

Inquiry into Future Support for Agriculture in Scotland

The Interim Report

Chairman: Brian Pack OBE



The Scottish
Government

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1. Introduction

Scottish agriculture is at a crossroads. The current European Union financial period comes to an end in 2013 and debates about the size of the agricultural support budget and the future of agricultural policy are already well advanced. On the one hand, we face significant global challenges—such as food security, water scarcity, energy security, biodiversity decline and climate change—which agriculture is well placed to help tackle. Yet, on the other hand, the total agricultural budget is expected to fall. Debates about the future of agricultural support therefore revolve around how best to achieve our goals. Some argue for a continuation of the reform process that is shifting the sector towards a much more market-led approach in which direct support for farmers has no role. Others want agricultural policy to focus on the delivery of public goods, while still others want agricultural policy to remain the same. But, as is clear from the fact that we continue to debate agricultural policy, there are no easy answers: each approach has its benefits and its drawbacks. So we, as a society, and Scottish Government in particular, face some difficult decisions.

To ensure that the Scottish Government received considered advice prior to making these difficult decisions, Richard Lochhead, Cabinet Secretary for Rural Affairs and Environment, asked that I undertake an Inquiry into the future of agricultural support in Scotland, reporting in April 2010.

On the basis of the evidence received to date, this interim report sets out some of the issues that we must consider in thinking about the future of support for agriculture and highlights some emerging ideas. The purpose of producing an interim report part way through the Inquiry is to stimulate further discussion about potential ways forward. It will hopefully provide a grounding for further engagement with interested parties in a series of public meetings and for a second consultation on specific policy options. This introductory section sets out some background on the Inquiry remit, the process and committee.

Remit of the Inquiry

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 deliver the Scottish Government's purpose of sustainable economic growth.

The specific remit of the Inquiry is to examine and provide recommendations on 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 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 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.

The purpose of the Inquiry is therefore not to rethink the Common Agricultural Policy. Rather, the Inquiry should identify the key issues that we face in Scotland and consider the sort of support that might be appropriate to help us address these issues. It should also consider how best to implement the CAP, what direction we should be travelling in within the confines of the options allowable under the CAP Health Check, and, given our preferred direction, what we should be arguing for in European debates about the future of the CAP.

Inquiry Committee

Brian Pack chairs the Inquiry. Brian receives assistance and advice from several other key figures with expertise in a range of sectors.

Brian Pack OBE

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

In addition to the Chair, several other members were appointed to the Inquiry committee to act as advisors. These advisors 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

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 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 M&S livestock supply chains and for interaction between the retailer and its Farmer producers.

The committee has met six times since September 2009.

Activities to date

The Inquiry began in June 2009 and will report by April 2010. The initial phases have included gathering evidence from a variety of sources, consulting the public and interested stakeholders and visiting key people in Brussels.

Evidence gathering

The Inquiry has gathered evidence on the current state and importance of the agricultural industry in Scotland and on the current implementation of agricultural policy and the possible options open to us in the short and medium term. This evidence has been gathered through meetings with a range of people including Scottish Government staff (primarily in the Rural and the Rural Payments and Inspections Directorates), researchers based in the Scottish Government's Main Research Providers, in particular technical support and discussions with the Macaulay Institute, representatives from the industry and from government agencies such as the Forestry Commission and Scottish Natural Heritage.

Several evidence papers have also been produced and placed (or will shortly be placed) on the Inquiry web pages (www.scotland.gov.uk/BrianPackInquiry). There are papers on:

- Economic trends in Scottish agriculture (produced by Scottish Government)
- The importance of livestock production to the Scottish economy (produced by QMS)
- The Scottish arable sector (produced by Scottish Government)
- Farming and the natural environment (produced by SNH)
- Evidence from Forestry Commission Scotland
- Commissioned work on public goods and decoupling (undertaken by SAC)
- United States support (produced by Scottish Government economists)
- Retailers perspective on climate change
- Rural Payments and Inspections Directorate – IT issues

The purpose of these papers is to ensure that everyone has the same information on where the industry and rural areas are now, to inform discussions about how best to implement agricultural support and about future direction.

Fact finding trip to Brussels

A visit to Brussels included meetings with Marian Fisher Boel (Commissioner for Agriculture and Rural Development), Paulo deCastro (Chair of the European Parliament Agriculture Committee), Tassos Haniotis (Head of Agricultural Policy Analysis and Perspectives, DG Agri), Tim Render (UK Representative), Alec Page (Defra expert seconded to the European Commission), Andreas Lillig (Single Farm Payment Implementation, DG Agri) and Maeve Whyte (Director, British Agricultural Bureau). This trip facilitated insight into the debates taking place in Brussels on the future direction of the CAP. This was particularly useful in providing the context within which debates in Scotland will take place.

Initial consultation

An initial consultation ran from September to the end of October 2009. This initial consultation was structured around the remit of the Inquiry to canvass opinions about the broad issues under consideration. A total of 105 responses were received, comprising 58 responses from individuals and 47 from organisations. The responses have been analysed and an overview of these is included as an annex to this report.

Structure of this report

This interim report has been informed by the evidence received to date, and the responses to the initial consultation, and highlights the issues that we must consider in thinking about the future of support for agriculture in Scotland. It begins by briefly examining some of the context. As many of the respondents to the initial consultation pointed out, we face some major global challenges that we must consider as we think about how best to design agricultural support. We cannot develop an approach to agricultural support that ignores these challenges, not least because EU policy is increasingly focusing on these big issues. The report then looks at some of the issues at the level of the European Union that are changing the debates about agriculture, before looking at what Scotland has to offer and what we need to consider in thinking about how support should be delivered in future. The report then puts forward some principles and objectives of future support, together with a proposed structure for support under a reformed regime. These ideas are included at this stage to prompt debate and discussion among stakeholders and to provide the basis for a much more focused consultation on specific options. The report ends with some ideas for how the current support regime might be changed in the short-term to address the specific challenges that we face today.

2. Global challenges

Much of the evidence received so far has either implicitly or explicitly referred to the importance of issues operating at a global level. Many providers of evidence highlighted that we face significant challenges, such as food security and climate change, which provide the context for thinking about the future of agricultural support. But while many contributions do point out the problems and the way that agricultural policy can sometimes be part of the problem itself, an important theme running through all responses and evidence is that agriculture can also be part of the solution.

It is clear that any consideration of the future of agricultural support in Scotland must consider the bigger picture. If we are to make sensible decisions about how best to target and distribute agricultural support, we need to think about what we are seeking to deliver, about what our priorities are for the future and about the issues on the horizon that may require targeted action.

Thinking about these global challenges can also help to crystallise priorities and direction and provide a more robust rationale for agricultural support. This is important because one of the main criticisms of the current system of agricultural support, and specifically direct payments, is that they lack a robust justification. An industry that is focused on helping tackle the key issues of concern to society will be better placed to justify the support it receives in the form of public money.

This section of the report therefore briefly looks at some of these global challenges. It also draws out what we take to be two key points: agriculture has a role to play in tackling these global challenges and there will be an ongoing need for support for agriculture to help farmers tackle these challenges, thereby delivering benefits to society as a whole.

The challenges

Responses to the initial call for evidence referred to many contextual global issues. Here we focus on food security, water supply, energy supply, climate change and protecting biodiversity.

Food security

Since the high food prices of early 2008, the issue of food security is now firmly back on the international agenda. High prices caused hardship for many of the world's poorest people and prompted food riots in thirty countries worldwide. The prices increased for a variety of reasons, including rising demand for food resulting from economic growth and higher incomes, restricted supply resulting from recurrent bad weather and subsidised production of bio-fuels that substitute food production. High energy prices also had a major impact on the price of food given the importance of oil in food supply chains. Although prices have subsequently fallen, the sharp rise and fall suggests that we are moving into an era of price volatility which itself presents food security problems.

Looking to the future, there are projected increases in global demand for food from a growing population and from a growing middle class. The FAO estimates that global food production needs to rise by 50% by 2030 and double by 2050. Food production will have to increase. Yet, at the same time, there are various forces tending to reduce the productive area. Farmland can be used to provide people with places to live and climate change is likely to cost us valuable agricultural land by flooding some areas and making others too arid for production. This implies that the necessary increases in supply will depend on achieving higher yields and on areas less affected by climate change contributing more.

Water supply

Scotland has abundant water resources, but globally water security is a growing issue with major implications for agriculture and food production. Within the EU, for example, the southern Member States are expected to experience restrictions in water availability with a higher risk of droughts and lower summer rainfall. There is a range of reasons for growing concerns about water scarcity, with both natural and anthropogenic causes and with issues of changing supply and increasing demand. 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. Climate change is likely to alter the temporal and spatial availability of rainfall making it more erratic and unfavourably distributed over the growing season and as the climate changes, climatic zones are expected to migrate, leaving the climate of some regions drier. This is a massive issue because the availability of water represents a major limiting factor on the level of production and if key food producing countries do experience reductions in water availability, their agricultural output could decline at a time when we need to be increasing production. While it would be easy to dismiss the issue as irrelevant to Scotland, we operate in a global industry and we may expect a sharp increase in demand for Scottish agricultural products when other food-producing regions of the world become more arid.

Energy supply

Around the world, many countries are facing similar energy challenges. Energy is essential for economic growth—so security of energy supply is vitally important—but most of our energy is sourced from finite natural resources that will eventually run out. In addition, our energy demand continues to increase, with world demand for energy set to rise by 40% between now and 2030, leading to greater competition for a limited resource¹. 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.

Predictions about when fossil fuels will run out are notoriously difficult, but it is generally accepted that they will run out and that we need to move away from our

¹ See International Energy Agency, 2009, World Energy Outlook 2009, <http://www.iea.org/weo/2009.asp>.

reliance on them, not least because we, in the UK, will gradually become more vulnerable to problems of supply as we become dependent on a few key states, often in volatile parts of the world². We only have to think of the impact across Europe when Russia restricted supplies across the Ukraine in early 2009 to understand the potential problems.

Issues of energy supply have significant implications for intensive food production systems. Nitrogenous fertiliser has been a vital element in the growth in production over the last fifty years, but it is energy intensive and therefore potentially much more expensive in the future, as fossil fuels become scarcer. Food production systems in the future will have to adapt to use less nitrogenous fertiliser at a time when we need to increase output.

Agriculture and land management also potentially have a role to play in dealing with the issue of energy supply. Many of the renewable options that would enable us to diversify our energy mix (wind, hydro, biofuels, biomass, anaerobic digestion) require land or are actually dependent on changing land management.

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 future³.

In the context of the other challenges we face—such as feeding the world's population—it can be tempting to think that worrying about biodiversity is a marginal issue. But biodiversity underpins the systems within which we live and contributes to many aspects of human well-being. It affects key ecosystem processes such as the production of living matter, nutrient and water cycling, and soil formation and retention, and, as such, has a key role to play in global food production.

There are many initiatives to encourage action to protect biodiversity, such as the Convention on Biological Diversity, pan-European activity through Natura 2000 sites and through national legislation. However, biodiversity loss continues. It is widely acknowledged that the EU will fail to meet its target of halting the loss of biodiversity by 2010 and, in Scotland, evidence from SNH⁴ highlighted that while many aspects of the farmed environment have improved in recent years, farmland biodiversity continues to suffer. Indeed, the latest Countryside Survey highlighted that plant species richness declined in most farmland habitats between 1998 and 2007 (by c. 10%) after a period of relative stability between 1978 and 1998⁵. And although we

² See the UK Energy White Paper, 2007, http://www.decc.gov.uk/en/content/cms/publications/white_paper_07/white_paper_07.aspx.

³ See <http://www.millenniumassessment.org/documents/document.354.aspx.pdf>.

⁴ SNH, 2009, Farming and the Natural Environment, <http://www.scotland.gov.uk/Resource/Doc/278281/0090713.pdf>.

