demonstrated some weaknesses in the LCA-based approach. In particular this approach led to significant reductions in support across many of the farm types important to Scotland. These weaknesses, along with the technical difficulties associated with implementing an approach based on the LCA, led the Inquiry to consider other options, including options using LFA status rather than LCA to differentiate payments.

LFA-based scenario

The LFA-based scenario set out in this Report is based on the payment rates in Table A4. For the purposes of the analysis it has been assumed that the Non-LFA area top-up of €100/ha is always utilised to its full potential. It is important to note that the analysis only captures the direct financial impacts of the changes in support, and does not assess any consequences of farm businesses' reactions to changes in farm support.

	Target	Amount
Non-LFA:		
Area Payments	Per hectare	€200.00
Top Up Fund	Per hectare	€100.00
LFA:		
Area Payment	Per hectare	€30.00
Beef Headage Payment (per calf)	1 to 5, per head	€220.00
	6 to 15, per head	€190.00
	16 to 40, per head	€165.00
	Above 40, per head	€135.00
Dairy/Beef Headage Payment (per calf)	All, per head	€135.00
Sheep Headage payments (per lamb)	All, per head	€8.00
Top-up Fund: Standard Labour Requirement Payment (per SLR)	Per unit	€6,400.00

Table A4: LFA-based Scenario for CAP Pillar 1 Payments

Tables A5 and A6 show the impact of the LFA-based scenario proposed in this Report on total Pillar 1 payments by farm type and on FBI.

	Baseline Pillar 1 Support	New Pillar 1 Support	Change in Pillar 1 Support	
			Amount	% of Baseline Pillar 1 Support
Specialist Sheep (LFA)	£18,957	£26,760	£7,803	41%
Specialist Beef (LFA)	£37,435	£26,887	-£10,547	-28%
Cattle & Sheep (LFA)	£39,734	£43,712	£3,978	10%
Cereals	£36,583	£37,495	£911	2%
General Cropping	£37,828	£43,415	£5,588	15%
Dairy (LFA)	£36,614	£31,943	-£4,671	-13%
Dairy (NLFA)	£29,267	£25,101	-£4,166	-14%
Lowland Cattle & Sheep	£31,849	£32,585	£737	2%
Mixed (LFA)	£49,669	£31,827	-£17,843	-36%
Mixed (Non-LFA)	£45,128	£38,578	-£6,551	-15%

Table A5: Impact of LFA-based Scenario on Pillar 1 Payments

	Baseline FBI	New FBI	% Change in FBI
Specialist Sheep (LFA)	£16,268	£24,072	48%
Specialist Beef (LFA)	£27,105	£16,557	-39%
Cattle & Sheep (LFA)	£26,911	£30,889	15%
Cereals	£42,372	£43,283	2%
General Cropping	£57,278	£62,865	10%
Dairy (LFA)	£88,475	£83,804	-5%
Dairy (Non-LFA)	£58,391	£54,225	-7%
Lowland Cattle & Sheep	£23,338	£24,075	3%
Mixed (LFA)	£45,693	£27,851	-39%
Mixed (Non-LFA)	£53,193	£46,642	-12%

Table A6: Impact of LFA-based Scenario on Farm Business Income

Table A5 shows that making Pillar 1 payments on the basis of the LFA-based scenario would increase the amount of support going to Specialist Sheep (LFA), Cattle and Sheep (LFA), Cereals, General Cropping and Lowland Cattle and Sheep farms. The average Pillar 1 payments to Specialist Beef (LFA), Dairy (LFA), Dairy (Non-LFA), Mixed (LFA) and Mixed (Non-LFA) farms would fall.

Comments on the methodology

Under the LFA-based scenario the LFA status was determined by the share of a business's total area located inside or outside of the LFA, with the majority share determining the LFA status. For the LCA-based scenario the analysis drew on the Macaulay Institute research for the Inquiry. Both the LCA-based and LFA-based scenarios assumed the same overall Pillar 1 budget.

Any comparison between the results of the two scenarios has to be treated with caution, as the two scenarios are based on different payment criteria (LCA classes & LFA status) and different datasets, and assumptions had to be used in the estimation of impacts on farm businesses. This means that a direct comparison between the results for the two scenarios is not possible, although they do provide indicative estimates of the relative financial impacts on different farm businesses under each given scenario.

Another important caveat to this analysis is that the results only show the impact on the average farm within each farm type in the sample. These average farms are not a true industry average as the sample is only partly representative for the whole of Scotland.

In reality there would be a significant amount of variation within any given farm type. In particular this analysis does not consider varying levels of activity within farm type. However the level of activity both in the SFP reference period and in the future is a very important variable which will have an impact on the level of support under the scenarios. This means that the model is not able to show how more or less active farms within a farm type are affected differently. Businesses that have become less active since the reference period are likely to fare less well than these results suggest, as their relatively high baseline level of support is likely to be reduced. On the other hand relatively more active businesses will benefit more from the Top-Up Funds and the headage payments for LFA farms. The results above are therefore only an indicative estimate of the overall relative impact of the proposals between farm types. It is likely that within farm types the distribution of changes would be likely to favour the more active.

Further detail on the analysis of payments using FAS data, and a consideration of some wider economic impacts, will be published by the Scottish Government shortly.

Conclusions and further work

As described in this Report, the Inquiry believes that this modelling demonstrates that the LFA-based approach meets the needs of Scottish farming better than other scenarios, including the LCA-based one illustrated in the Interim Report.

The Inquiry notes that the analysis summarised here takes no account of changes in farm business behaviour that might result from the changes in support and FBI, including changes in pattern and intensity of land use which could lead to impacts on the environment. The Inquiry considers that Scottish Government should undertake further work to analyse these impacts.

The Scottish Government

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