⁵ Norton, L.R.; Murphy, J.; Reynolds, B.; Marks, S.; Mackey, E.C., 2009, *Countryside Survey: Scotland Results from 2007*. NERC/Centre for Ecology & Hydrology, The Scottish Government,

attempt to undertake work to benefit biodiversity by designing and implementing agri-environment schemes, the latest evaluation of their effectiveness suggests that they have limited impact⁶.

Climate change

It is now widely accepted that the planet is warming and that this warming is a result of human activity. Current projections suggest that by the 2080s Scotland will be warmer, especially in summer, with wetter winters, and that we will be subject to a higher number of extreme events. This will have both beneficial and negative impacts on agriculture in Scotland, but other countries are facing much more severe consequences. Climate change threatens agricultural production through higher temperatures and changes in rainfall patterns, and a higher likelihood of droughts and floods. Crucially, it is the poorest regions of the world, those areas with the highest levels of chronic hunger, that are likely to be worst affected. Arid areas could become unviable for productive agriculture, reducing the total productive capacity and contributing to issues of food security. It is therefore incumbent on those countries less affected by climate change to produce food to feed the world's population and to try to do so while reducing emissions of greenhouse gases.

Yet while climate change will have an impact on agriculture, we must also acknowledge that agriculture is also responsible for 14% of global greenhouse gas emissions. Agriculture therefore has its part to play in reducing emissions. In Scotland there have been significant reductions in emissions from agriculture in recent years, but further reductions will be expected because the government has set challenging targets (42% reduction in CO₂e by 2020 (from 1990 levels)) for long-term emission reductions. This need not be understood as a burden because there is much that can be done that is a win-win. Recent work by SAC suggests that farmers can reduce emissions whilst saving money and improving profitability⁷.

Meeting the challenges

We are faced, then, with significant challenges. Addressing them will not be easy. Indeed, we, as a society, may in future face difficult choices about priorities. Although, politicians like to suggest that we can achieve everything, it may be that we cannot increase food production without some sort of environmental degradation. There are potentially difficult trade-offs: if we think that feeding the world's population is our top priority, for example, we may have to accept that this entails greenhouse gas emissions. These sorts of decisions are beyond the scope of this Inquiry, but what is readily apparent is that agriculture has a part to play. But agriculture will also need to meet multiple demands. It will have to produce food at the same time as reducing greenhouse gas emissions and maintaining and potentially enhancing biodiversity.

Scottish Natural Heritage, 83pp. (CEH Project Number: C03259),
http://www.countrysidesurvey.org.uk/scots_reports2007.html.

⁶ Scott Wilson Scotland Ltd, 2009, Monitoring and Evaluation of Agri-environment Schemes
<http://www.scotland.gov.uk/Resource/Doc/289188/0088491.pdf>.

⁷ Moran, D., *et al.* 2008, UK Marginal Abatement Cost Curves for the Agriculture and Land Use, Land-Use Change and Forestry Sectors, see <http://hmccc.s3.amazonaws.com/pdfs/SAC-CCC:%20UK%20MACC%20for%20ALULUCF;%20Final%20Report%202008-11.pdf> and <http://www.theccc.org.uk/sectors/non-co2-gases/>.

What is also apparent—and this is a point that came out strongly in many responses to the call for evidence—is that public policy and public money must focus on achieving positive outcomes for society and for the natural environment. With regard to support for agriculture, this suggests that the rationale for support is changing. Indeed, we have already seen a move in this direction with the new challenges identified under the CAP Health Check. Governments are increasingly less keen to support agriculture without question; they will support agriculture to deliver against specific policy goals. In agriculture, we need to recognise this change in culture and work with it to deliver what society needs and wants.

Agriculture is part of the solution

A key theme running throughout the responses to the call for evidence is that while these global challenges present problems for agriculture, farmers and land managers also have an important role to play. This is because one thing that connects all these challenges is land. The way that the land is managed can be an important factor in our ability to face up to these challenges. Land managers have a vital role to play because they can help implement policies and strategies put in place to tackle these issues. 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 (which is likely to be more cost-effective than some of the more expensive technological solutions)
- 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.

But it could legitimately be asked that if agriculture is part of the solution and if farmers could be doing all these things, why are they not doing so at present? Of course, there are many who are helping address these challenges, but as a whole the industry could do more. One of the reasons why the industry is not already doing so is because undertaking work to help tackle the challenges often involves the production of non-market goods and services for which there is no financial gain. Another is that today's agriculture is still guided to a significant extent by previous policy and support regimes. Another is that farmers receive many different signals from policymakers. It is clear, then, that agricultural policy and support has a key role to play and the majority of respondents to the call for evidence highlighted that support for agriculture is a vital tool to help deliver benefits to society.

Using agricultural policy and support to tackle the challenges

It seems clear that without some sort of intervention to maximise the public benefits of agriculture, a significant proportion of the potential benefit would not be delivered.

It was pointed out to the Inquiry that agriculture and land management receive support and are regulated because the sustainable production of food and management of land cannot be left to the market alone. Governments therefore intervene in the sector through agricultural support to deal with various forms of market failure. The market can fail to secure food supplies or lead to agricultural incomes becoming very low and subsequently threatening the sustainability of food production. Alternatively, the operation of the market can generate negative environmental consequences or ignore animal welfare. Agricultural support is therefore a tool for dealing with different forms of market failure and, given the importance of ensuring sustainable food production and land management, there will continue to be a role for government intervention in some form.

Given the fact that many of the challenges we face cannot simply be left to the market to solve, the argument was made by many contributors that there will be an ongoing role for agricultural support. Of course, this issue is contentious and different people, interest groups and countries have different ideas about how best to tackle the major challenges we face and the role that financial support to agriculture should play.

Taking food security, for example, some argue that markets play a fundamental role in the supply of food and that they should be left to operate without the distorting effects of agricultural support. They argue that the market is a much more efficient way of dealing with issues of food supply. Others argue that food security is not an issue in the EU because we have the capacity to source supplies on the market and that if we want to tackle world food security we would be better investing in agricultural research and infrastructure in developing countries rather than giving money to European farmers.

Others argue that while we import much of our food and while trade will continue to be an important element of meeting our food requirements, trade alone is not the answer. They suggest that we must also ensure that we maintain a thriving domestic food production capacity. If left entirely to the market, food production would become concentrated in particular areas of the world, making it potentially vulnerable to bad weather, disease or unstable political regimes. Under this argument, support for agriculture has an important role to play in maintaining our food production capacity so that we can respond in times of need.

On balance, though, the majority of responses to the call for evidence suggested that agricultural support will be necessary in some form going forward.

Agricultural support and the WTO

The role of support is one of the key debates in the (currently stalled) Doha round of WTO trade negotiations and these talks provided an important context for the future of support for agriculture in Scotland. Any support measures will have to comply with international agreements about what sort of support is acceptable.

The key issues revolve around the degree to which markets are open to international trade. Although there are a variety of positions, the key debate takes place between those countries that want free trade and those that argue that their farmers need

protecting from free trade because if they were exposed to it they would be at a disadvantage.

Currently, the Cairns Group argues for much more open markets while the EU argues for the continuation of support (and therefore protection) on the basis that European agriculture is multi-functional (with farmers delivering quality landscapes and retaining a vibrant countryside as well as producing food). The EU suggests that without support, and if left to the vagaries of the international market, 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.

The dominant Scottish reaction to the WTO negotiations mirrors that of the EU. There has been significant concern over the potential impact of a Doha deal because opening up Scottish markets to cheaper imports (which have not necessarily incurred the high costs associated with high welfare standards and delivering environmental goods) could put pressure on Scottish producers.

In recent years, though, the WTO debates have become rather more technical than ideological. Many nations accept that some form of support for farmers is needed to help deliver wider benefits and so discussion has tended to focus 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'). Within the EU, decoupling and the introduction of the Single Farm Payment was to a significant extent about ensuring that direct payments met WTO rules and were acceptable.

All this is important because the wider debates about international trade sit behind all agricultural policy and support, and responses to the call for evidence. For example, what is clear is that while our concerns for livestock declines prompt suggestions for re-coupled payments, coupled support is understood as trade distorting and is not permitted unless coupled payments account for no more than 3.5% of the EU support budget. These wider debates potentially put restrictions on the sorts of things we can do in Scotland.

A preliminary view from the Inquiry

While there are strong arguments for a more market-based approach in agriculture—and we should continue to move in this direction—the evidence presented to the Inquiry suggests that the principle of supporting agriculture is sound. We can learn from the experience of others because some countries (notably New Zealand and Australia) provide very little support to their farmers and their free market approach has freed up farmers to react to the market, but there are also consequences in that today there are growing concerns for the environment. So while farmers can and do produce for the market, support for agriculture can play a positive role in the context of securing a wide range of policy objectives. The Inquiry takes the view that agriculture deserves support in the form of public money if it delivers benefits to society. Farmers and other land managers cannot be expected to deliver a range of benefits to society at a cost to themselves. We need to devise systems that reward them for the contribution that they make to meeting societal needs.

At present, the Inquiry takes the view that:

- We face major global challenges and these are likely to become increasingly important in public policy
- Agriculture can help tackle these challenges
- Farmers and land managers must recognise that future support is likely to be linked to these challenges and that agriculture will have to provide adequate justification for receiving public money.
- Agriculture can justify this support
- Support will continue to play an important role in agriculture
- But the way this support is deployed will be guided by WTO negotiations.

3. A changing European context

Given the importance of the EU's Common Agricultural Policy (CAP) in setting the direction and the range of policy options open to us in Scotland, all the evidence received to date has highlighted the changing European context and what this might mean for the future of support for agriculture in Scotland. But in recognition of the importance of the European dimension, the Inquiry Chair has also visited Brussels to meet politicians and officials working in the agricultural arena, received input from Scottish Government staff that work with EU officials and on CAP reform, and received many submissions that specifically address the future of the CAP. This section of the report details some of the European issues that have been raised which impinge on considerations of the future of agricultural support in Scotland.

Background

The Common Agricultural Policy was created in the 1957 Treaty of Rome to increase agricultural productivity, ensure a fair standard of living for the agricultural community, stabilise markets, assure the availability of supplies and ensure affordable prices for consumers. While it has been controversial, and there is much debate about the best way to deliver these objectives, to a significant degree it has been successful. Agricultural productivity has risen, we have good supplies of food and food has remained affordable over the long-term.

Until the 1970s, financial assistance was provided for market support and for the restructuring of the farming industry, with an emphasis on increasing production by enhancing farm investment, improving management and the utilisation of technology. By the 1980s, the EU had to contend with almost permanent surpluses of the major farm commodities. These measures, which had a high budgetary cost, distorted world markets and became unpopular with consumers and taxpayers.

Since then, the CAP has undergone a series of reforms. In 1992, reforms involved reducing support prices and compensating farmers by paying them direct aids. While receiving direct aid, farmers were encouraged to look more to the market place and to respond to the public's changing priorities. The 'Agenda 2000' reforms ushered in a new era by dividing the CAP into two 'Pillars': production support and rural development. A new rural development policy was introduced which supported many rural initiatives while also helping farmers to diversify, to improve their product marketing and to re-structure their businesses. More recently, the 2003 reforms saw the introduction of the Single Farm Payment and the decoupling of support payments from the level of production. Also, over time the emphasis of the CAP has gradually changed from a principle focus on productivity to gradually include a focus on competitiveness and sustainability⁸.

Today, the future of the CAP is again up for debate. The current financial framework comes to an end in 2013 and it is generally accepted that agriculture's share of the

⁸ For a fuller review of the development of the CAP see *The CAP in perspective: from market intervention to policy innovation*, http://ec.europa.eu/agriculture/publi/app-briefs/01_en.pdf.

future EU budget will continue to gradually fall. At the same time, the current rural development plans come to an end in 2013, so all those with an interest in shaping future agricultural policy are arguing their case in an effort to influence future direction.

The Commission will issue a paper on the CAP after 2013 in 2010, but the general principles are already established. The Commission has already made clear that the debate on the CAP post-2013 will mainly focus on the need to have a strong policy for agriculture which will:

- address concerns about food security;
- ensure good land management;
- help tackle the problem of climate change;
- support balanced development in rural areas⁹.

Furthermore, the Commission has said that the general principles should be that the CAP:

- leaves room for farmers to be as market-oriented as possible;
- gives farmers some kind of safety net so that occasional crises do not inflict serious long-term damage on our production base;
- helps farming to modernise, to provide public goods and to meet various new challenges such as climate change.

While there are calls for fundamental reform that recasts the CAP as a rural policy or as a policy that should be completely about the delivery of public goods, the Inquiry takes the view that such fundamental reform is not likely in the near future, not least because procedures for valuing public goods are not well developed. The key issue, around which there is much debate, is therefore not about whether we should have a CAP but about the question of how the CAP will deliver against the global challenges in section 2.

The need for the Common Agricultural Policy...

Many of the people consulted in Brussels, and many of the respondents to the call for evidence, highlighted the continuing need for the CAP. The CAP is seen as an important tool. Farmers and farmer's organisations highlight the importance of the CAP in supporting the industry to meet all the welfare and environmental obligations that they have to meet. While environmental organisations tend to argue that some sort of (reformed) policy is still required to shape land management and rural development. There are many disagreements over what the policy and support regime should be doing, but there is mostly agreement that some sort of policy is required.

Several respondents to the call for evidence suggested that it is important not to forget fundamental principles. Amongst all the clamour for reform it can be easy to

⁹ See http://ec.europa.eu/agriculture/cap-post-2013/index_en.htm.

lose sight of why we have the CAP in the first place. While it is not perfect, and we must recognise its deficiencies and seek reform along the way, there are good reasons for having a common policy. Foremost amongst these is the importance of retaining a common market in agricultural products within the EU. What is not generally set out clearly is how we attempt to achieve the goal of a level playing field that enables this common market. One way that we do this is by establishing a regulatory framework that imposes common environmental, health and welfare standards. Although regulation can be heavy-handed and ill fitting to local circumstances, it is a necessary evil that is aimed at creating a level playing field to facilitate trade. Producers from countries with stringent environmental rules, and therefore higher costs of production, would be at a disadvantage if producers from other countries with very lax environmental rules, and therefore lower costs of production, were trading in the same market. Consequently, we develop common regulations to level the playing field.

On the international stage (i.e. above the level of the EU), however, all this regulation imposes higher costs of production on the European agricultural industry than experienced in countries with less comprehensive rules. European farmers and other land managers must comply with welfare standards, with NVZ rules, with stringent traceability requirements, and with restrictions on pesticides and genetically modified crops/feed. CAP support therefore compensates farmers for these higher costs. If the regulation remained without the support, many farmers would not be able to survive. And while we should not be in the business of just keeping everyone in business—farmers should be encouraged to be as efficient and competitive as possible—there remains a strong rationale for the continuation of agricultural support.

Looking to the future, the importance of the CAP is only reinforced. We need to meet the global challenges and the CAP provides a useful tool to help us do so.

...but the budget is under pressure...

The CAP currently accounts for 41% of the total EU budget. The Common Agricultural Policy is the most integrated of all EU policies and consequently accounts for the largest share. But agricultural spending has been falling as a proportion of the total budget for many years. In 2002, Member States agreed that spending on agriculture (excluding rural development) should be held steady in real terms between 2006 and 2013, despite the admission of ten new members in 2004 and two more in 2007. And under the current Financial Perspective, agricultural spending peaked in 2009, in nominal terms, and will decline until 2013.

The current Financial Perspective comes to an end in 2013 and discussions about the next budget are already well advanced. In these discussions the agricultural share of the budget is under significant pressure. Many claim that the expansion of the EU's other responsibilities means that the financial arrangements need to change. There is a growing focus on common foreign policy, security, immigration, citizens' rights, research and infrastructure, but if these are to receive more attention, they need bigger budgets which will require funds to be released from elsewhere.

A potentially smaller pot of money has prompted a great deal of positioning with different Member States setting out their vision and priorities. Each is trying to ensure that as high a proportion of the eventual budget goes to support their farmers. Ultimately, though, budget pressures at the level of the EU will filter down to farmers. There is likely to be less money available for agriculture and it is likely to decline over the medium term. Farmers will have to recognise this and plan accordingly. Although support is important to farmers, and the Inquiry takes the view that this support should continue, in the long-term the amount of support is likely to decline, implying that farmers should focus on finding ways to improve their profitability without relying on support.

But there are also wider issues than simply those relating to the declining total pot of money. There is also an increasing pressure that European expenditure should deliver added value and that public expenditure needs to be supported by a solid conceptual rationale. Not only is the total amount of money available to agriculture going to decline, but agriculture will have to ensure that it can justify the use of public funds to support it.

What is clear is that difficult decisions about priorities at the level of the EU will have to be made. In the context of all the other demands on a finite amount of money, the pressure to reduce the agricultural budget is understandable. But 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.

...and the growth of the EU creates new challenges

Enlargement of the EU to include 27 Member States (with Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joining in 2004 and Bulgaria and Romania joining in 2007) has had a dramatic impact on EU agriculture. An additional 7 million farmers have been added to the 6 million of the EU 15 and the area of agricultural land has increased by 40%.

This expansion has introduced a new dimension to issues of agricultural support from a Scottish perspective. When new Member States joined the EU they gained access to the single market and became eligible for direct support (which is phased in gradually to reach the full EU level) and rural development measures. This means that the total support budget is more thinly spread.

A key issue relates to questions of equity and the fact that there are major differences in the levels of direct payments between Member States. These differences come about because the level of direct payments mirrors average production and support in the reference period, and the further we move from the reference period and the more we move away from a link with production, the greater are the calls for some sort of redistribution. A rebalancing of direct payments is therefore likely, with consequences for Scottish agriculture.

Quite what shape future policy will take is still to be decided, but various options have been floated, such as a single flat rate for direct payments for the whole of Europe, which has the *appearance* of equity. Another is the suggestion of connecting direct payments in some way to public goods, which could potentially see funds transferred to areas in the new Member States.

The Inquiry takes the view that any redistribution should recognise the average earnings and GDP of different Member States because if support falls and reduces incomes to a level far below average earnings, people will leave the industry, with consequences for retaining our food production capacity. Support should also reflect the historic levels of different Member State's contributions. The UK has long been a net contributor to the European budget and if changes to agricultural support arrangements do not reflect Member State's average earnings or contributions it could be damaging to the agricultural industry of the UK, but particularly of Scotland, Wales and Northern Ireland.

Signals from Europe

The debates about the future direction of the CAP are fast moving, with many different positions being proposed and discussed amongst the key players—the Commission, the 27 Member States and the Parliament. Some of the main issues of debate and potential ways forward can, however, be identified. Here we focus on a couple of key issues of particular interest in Scotland.

Direct support – There is a great deal of debate about the future of direct payments i.e. what they are for and whether or not Pillar 1 has a future. With regard to the Member States, the major dividing lines are already drawn between those states that want to retain direct payments and those that want to see them phased out or linked more strongly to the delivery of public goods. At present, it seems that those in favour of retaining direct payments are in the ascendancy. For example, the declaration issued by the G-22 Member States following the recent meeting in Paris which in the face of climate change, volatile global markets and the resurgence of health crises, called for a continent-wide agricultural policy with adequate resources to safeguard Europe's independence.

With regard to the Commission, Mariann Fischer Boel has recognised that the lack of effective market price support exposes farmers to greater market volatility with all the associated difficulties. She has accepted that some form of income safety-net will be needed, especially if we want to avoid more costly, and more distorting, forms of income support. There is a need to address issues relating to the relationship between direct payments and other existing instruments – particularly market regulation measures and rural development tools, and the differing level of the direct payments between Member States, but there seems to be an acknowledgement that direct payments do have a role to play. It remains to be seen what line Dacian Cioloş will take, although it is reported that he has a leaning for a continuation of direct support.

With regard to the Parliament, we must remember that following the entry into force of the Lisbon Treaty on 1 December 2009 any future agreement on the CAP will take place through the co-decision procedure involving both the Council of Ministers and the European Parliament.

Less Favoured Areas – There appears to be strong support for the LFA scheme and an appreciation of the importance of LFA to Scotland. An important point is that there appears to be a conceptualisation of support within the EU that still sees a role for the LFA in the long-term. The Commission makes clear that whereas the Single Farm Payment aims to sustain farmers' income by providing direct income support, LFA schemes are intended to prevent farmland abandonment in areas that suffer from natural handicaps and compensate farmers for the specific disadvantage they face¹⁰. Equally, while the LFA payments contribute to environmental objectives and therefore fall under Axis 2 of Pillar 2, the scope of LFA payments is also quite distinct from that of agri-environment payments. Whereas agri-environment payments cover the income foregone and costs incurred linked to specific environmental commitments going beyond the mandatory baseline, LFA payments only compensate the natural disadvantage by covering the additional costs and income foregone related to the natural handicap.

The current changes to the scheme are focused on tightening up the classification of the LFA, especially the intermediate areas, by developing common classification criteria based on bio-physical features, so that there is greater clarity with regard to what the payment is for. The socio-economic objectives are also being removed so that LFA payments focus on natural handicaps. Despite the changes that are taking place as a response to the criticisms from the European Court of Auditors, the Inquiry Chair was assured that the aim is not to reduce the area suffering disadvantage; the aim is to make the LFA schemes more robust, justifiable and accountable.

Member states have undertaken a mapping exercise applying bio-physical criteria to re-draw the LFA and at present, although the precise lines on maps will be different, overall this redefinition is not expected to have a major impact on the amount of LFA in Scotland.

Timeline – In terms of the short-term agenda for change, the European Commission (DG Agri) will produce a paper on the CAP post-2013 in 2010, but a deal is not likely to be done until the first half of 2012 during the Danish Presidency.

We should acknowledge though that there might not be an agreement and that if this were to transpire then the current schemes will role forward until there is an agreement.

¹⁰ European Commission, 2009, Towards a better targeting of the aid to farmers in areas with natural handicaps, http://ec.europa.eu/agriculture/rurdev/lfa/comm/index_en.htm.

A preliminary view from the Inquiry

The need for the CAP

- There is still a need for the Common Agricultural Policy and for a continuation of agricultural support
- We must not lose sight of the importance of the common market for agricultural products and that ensuring this common market imposes higher production costs on the EU's agricultural sector with support compensating for these costs

Budget pressures

- We must recognise that there are many other demands on the CAP budget and that support for agriculture in the long-term is likely to fall
- But if the new challenges are to be addressed through agriculture they will require financing so funds are likely to remain available, although they will potentially be more closely targeted on particular ends

Direct payments

- We must also recognise that enlargement of the EU has highlighted the large variability in direct payments across the EU, suggesting that direct payments are also likely to change significantly in future
- But there is EU recognition that without effective market price support there will be a need for direct payments or new vehicles that can allow farmers to cope with increasing market volatility.
- Any attempt at redistribution must recognise member states GDP and average earnings and the historic levels of contributions to the EU budget

LFA

- There is EU interest in supporting the LFA to avoid land abandonment, albeit within a more strictly defined and auditable system.

4. Meeting Scotland's objectives

The remit of this Inquiry is to 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. The global and European challenges provide important context but this section looks at some of the issues specific to Scotland. It begins with Scottish Government objectives and then looks at the role that agriculture can play in helping achieve these, before examining some of the key issues that we need to consider in thinking about the future of support in Scotland.

Scottish Government objectives and policies that frame debates about agricultural support

The Scottish Government has a single purpose set out in the Government Economic Strategy: 'to focus the Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth'. 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 Framework¹¹ 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 next ten years 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

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

- 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
- 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

Scottish Government policies that relate to agricultural support

A developing vision for Scottish Agriculture

Over the last year, Richard Lochhead has been developing his vision for agriculture. In speeches delivered in 2009 at the Oxford Farming Conference and the NFUS AGM, he began to set out his ideas based around the concept of natural resource productivity, a concept that was subsequently developed in a publication in April 2009¹². It is possible to identify the main principles from the speeches, policy announcements and publications. These appear to be:

- Farmers must be free to produce for and be guided by the market
- It is legitimate to spend public money on public goods (where public goods includes environmental services, maintaining food production capacity and maintaining rural communities)
- We need a new contract between farming and society based on greater clarity about what farmers are expected to deliver to society as a whole
- Farming should be appropriately regulated, not over regulated

Natural Resource Productivity is a term that seeks to capture the government's desire to optimise the sustainable use of our natural resources to deliver the maximum economic and public benefit. The government wants to extract the optimum benefits from our unique assets and resources.

¹² Oxford Speech: <http://www.scotland.gov.uk/News/This-Week/Speeches/Greener/farmingfuture>;
 NFUS Speech: <http://www.scotland.gov.uk/News/This-Week/Speeches/Greener/nfu-agm-09>; Natural Resource Productivity, <http://www.scotland.gov.uk/Publications/2009/03/31111317/0>.

National Food Policy

The Scottish Government published Scotland's first National Food and Drink Policy, *Recipe for Success*, in June 2009¹³. The aim of this policy is to promote Scotland's sustainable economic growth by ensuring that the Scottish Government's focus in relation to food and drink addresses quality, health and wellbeing, and environmental sustainability, whilst recognising the need for access and affordability at the same time. It attempts to bring together different agendas – food and drink, health and environment, and obviously has strong links with production.

Climate Change Policy

The Climate Change (Scotland) Act 2009 creates the statutory framework for greenhouse gas emissions reductions in Scotland by setting an interim 42% reduction target for 2020 and an 80% reduction target for 2050¹⁴. To help ensure the delivery of these targets Scottish Ministers must also set annual targets for Scottish emissions from 2010 to 2050. Other relevant targets include generating 50% of Scotland's electricity from renewable sources by 2020, with an interim target of 31% by 2011. It is presumed that all sectors of the economy, including agriculture, will contribute to these ambitious targets.

Land Use Strategy

An important part of the Climate Change (Scotland) Act is the requirement to produce a land use strategy¹⁵ by March 31, 2011. The strategy must set out the Government's objectives in relation to sustainable land use, as well as proposals, policies and their associated timescales for meeting them in a way that contributes to obligations under the Act. The recent Rural Land Use Study will form a key component of the thinking going into the land use strategy¹⁶.

Water

The EU Water Framework Directive was introduced in 2000 to establish systems to manage the water environment, and was transposed into Scots Law in 2003¹⁷. The two key components of the WFD are the introduction of river basin management planning and the control of adverse impacts on the water environment with the aim of achieving "good" ecological status for water bodies by 2015. The Controlled Activity Regulations came into force in 2006 and during 2009 SEPA published the Scotland and Solway-Tweed River Basin Management Plans. These plans are intended to ensure that statutory agencies, businesses, public sector bodies and individuals work together to protect the water environment and address significant impacts by co-ordinating all aspects of water management.

Flooding

The Flood Risk Management (Scotland) Act 2009 was enacted on June 16, 2009. The Act will introduce a more modern approach to flood risk management, superseding the Flood Prevention (Scotland) Act 1961 once fully in force. It will create a joined up and coordinated process to manage flood risk at a national and local level

¹³ See <http://www.scotland.gov.uk/Resource/Doc/277346/0083283.pdf>.

¹⁴ See <http://www.scotland.gov.uk/Topics/Environment/climatechange/scotlands-action>.

¹⁵ See <http://www.scotland.gov.uk/Topics/Environment/Countryside/Landusestrategy>.

¹⁶ See <http://www.scotland.gov.uk/Topics/Research/About/EBAR/RLUS>.

¹⁷ See <http://www.scotland.gov.uk/Topics/Environment/Water/WFD>.

as it creates a framework for coordination and cooperation between all organisations involved in flood risk management, develops flood risk management plans, streamlines the process for flood protection schemes and introduces new methods to enable stakeholders and the public to contribute to managing flood risk.

Biodiversity

The UK is a signatory to the Convention of Biological Diversity and the Scottish Government works towards fulfilling Scotland's contribution to the UK's obligations. Scotland's biodiversity strategy, *Scotland's Biodiversity: It's in Your Hands*, was published in 2004 and sets out how the government will conserve biodiversity for the health, enjoyment and wellbeing of the people of Scotland now and in the future¹⁸. The Scottish Biodiversity Forum—a working partnership of Government, its agencies and non-government organisations—aims to coordinate activity that contributes towards achieving the aims of the strategy and has produced a series of implementation plans setting out the activities required¹⁹. Many of the actions in the implementation plans relate to land use and farming.

Renewable energy

The Scottish Government is keen to promote increased use of renewable energy sources and has set clear targets for renewable electricity²⁰. Ministers want 50% of the demand for Scottish electricity to be supplied from renewable sources by 2020, with an interim milestone of 31% by 2011. Similarly, a target has been set for 11% of Scotland's heat to be met from renewable sources by 2020. An expansion of renewable is important for agriculture in several ways. Farmers can benefit by developing energy projects such as wind farms, but biofuels, biomass and anaerobic digestion are also possibilities.

Agriculture's role in meeting Scottish Government objectives

Much of the evidence received and many of the responses to the initial call for evidence have emphasised the importance of active management of the land for the delivery of a range of economic, environmental and community outcomes sought by the Scottish Government. Without active management, without agriculture, the Scottish Government would struggle to meet its own objectives. The evidence gathered, including responses to the call for evidence, has highlighted several roles that agriculture performs:

- Agriculture produces food and helps achieve food policy objectives by working with the rest of the supply chain to deliver healthy food to the market.
- Agriculture is an industry that contributes to economic growth through direct output, indirect output, and through both direct and indirect employment.
- Agriculture plays a vital role in managing the countryside, helping to protect it so that present and future generations can enjoy it.

¹⁸ See <http://www.scotland.gov.uk/Topics/Environment/Wildlife-Habitats/16118/BiodiversityStrategy>.

¹⁹ See <http://www.biodiversityscotland.gov.uk/index.php>.

²⁰ See <http://www.scotland.gov.uk/Topics/Business-Industry/Energy/Energy-sources/19185>.

- The management of farmland can play an important role in the delivery of a wide range of public goods from which all of society benefits, including:
 - Attractive landscapes that underpin wider economic activity such as tourism
 - Protecting farmland biodiversity
 - GHG emissions mitigation
 - Reducing the risk of flooding
 - Reducing the risk of fire
 - Protecting soils
 - Ensuring water of high quality
 - Ensuring water availability
 - Ensuring air of high quality
 - Ensuring food security
 - Achieving high animal welfare standards
 - Ensuring high levels of animal health

- Farmers and other land managers play an important role in rural communities, contributing to their strength and resilience.

Agriculture clearly plays a role in meeting Scottish Government objectives. But the predominant message from the responses to the call for evidence was that the key to maximising agriculture's contribution to meeting Government objectives lies in developing an appropriate support regime that is tailored to supporting the Scottish industry.

It is clear, then, that in thinking about the appropriate support regime for the future, we must retain a focus on the key attributes or fundamentals of Scottish agriculture.

Features of Scottish agriculture that frame debates about support

The following are the key characteristics that have been identified by the Inquiry as vitally important in considerations about future support.

The nature of the land itself

Eighty five per cent of Scottish agricultural land is classed as Less Favoured Area. Land management in these areas faces particularly difficult physical and climatic conditions and access to suppliers and markets is hindered by remoteness (figure 1). The options for farmers in much of the LFA are very restricted. Much of the land is rough grazing, which can only really be used for extensive livestock production. This means that there are few alternatives for farmers; if prices fall, they cannot simply respond to the market by producing something else. If prices fall too far, they will simply go out of business, with resulting land abandonment. The nature of the land itself, reflected in the fact that so much is classed as LFA, means that the agricultural industry takes on a particular structure that needs targeted policy.

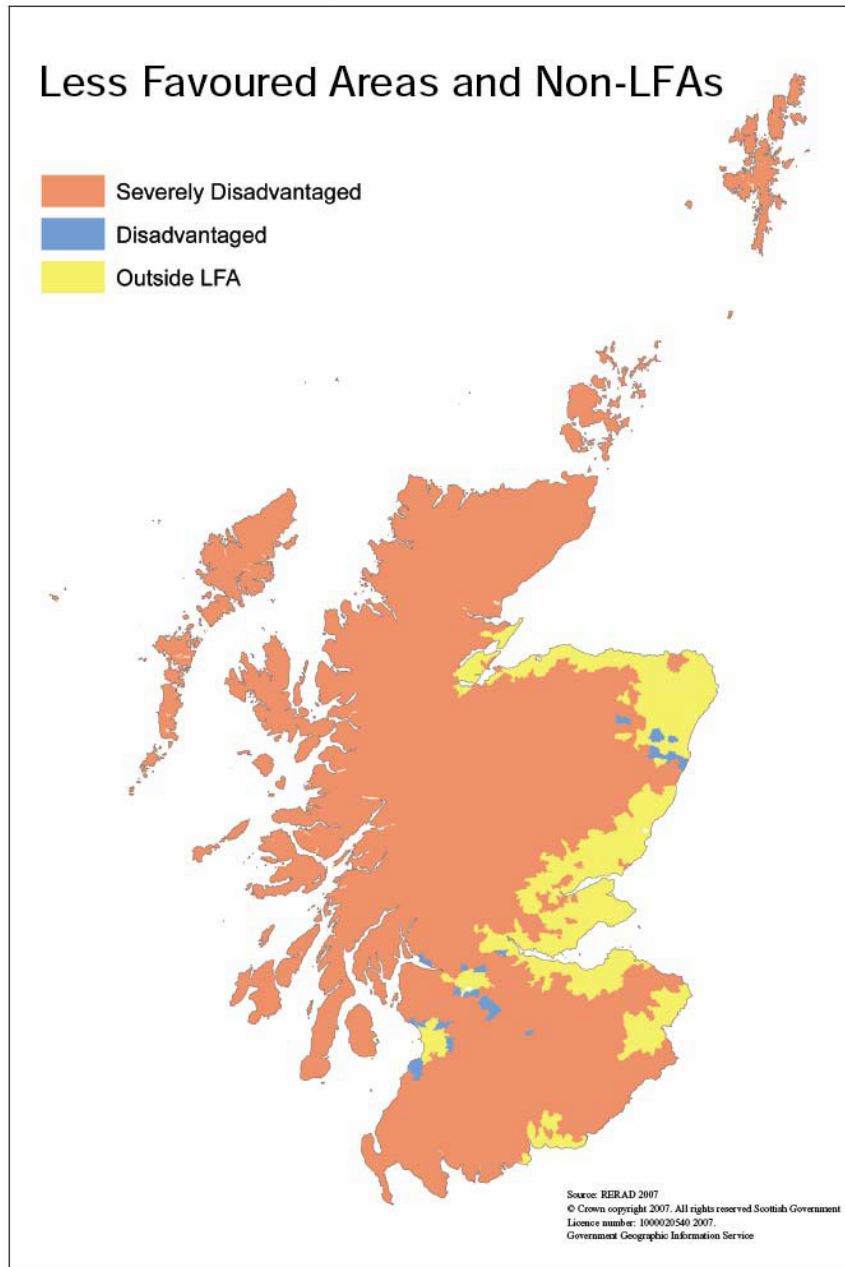


Figure 1: LFA in Scotland

Importance of livestock production

Evidence from QMS highlights that the production of milk, beef and sheepmeat accounts for between forty and fifty per cent of Scottish agricultural output with a value of approximately £1bn²¹ (figure 2). Scotland is therefore disproportionately dependent upon ruminant livestock farming, with only Ireland having a greater dependency in the EU. This dependence upon ruminant livestock production is a reflection of the land capability of Scotland and the limited alternative uses to which the land could be put. Any consideration of future support must recognise the structure of the industry in Scotland.

²¹ QMS, 2009, The importance of livestock production to the Scottish economy, <http://www.scotland.gov.uk/Resource/Doc/278281/0090717.pdf>.

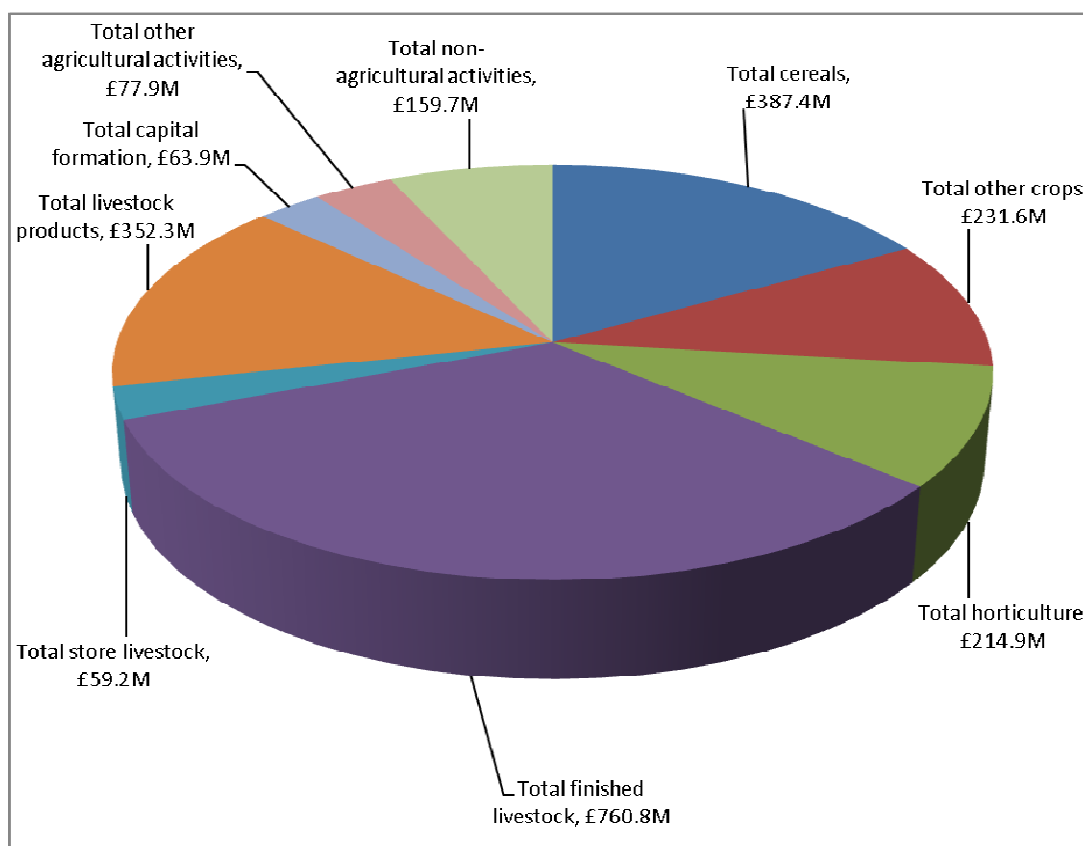


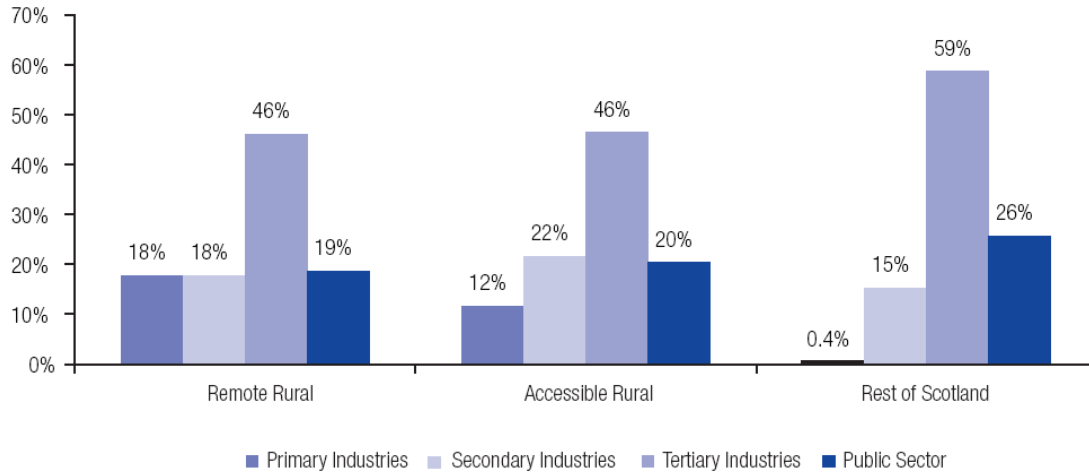
Figure 2. Gross Scottish Agricultural Output by sector, 2008²²

The importance of agriculture in rural areas

Evidence from the Scottish Government highlights that, in broad terms, the direct contribution of Scottish agriculture to the economy is small (about 0.7% of Scotland's total GVA)²³. But agriculture does have a much greater impact in specific areas. Agriculture, forestry and fishing, for example, account for 12% of employment in accessible rural areas and 18% of employment in remote rural areas (figure 3). Furthermore, farming has important links with other industries supplying farming and industries using Scottish agriculture produce, meaning that agriculture also makes indirect contributions to the economy. A study of the cumulative backward industry output multiplier for dairying, for example, suggests that an increase in the final demand for Scotland's dairy farms by £1 million would generate an additional output of £0.79 million in industry sectors supplying Scotland's dairy farms. The importance of agriculture to rural areas has also recently been highlighted in concerns about the decline in livestock numbers in the hills. If farmers were to leave an area it could have significant knock-on effects for other businesses and for communities (for example with falling school rolls in areas with already precariously low numbers).

²² Source data taken from Scottish Government, 2009, Economic Report on Scottish Agriculture 2009, <http://www.scotland.gov.uk/Publications/2009/06/16142957/0>.

²³ Scottish Government, 2009, Economic trends in Scottish agriculture <http://www.scotland.gov.uk/Resource/Doc/278281/0090711.pdf>.



Source: Inter Departmental Business Register 2008
(Using Scottish Government Urban Rural Classification, 2007-2008)

Figure 3. The importance of primary industries (agriculture, forestry and fishing) in rural areas²⁴.

The role of agriculture in delivering public goods

Farmers and land managers play a significant role in managing the countryside. The landscape and biodiversity that Scottish people enjoy and which tourists come to see is the result of generations of active land management. Without active land management many of the benefits that we derive from agriculture without necessarily acknowledging it would be lost. Work undertaken for the Inquiry by SAC identified a range of agricultural public goods including: the cultural and ecological aspects of agricultural landscapes; farmland biodiversity; climate – GHG emissions mitigation; reduced risk of flooding; reduced risk of fire; soils of high functionality; water of high quality; water availability; air of high quality; food security; animal welfare; and animal health²⁵. Farmers already play an important role in delivering public goods to society, but it must be recognised that the non-market nature of these goods often leads to an under-supply. Agriculture could deliver more public good benefits, but support is needed to stimulate specific activities which will enhance the provision of these goods. Therefore government intervention is required.

Any future support regime must be tailored to these specific Scottish concerns and with these features of Scottish agriculture in mind, this report now turns to consider some of the key issues surrounding the current support regime.

Key issues in the current system of agricultural support

The use of the historic model

The agreement to decouple EU direct farm payments from production and introduce the Single Payment Scheme was made in 2003, with implementation in Scotland in

²⁴ Scottish Government, 2009, Rural Scotland Key Facts, <http://www.scotland.gov.uk/Publications/2009/09/24095407/6>.

²⁵ McVittie, A., Moran, D., Thomson, S., 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 Scottish Government's Rural and Environment Research and Analysis Directorate.

2005. Amongst concerns that full decoupling would create problems of abandonment or social and environmental problems in areas reliant on farming, the agreed Single Payment Scheme provided Member States with different options and allowed them to choose the option that most suited their agricultural sector. There were three implementation models for the Single Payment Scheme:

- The Historic model – where payments are based on each farm’s average annual payments for the reference period 2000-2002.
- The Regional model – where payments are based on a single “flat rate” for each region designated within a member state
- The Hybrid model – where a mix of historic and regional payments are used. This can be a Static Hybrid where the relative weightings for the regional and historic payments remain the same through time, or it can be a Dynamic Hybrid where the relative weightings change through time moving further away from the historic model towards a fully regional model.

Scotland adopted the historic model, which was largely decoupled from production (with the exception of the Scottish Beef Calf Scheme).

Now, though, there seems to be general agreement that we need to move away from the historic model. There are different reasons for this. One relates to the fact that we are getting further and further away from the reference period and payments made on the basis of activity between 2000 and 2002 are harder and harder to justify. Another reason for wanting to move away from the historic model relates to equity. The Single Farm Payment is paid in relation to entitlements that were allocated on the basis of subsidies in the reference period, but farmers that are either new to the industry or who did not receive entitlements in the reference period are excluded from the support offered by the Single Farm Payment. Thus the longer the historic model is in place the weaker its rationale becomes.

The lack of connection between payments and active farming

An artefact of decoupling and the utilisation of the historic model has been the creation of a disconnect between payments and activity. At present, the Single Farm Payment is made on the basis of the level of subsidy (and therefore activity) in the reference period, but without any obligation to continue that level of activity (because of decoupling). It is perfectly possible for a farmer to have completely changed their operation, but to still be receiving public support on the basis of their operation in the reference period (provided they comply with the Statutory Management Requirements (SMRs) and maintain the land in Good Agricultural and Environmental Condition (GAEC)). This means that it is possible for a farmer to have significantly reduced their output and related activity—thereby reducing the delivery of benefits to society—and yet still be in receipt of the same amount of public money.

Equally, because payments are made in relation to entitlements and not the land itself, a farmer who was active in the reference period could potentially have rented out or sold their good quality land and then rented poorer quality land that required little management to meet cross compliance requirements and still claim their Single Farm Payment whilst not actively farming.

Clearly, if the direction of travel is towards a system where agricultural support needs a strong and robust rationale, the current system is lacking. It is hard to justify support to agriculture whilst the current system allows payments to armchair farmers. Agriculture does need support, but that support must be directed at those that are delivering benefits to society.

Potential land abandonment

Decoupling and the introduction of the Single Farm Payment represent the latest phase in the gradual process of reforming the CAP. This process has incrementally sought to reduce the role of policymakers in shaping the activity of farmers and encouraged farmers to respond to the market rather than policy. One of the consequences of this move was a decline in livestock numbers²⁶. While evidence given to the Inquiry by SAC highlights that it is difficult to make any easy connection between decoupling and land abandonment, an expected outcome of decoupling was a fall in livestock numbers²⁷. Since payments are no longer linked to production, farmers (notably sheep farmers) have been re-assessing their numbers in order to maximise profitability (or at least minimise losses). If a farmer is making a loss on each animal, it makes economic sense to reduce the number of animals in order to reduce the losses. Equally, reducing stock numbers can be a way of making an operation more manageable and removing the costs associated with employing workers.

The spectre that declining stock numbers now raises is land abandonment. Land abandonment is negative because if land is abandoned we would potentially lose agricultural capacity and expertise. Once land is out of production, it is not necessarily easy to bring it back. Similarly, once a herd of cattle is lost, it can take years to rebuild. Moreover, the lack of agricultural activity could lead to considerable landscape change in terms of biodiversity and related ecosystem functions but also the social and cultural aspects of landscapes.

Richard Lochhead announced increases to LFA payments in very fragile and fragile areas in 2009 to help farmers in marginal areas, but the issue remains.

Key issues for the future of agricultural support

The future of Pillar 1

The future of Pillar 1 is at the heart of debates about the CAP. Some Member States have signalled their desire to see an end to direct payments, preferring to see the funds transferred to Pillar 2 and rural development initiatives, while others have signalled a commitment to direct payments and their preference to retain a strong Pillar 1. The UK Government has come out clearly in favour of phasing out direct

²⁶ SAC, 2008, Farming's Retreat from the Hills, <http://www.sac.ac.uk/mainrep/pdfs/retreatreport.pdf>.

²⁷ McVittie, A., Moran, D., Thomson, S., 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 Scottish Government's Rural and Environment Research and Analysis Directorate.

payments²⁸ but Richard Lochhead has clearly stated his preference that direct payments be retained in Scotland.

Those that want to move away from direct payments argue that we should be moving towards a much stronger market focus and that transferring the funds to Pillar 2 makes them much more justifiable (because it is easier to identify what the payments are trying to achieve). But those that want to see them retained argue that without direct payments there would be large scale and disruptive structural change in the industry that would damage our food production capacity, the landscape and rural communities.

Distribution of Pillar 1 funds

Although debate about the future of Pillar 1 continues, at present it seems that direct payments are likely to be retained. Nevertheless, they will change as policy changes to reflect the wider EU membership and new challenges. We must therefore ask how we can best distribute direct payments to achieve our goals.

The current distribution of direct payments under the historic model is highly asymmetrical (figure 4). To a significant extent, this reflects the levels of support under prior support regimes because the current distribution of payments was captured through the reference period of 2000-2002. As such, in a similar way to prior regimes, most support goes to the most productive farmers.

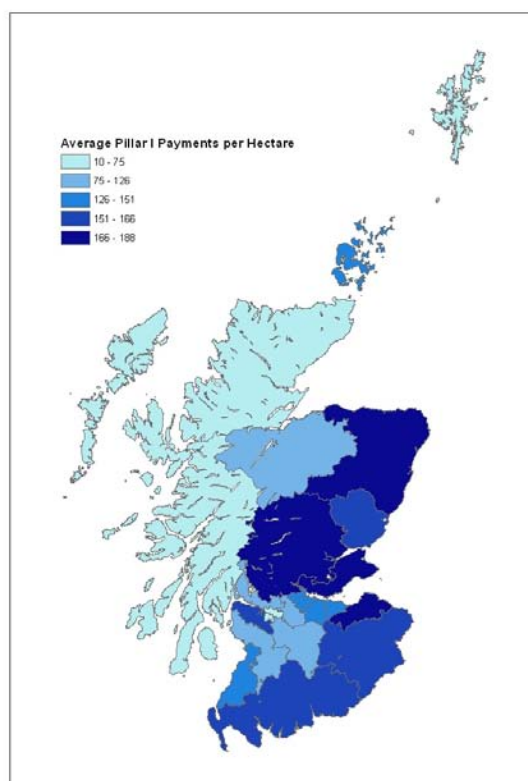


Figure 4: Average Pillar 1 payments per hectare

²⁸ See http://www.hm-treasury.gov.uk/the_common_agricultural_policy.htm.

This situation creates a great deal of debate. Some question why farmers on the best land who are best placed to run profitable enterprises also receive the most support. They suggest that support should be targeted at those that need the support the most or at those that can deliver the most in terms of public goods. Others defend the current distribution of payments on the basis that the farmers who currently receive the most support are the ones that contribute most to our agricultural output. If we want to retain our agricultural capacity, it is suggested that we need to make sure that we retain our best farmers.

This is a fundamental issue because it relates to the question of what direct payments are for. Clearly, an important element of this is ensuring sufficient clarity about the objectives of direct payments.

This is also a difficult issue because any significant change could lead to a redistribution of direct payments. Those that argue that support for agriculture should be dependent on the delivery of public goods implicitly argue for a re-distribution of support from the South and East towards the North and West.

The balance between Pillar 1 and Pillar 2

At present, the majority of funds are distributed through Pillar 1 in direct payments. In 2009, Single Farm Payments amounted to £566.4 m and between 2007 and 2013 on average £215 m per annum will be spent on Pillar 2 SRDP measures. This reflects the structure of the CAP under previous arrangements. Decoupled direct payments were introduced when market price support was withdrawn to ensure that farmers could cope with market volatility. Gradually, though, rural development has become more important in the CAP and now there are calls to shift the balance even further so that more funds are available in Pillar 2 (taken from Pillar 1).

Clearly, how funds are distributed between pillars is a European matter, but the key will be deciding priorities and clarity about what the goal of each pillar is. Only once we have clarified objectives will we be able to decide on the appropriate balance between pillars.

A preliminary view from the Inquiry

It is clear that any consideration of the future of the support regime in Scotland is highly complex. Previous sections have examined what support for the agricultural and rural sector has to achieve with reference to global challenges and developing EU thinking, and this section has highlighted the range of relevant policy areas and the more specific issues that we have to think about in Scotland.

The next two sections spell out some proposals in much more detail but here we can emphasise some fundamental principles that have provided the starting point for the development of these ideas.

- Scottish agriculture is unique and requires an agricultural support regime that specifically addresses the needs of the industry in Scotland. The nature of the land itself, the importance of the livestock sector, the importance of agriculture

in rural areas and the role of agriculture in delivering public goods are all characteristics that are substantially different to other parts of the UK.

- Agriculture can deliver against a range of Scottish Government policy objectives. The management of the land has a role to play in addressing many issues from feeding a growing global population to adapting to and mitigating climate change.
- But for agriculture to deliver against a range of Scottish Government policy objectives our focus should be on ensuring that we maintain a vibrant and productive sector. Without a productive farming sector it will be difficult to deliver the wider benefits that agriculture could provide to society. Producing the best high quality food we can off 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. Scottish agriculture can deliver a wide range of public good benefits as well as produce food, but these are the outcome of productive and sustainable agricultural activity. Our focus should therefore be on maintaining a productive sector that will then have the capacity to deliver the wider benefits.

The following two sections therefore focus on the measures that we should be thinking about to maintain a productive farming sector.

5. Emerging ideas about the future of agricultural support

Introduction

We need a system of support that helps deliver against the global challenges, works within the context of developing EU trajectories and helps maintain a Scottish agricultural sector so that Scottish farmers can deliver a wide range of benefits—from contributing to food security to attractive landscapes—for the people of Scotland.

Designing a future support system is therefore not an easy task. Nevertheless, if we take account of the global challenges, developing EU thinking and Scottish Government objectives, several issues provide a starting point for thinking about what future agricultural support might look like:

- Future support schemes must follow the pattern of Agenda 2000 and the Mid Term Review by meeting a wide range of objectives;
- Future support schemes must be WTO compliant;
- Future support schemes are likely to be no better funded than at present and there will be pressure to reduce the budget over time;
- Future support schemes should help deliver the Scottish Government's aim of achieving a 'new contract between farming and society';
- Future support schemes must be designed to work towards clear objectives so that it is clear what investment in agriculture is seeking to achieve.

In addition, the Inquiry has highlighted that:

- Future support schemes must have agricultural production at their heart, thereby sustaining agricultural production;
- Future support schemes should be simple and not incur high administration costs.

Yet even with these broad principles providing a starting point, thinking about how future support should be structured and what it should be aiming to achieve is complex. The difficulty arises in the detail of where money should be targeted and to what end. Within the Inquiry committee there are divergent views, which, given the nature of the Inquiry, is only to be expected. In this section of the report, some ideas about the principles and objectives of future support are suggested along with one example of how future area support might be structured. This is very much an embryonic idea that would require much research and analysis for it even to be considered as a proposal. This example is offered as a means of focusing discussion and encouraging feedback.

Towards a reformed system of agricultural support

One of the criticisms of the current system of support—voiced many times in the responses to the call 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 sector, then there needs to be a robust justification for its use in this way.

With this in mind, the Inquiry has identified several objectives that should provide an underpinning rationale for future support. Future agricultural support should:

- **Maintain a productive agricultural sector in Scotland** – so that we maintain our capacity to respond to issues of food security;
- **Help the industry to adapt and improve** – the industry needs to continually improve its competitiveness and its adoption of new practices;
- **Maximise the delivery of public goods** – public investment in agriculture can enhance their delivery;
- **Mitigate the disadvantage experienced by Scottish agriculture** – 85% of the land is classed as LFA.

Given these high-level objectives, it is proposed that future support should be structured around four main streams each with their specific justification and objectives and irrespective of Pillars (at present, the Inquiry takes the view that all the debate about Pillars is a distraction and makes the architecture of the CAP the focus of debate, diverting attention away from the objectives that we should be focusing on). The four streams proposed are:

- **Direct Payments** – Direct payments are needed to help farmers cope with market volatility, to provide a safety net and underpin farm incomes, and to compensate farmers for the costs of operating in a common market;
- **Top Up Funds** – A Top Up Fund could be available to farmers in receipt of direct payments and be used to achieve transformational change in the industry with support linked to the adoption of certain practices to enhance competitiveness and sustainability;
- **Rural Development Programme** – In a similar way to the current arrangement, the SRDP would be the prime delivery mechanism for public good benefits from agriculture and for wider investment in rural development and communities;
- **Less Favoured Area** – Given the nature of available land in Scotland it is important that compensation for disadvantage is set realistically in recognising the true increased cost and reduced income of operating in much of Scotland.

In the following sections we try to provide a little more detail as to what these different funding streams might involve.

Direct payments

The Inquiry believes that while they are a blunt policy instrument there will be an ongoing need for direct payments. Although the current lack of clarity about objectives has led some to argue that direct payments should be phased out, we believe that the lack of clarity is not a reason for their removal: it simply means that we need to be clearer about the objectives. There are good reasons for direct payments and we should not be afraid of spelling them out.

The objective of direct payments should be to provide farming with some financial stability against the risks of the market and weather and to compensate producers for the increased costs stemming from a common market, regulation and cross-compliance. Maintaining farmers' incomes is the key to providing the wider benefits from managed land and is fundamental to achieving many of the Scottish Government's objectives.

The move to encourage farmers to produce for the market has exposed farmers to greater market volatility and if left entirely to the market, many businesses would not be able to survive. Direct support helps farmers to deal with this volatility and ensure a degree of stability that facilitates business planning and change.

Although other industries may complain that they are not supported despite the fact that their markets are equally volatile, the important distinction is that farming is strategically important to the country and if we simply left farmers entirely to the market we could damage our food production capability in the long-term and potentially lose the public benefits we associate with agriculture.

But even if we tighten up the objectives of direct payments, any future system of direct support will have to be reformed from the current system. It has to be accepted that it is necessary to move from a historic to an area-based system of support and that this will result in large-scale redistribution of subsidy payments between the same farm types. This arises because of differential levels of historic subsidy entitlement and will be most marked on mainly livestock farms where there are large variations in stocking density. Scotland's upland and hill livestock farms are likely to suffer worse from this redistribution with potentially serious consequences for our beef industry – after all, beef subsidies were a major factor in the widely varying value of historic entitlements.

Developing an area-based system

When considering the objective basis on which to allocate direct payments under an area-based system, the choice seems to lie between an allocation on geographical areas or land capability with the rules set to either minimise the redistribution between geographic areas or farm types or set on an objective basis to reflect current conditions and future demands.

Whatever basis is chosen for future direct payments there will be major losers and winners with the more agriculturally productive in 2000 – 2002, particularly those with a greater emphasis on livestock, in the losing category. It therefore has to be accepted that the consequences of this redistribution of subsidy between farms of the same type, different types and between regions of Scotland might be serious for Scotland. It is intended to research the possible consequences of the change and use this along with the public consultations and written evidence to inform the final recommendations of the Inquiry, but it is feared that extensive redistribution is inevitable.

An example of an area-based direct payments scheme

To arrive at a final recommendation for how area payments are decided much more analytical work is required along with wide consultation, but to provide a focus for this work, the following is offered as a possible scenario.

The basis of allocation in this example is land capability for agriculture using the Macaulay Land Capability for Agriculture classification (LCA) (see Annex 1). Ideally, this would be applied on a field by field basis with the dominant LCA class of the field deciding which category it is²⁹. The area entitlement awarded would not be able to be transferred to a different land class.

It appears essential that whatever area allocation basis is chosen the area eligible to receive direct payments should be adjusted annually to ensure that all farmers with eligible area during a scheme year receive payment and, where land becomes ineligible, it falls out – using an historic base will soon become discredited. The main causes of change in the total area in a particular year will result from the minimum stocking rate requirement, planting trees on unstocked land and producers opting out of GAEC requirements. Annual allocation will rule the trading of entitlements irrelevant.

The impact of a dynamic area on administration requirements and therefore costs and payment dates needs to be considered carefully before the final recommendations are made.

Bearing in mind that this example includes additional Top Up Funds available to individual businesses which deliver wider benefits (see below), it is felt that a simple, fairly flat payment system could be appropriate. The following is provided as an example of what a scheme might look like in order to highlight the decisions that are required to construct an area payment system. As more data is produced it will be posted on the Inquiry website.

²⁹ It is recognised that currently the capacity does not exist to run the system on a field by field basis. It is intended that prior to the completion of the final report the requirements for such a system and the timescale to deliver it will be identified together with where data might be inadequate. These factors, along with the results of the consultation, will inform our final recommendations about how such a scheme might be structured.

LCA Class ⁽¹⁾	Annual qualifying requirement ⁽²⁾	£/ha ⁽³⁾
1 – 3.1	GAEC & minimum cultivation (new GAEC) of arable land	130 ⁽⁴⁾
3.2 – 5.1	GAEC incl Stocking rate >0.12	130 ⁽⁴⁾
5.2 – 5.3	GAEC incl Stocking rate >0.12	45 ⁽⁵⁾
6.1 – 7	GAEC incl Stocking rate >0.12	15 ⁽⁶⁾
3.2 – 7	Failure to achieve Stocking rate > 0.12	0 ⁽⁷⁾

Table notes

(1) The Macaulay Land Capability for Agriculture (LCA) classification provides an objective basis for dividing Scotland's land mass according to its agricultural capability. This capability is a constant over time and does not necessarily reflect the land's actual production which varies with management (see Annex 1). **Details of individual farm LCA classification are not available at this time, but they are not considered necessary for the discussion of principles.**

(2) In order to ensure active human intervention in the land (in keeping with the reasons for direct payments), minimum cultivation for arable and a minimum stocking rate for permanent grass and rough grazing is required.

(3) These figures are offered as a basis for discussion only. On the basis of some fairly broad assumptions they are thought to be affordable if the future CAP budget resembles the current, but even if the concept outlined is adopted the actual values will depend on future EU budget setting and CAP reform agreements. **In this example, a Top Up Fund equal to half these area amounts would be established.**

(4) This broad range of categories (1 – 5.1) covers the land with the potential to be most productive and that on the margin of being most productive i.e. the land types which contribute most to Scottish agriculture's output and could be argued to cover all land involved in any kind of intensive system.

(5) The payment rate is designed to recognise the potential contribution of this land to agricultural output compared with LCA 1 – 5.1. The payment recognises the compensation required for the increased costs of operating within the EU and for risk. The payment should also help to protect production capacity. Payment for physical disadvantage should be via the LFASS.

(6) A figure to reflect the very extensive nature of production in these land classes but sufficient to achieve opt in to facilitate the application of cross compliance and a minimum production.

(7) Land which does not achieve the minimum stocking rates of 0.12 livestock units per hectare in each scheme year would receive no area payment. Stocking rate consists of the two elements, stock and area, and in the very extensive areas with low stock numbers it is envisaged that the area claimed will be adjusted to satisfy the minimum stocking rate rather than increasing stock numbers.

The area of Scotland to be supported

A further factor contributing to redistribution is the extent of the area of Scotland that is eligible for area payments. The current Health Check rules allow area payments to only be paid to those areas currently used to activate historic entitlements. Given that such a position would perpetuate some of the evils of the past – exclude new entrants and those not receiving subsidies in the base years and include inactive farmers – this is discounted as a basis for designing a future support regime.

It is very clear from the responses received in answer to the call for evidence that future allocations of direct payments should cover all active farmers although, in most cases, active was not defined e.g. outdoor pig keepers, vegetable and potato growers? Deer farmers were very forceful in arguing that deer farming should be included as active farming – a case that is difficult to argue with. Equally, Forestry Commission Scotland (FCS) argued that at the very minimum, all new tree planting (from 2009) should be eligible for area payments. Indeed, FCS, as well as several respondents to the call for evidence, suggested that given the importance of trees to the Scottish economy, and for climate change mitigation, planting must be encouraged rather than direct payments acting as a disincentive, a view the Inquiry supports.

The wish for direct payments to be more inclusive will dilute further the money paid to existing SFP recipients. The extent of this dilution is difficult to estimate and will require further analysis before the final report.

The estimates of possible area payments included above are based on the broad assumptions that approximately 6m ha are eligible for consideration with approximately 1m ha failing to achieve the minimum stocking rate. The 5m ha to be considered for receiving the new area-based payment compares with the 4,365,530 ha used to activate the current historically-based SFP. This means that the proposed change would bring in approximately fourteen per cent more agricultural land into Scotland's new area based payment scheme.

The inclusion of a minimum stocking rate for LCA 3.2 - 7 of 0.12 livestock units per hectare is in some ways not ideal but there appears no other way of excluding vast tracts of wilderness that have no human intervention. It might be possible that Scotland could convince Europe and the UK that it has a disproportionate amount of land excluded (30% or more) from the historic basis of calculating SFP and, therefore, the Scottish ceiling should be increased to correct this anomaly. Unless such additional funds are forthcoming from Europe, it is essential to limit the area receiving direct payments post 2013. If the EU decided, wrongly, on a level area payment right across Member States, then the total eligible area for Scotland must be at least 6m ha. Such a move by the EU would fly in the face of common sense and fairness.

Area payments impact on land values/rents

During the evidence gathering, various representations were made regarding the danger that, in an area-based system the landlord would be the main beneficiary with the direct payment reflected in the rent. During our visit to Brussels, various Commission officials, including Mariann Fischer Boel, expressed their concern that area-based direct payments were increasing land values and rents. They were concerned that the EU was on a vicious cycle with a SFP designed to support farm incomes causing rent/land values to increase resulting in reduced farm incomes requiring ever greater SFPs, and so on.

A solution might be to design a system whereby the occupier of the land area eligible for a direct payment has to enter a contract with Scottish Government to deliver GAEC including a minimum stocking rate and/or arable activity, where applicable. Comments on this perceived dilemma are welcome during the consultation phase prior to final recommendations being made.

Market support

One of the issues that has become more visible recently is that there is no effective support for market prices, as we have seen with barley and, to a lesser extent, milk. Whilst, in theory, there are safety net prices, the way they operate makes them ineffectual as a means of protecting growers from low prices. Whilst producers' direct payments should provide businesses with a cushion against financially poor years, it would increase the sustainability of farming businesses and therefore European agriculture if a mechanism was found to level out the real troughs and, for that matter, peaks. The CAP Health Check enables mutual funds and disaster insurance to be aided under Article 68 but the Inquiry needs to gather more evidence on how they, or some other mechanism(s) might work and whether they are deemed desirable before taking a view. The Inquiry would welcome contributions on this challenge. The USA Counter Cyclical Payments are designed to provide a safety net price but due to an historic base (2002) for the calculation, can be ineffective³⁰.

Top Up Funds

Instead of allocating all direct payment monies into an area-based scheme, it is proposed that some of that money is retained in a fund, which can be regarded as a "Top Up Fund" (TUF) that is available to the recipients of direct payments provided they undertake activities that are targeted at achieving certain specified outcomes. The Inquiry suggests that such a fund would be particularly important for Scotland if future changes in Europe were to remove the current provisions in the CAP for special support through Article 68 (indeed the Inquiry suggests that Article 68 would not have a place in any future support system). The Top Up Fund is envisaged as a payment that is associated with direct area payments but is distributed in such a way as to achieve transformational change in the industry.

Given the evolving nature of the interim recommendations and the very tight time scale, it has not been possible to flesh out the top up schemes but neither would it be helpful to be prescriptive at this stage given that all stakeholders will have an opportunity to contribute their ideas. It is envisaged that these contracts will cover a wide spectrum including improving the efficiency of the use of natural resources (e.g. animal health schemes, stable beef production, reduced use of nitrogen, fuel efficiency, improved skills etc) and improving the sustainability of agriculture and rural areas (e.g. climate change mitigation, water management, renewable energy, economic activity to name but a few).

³⁰ Scottish Government economists have produced 'An Overview of USA Farm Support Policy', which should be available on the Inquiry website shortly.

To ensure the objective of underpinning agricultural production whilst achieving a wide range of desired outcomes, this fund probably needs to be around fifty per cent of the amount paid out as direct aid. This would mean that if £460m was available for payments in a given year, then direct area payments in Scotland would amount to £306.7m and £153.3m would be available through the Top Up Fund. However, other options to a 2:1 split of the total funds available for an area-based scheme may also be possible and the Inquiry would be interested in stakeholder's views about the appropriate balance between direct payments and the TUF.

TUF would be in addition to the existing Rural Development budget. Scotland's Rural Development Programme (the SRDP) is currently partly financed by modulation and partly by Scottish Government and EU funding. These should continue at least at the current level (and more if Europe and the UK accept that Scotland's allocation for rural development should be brought into balance with other Member States). Unlike the present situation where the UK receives only 80% of the modulated amounts, in the future, all of the funds currently modulated from Scotland's Pillar 1 payments should be allocated directly to Scotland's Rural Development Programme.

In time, the Top Up Fund might be included in the SRDP, but at this stage of EU negotiation it should be identified as redirected Pillar 1 funds intended as a supplement to a farmer's direct area payment and for use by them in return for delivering some of the Scottish Government's objectives. In effect, this would represent a new contract between Scottish society and farmers.

The design of TUF schemes will be a challenge as whilst they need to deliver the Scottish Government's objectives they must adhere to common principles across the enlarged European Union (ensuring a Common Market) and not be overly complex nor absorb a disproportionate amount of funds in administration. It is essential that any attempt by the EU to nationalise agricultural support is vigorously resisted.

The key features of the schemes will require much further work and discussion but the one certainty is that to deliver the range of objectives will require creativity and boldness. For example, the concept of industry self-policing as regards the delivery of the contract with Scottish Government, e.g. *via* an extension of farm assurance, must be explored in the ensuing consultation and analysis stage. Within these measures might be some that the WTO would treat as trade distorting (blue box) and it will be essential in the CAP reform negotiations to get agreement that Scotland, due to eighty five per cent being LFA, can have a fifteen per cent ceiling for such measures.

Using the Top Up Fund to support particular sectors

Another option that the Inquiry has considered is whether or not it might be appropriate to dedicate a proportion of the funds available under the TUF to supporting particular sectors.

The general principle for the TUF is that instead of allocating all direct payment monies into an area-based system, about one third could be retained in the TUF and directed at individual area claimants in proportion to their direct area payment in

return for certain specified outcomes. It might be possible, though, to provide support to particular sectors, on the basis of their strategic importance, by using a proportion of the TUF pot (perhaps around half of the total available for TUF) and targeting it at specific measures to improve and support that sector. If this option were developed then it would mean that if in a given year £460m was available for payments then direct area payments in Scotland would amount to £306.7m and £153.3m would be available to the Top Up Fund. From this £153.3m possible TUF funding, half (£76.7m) would be earmarked for support schemes for particular sectors. The remaining £76.7m would be available as TUF support to all producers in proportion to their area payments.

By way of example, the red meat sector is particularly important to Scotland and it is thought that livestock farmers, particularly the more intensive ones, will be hardest hit by change in direct payments. There might be an argument, therefore, that a proportion of the TUF could be used to provide transitional support to the red meat sector whilst it adjusts to area-based direct payments and provided in such a way that the emphasis is on improving the efficiency and competitiveness of the sector and maintaining production in the short-term. This could potentially be a 5 year scheme with review after 3 years.

Once again this is very much a concept of what might be achieved and is presented very much for comment and for further analysis of how it might work in practice.

EU Budget Agreement

It is thought that the above area payment scheme and top up fund could deliver their objectives as long as the future budget for the CAP and the allocation to Member States is within fifteen per cent of their current budget. If the budget is reduced Scottish farming and the rural community will be more vulnerable to the various risks it is exposed to and the delivery of wider benefits is likely to be curtailed.

In the unlikely event that the budget for the CAP for Scotland is cut by more than fifteen per cent, there could be an argument that the direct payment support for agricultural activity and for farmer income should take precedence as the very rural fabric which delivers the wide range of benefits will be under threat. It is highly likely that a budget cut of the order of twenty per cent would be as a result of a direct reallocation of budget at EU level to the "new challenges". The proposal outlined here envisages them being financed partly by the Top Up Fund and partly via the SRDP.

Rural Development Programme

It is hoped to comment on the Rural Development Scheme in the final report. The SRDP has already undergone a First Stage Review³¹ and will be subject to a mid term review during 2010 that should provide advice about the application of rural development measures post 2013.

Less Favoured Area

With eighty-five per cent of Scotland's utilisable area being designated as "other less favoured area" (i.e. intermediate under Article 19 of EC Regulation 1257/1999), the future shape of support for these physically disadvantaged areas is crucial to Scotland's wellbeing.

At present, LFASS is distributed under Axis 2 of Pillar 2, but in these proposals (in which 'Pillars' have no role) LFA payments are presented as distinct because although much agricultural activity in the LFA can contribute to environmental objectives, LFA payments are not simply agri-environment payments. As stated earlier in the report (p. 19), where agri-environment payments cover the income foregone and costs incurred linked to specific environmental commitments going beyond the mandatory baseline, LFA payments compensate for the natural disadvantage by covering the additional costs and income foregone related to the natural handicap³². As such, and for the sake of clarity, it is suggested that LFA payments be viewed as distinct.

Beyond this broad point, it is considered inappropriate to comment further at this time as various discussions are currently ongoing to revise the payment base for the 2011 scheme year to better reflect activity. It is intended to make recommendations on future support for the Less Favoured Area in the final report building on the current work being carried out between officials and stakeholders.

³¹ See Cook, P, 2009, Scotland Rural Development Programme: First Stage Review, <http://www.scotland.gov.uk/Topics/farmingrural/SRDP/SRDPreviews/FirstStageReview>.

³² European Commission, 2009, Towards a better targeting of the aid to farmers in areas with natural handicaps, http://ec.europa.eu/agriculture/rurdev/lfa/comm/index_en.htm.

6. Emerging ideas about tackling the short-term issues

The key short-term issues that the Inquiry has considered so far are:

- whether or not to move away from the 'historic' approach to allocating direct payments before 2013 (as allowed under the CAP Health Check provisions);
- how to ensure that agricultural support payments only go to those that are actively farming;
- potentially using Article 68 to the advantage of Scottish agriculture.

Each is taken in turn.

Using CAP Health Check provisions to move away from the 'historic model'

In common with many organisations and individuals, this Inquiry is hard pushed to provide a defence for direct support paid to farm businesses on the basis of supported activity in 2000 - 2002. All the more so due to the enormous range in the annual value of entitlements per hectare and the fact that some people are collecting their payments and have no agricultural output.

There have also been many losers under the historic model. As part of our evidence gathering, we received examples of businesses whose financial viability has been curtailed by the way that SFP was allocated in 2003 and how the historic model has operated since. These businesses had little or no historic subsidies in the reference period or have started up since, in some cases buying farms where the outgoing farmer has kept the entitlement (a similar situation exists with tenanted units where the outgoing tenant has kept the entitlement to sell or activate on annual lets).

These people that have lost out under the historic model want to see a flatter, more inclusive area based system introduced as soon as possible (particularly as it now appears that the SFP is much more than an annual payment to facilitate business adjustment before direct payments stop) and the Inquiry has sympathy with this view.

There are, however, wider considerations, not least uncertainty about the post-2013 support regime. The shape of the post-2013 support regime in Europe is at this time very uncertain and, in the evidence submitted, many argued that it would be a mistake to embark on a process of stepped changes towards a new system before we know clearly where we are heading.

There are also issues relating to administration systems. Any change to the way individual SFPs are calculated will result in new administration systems including, but not solely, computer systems³³. Currently the demands on the Rural Payments and Inspections Directorate (RPID) are high (due to complex changes to LFASS system)

³³ See 'The Future for RPID IT', which should be available on the Inquiry website shortly.

although their track record for speedy, efficient processing of farmers' claims is good. Compare this with the RPA in England and you can identify a model you would not wish to pursue (any doubters are referred to the National Audit Offices review of the RPA handling of SFP³⁴). Whilst we can be critical of the RPA's track record in handling new systems, we must accept that they embarked on a very complex data processing task with little time to prepare. We would not want Scotland to fall into that trap as the potential damage to our industry and RPID would far outweigh short-term gains.

The position reached by this Inquiry is therefore that there should be no change prior to 2013 apart from considering the use of Article 68 and the strengthening of GAEC.

However, given the strength of the arguments for immediate change, it seems reasonable that the basis of payment should change as soon as practical after 2013. The Inquiry believes that acceptance of the final report should be taken as notice that the current basis of payment will cease and a new basis start as soon as is practical after 2013. Given that EU agreement, if achieved, is likely to be very close to the start of the 2013 scheme year, it seems sensible to accept that change will happen in the 2014 scheme year thereby providing 3.5 years notice of change to the existing system.

To be clear, the Inquiry takes the view that a stepped change towards a flatter rate of SFP is not necessary. What is necessary is sufficient notice so that businesses can plan accordingly and so that the appropriate systems can be put in place to ensure a smooth transition. To achieve efficient implementation of the administration system for the new subsidy regime, whatever it is, it is essential that RPID start developing the new system architecture immediately.

New Entrants

New entrants have been particularly disadvantaged under the historic model and the Inquiry was keen to see what could be done for them in the short term. Since the main way in which a redistribution of payments could be achieved (moving to a flatter area basis for payments) has been ruled out, we must look at other options and there are two possible routes forward. These are either using the National Reserve (Article 41 of the EC Regulation 73/2009) or using the Specific Support provisions set out under Articles 68 – 72 of the EC Regulation 73/2009. Scotland has previously made good use of the National Reserve established in the 2003 reforms to award entitlements to new entrants.

Although the new Health Check Regulation EC/73/2009 still allows for entitlements to be awarded to new entrants, unlike the old Regulation (EC/1782/2003) the new Health Check Regulation EC/73/2009 does not allow Scotland to apply a new top slice to payments in order to generate the additional funds that would be needed to support new entitlement awards to new entrants. In the absence of a new top slice, the only possible sources of future funding that could enter Scotland's National Reserve would be from entitlements that no longer meet usage conditions,

³⁴ See NAO, 2009, A second progress update on the administration of the Single Payment Scheme by the Rural Payments Agency, http://www.nao.org.uk/publications/0809/2nd_progress_report_on_single.aspx.

entitlements that are not claimed since they now fall below the new minimum threshold conditions or if Scotland chose to apply it, funds that might arise from a siphon or windfall tax on the trading of entitlements.

Detailed rules set out in EC Regulation 1120/2009 indicate that the maximum retention on sales of entitlements without land is 30% of the value, for sales of entitlements with land up to 10% may be retained and where the sale involves an entire holding 5% may be retained by the Member State. However, the current low level of selling of entitlements and the relatively high administrative costs that would be incurred from implementing such a scheme strongly suggest that this would not be an effective way to top up the National Reserve.

The additional funding for the National Reserve that could be available through these various routes is thought to be extremely modest and insufficient to support the award of new entitlements. Unfortunately this means that although existing entitlements awarded from the National Reserve in 2005 will continue to be funded by a top slice to the SFP, it is not possible to use the National Reserve for further awards to new entrants. This is particularly disappointing to the Inquiry.

Focusing on agricultural activity

Current Situation

As time has passed since the original qualifying years (2000 - 2002) for the establishment of the historic SFP, businesses have changed considerably, which was, after all, part of the logic for decoupling. Some have ceased any form of active production, others have sold up and claim (or sold to others who claim) their entitlement on barren hillsides ("naked acres") whilst others have restructured their businesses, some dramatically, in answer to market signals. It is impossible to calculate the excess SFP paid to this latter category as the original subsidy basis was very complex with various interactions. The claiming on "naked acres" does not contribute a significant proportion of the total SFP budget.

The vast majority of responses to the call for evidence and the views of Commission and Scottish Government officials believe it is quite wrong for SFP to be paid where there is no agricultural activity or at the very least human intervention.

This Inquiry fully concurs with this view and believes that the most desirable solution is to implement new measures under GAEC. Due to the abhorrence in Europe of any suggestion that aid might be coupled, there are few tools available in the Health Check to ensure that those in receipt of SFP produce some agricultural produce and GAEC appears to be the only viable option, even if very limited.

Grazing

As regards grazing (rotational and permanent grass and rough grazing), the Inquiry is minded to suggest a minimum and maximum stocking rate common to all types of grazing. The minimum will have more significance for poorer land and the maximum for good rotational grass. The proposed figures are a minimum of 0.08 LU/Ha and a maximum stocking of 2.5 LU/Ha.

Arable

Requiring minimal activity in return for payments is obviously a desirable requirement for the receipt of all SFP payments in Scotland. Therefore, for arable producers, land that is left fallow would be required to have a cover crop sown and a maximum period where land is allowed to be fallow would be set in order to avoid scrub growing on this land. In addition, a new condition would be introduced requiring herbage be cut twice a year. The cover crop would need to be established immediately post harvest or as soon as ground conditions permit.

Although requiring minimum activity in return for payments is obviously desirable and certainly something to be negotiated in future EC policy discussions, it is not certain at this stage that the proposed arable measure could be developed as intended, under the current framework set out for GAEC in Annex III of the Regulation.

Application of new GAEC measures

It is suggested that where a producer falls foul of the grazing and arable requirements set out above they can provide their local RPID office with their justification for their actions and, if they fit with an agriculturalist's view of Good Agricultural Condition, the SFP payments will not be affected. Further guidance on this will be developed.

Where a producer is considered to be in breach of these additional requirements, standard payment reductions will be applied to their Single Farm Payment Scheme, Scottish Beef Calf Scheme, Energy Crop Scheme, Protein Crop Premium, Less Favoured Area Support Scheme and certain management options claimed under the Land Managers Options Scheme and Rural Priorities, in accordance with the penalties for breaches in cross compliance which are set out in the Health Check Regulation³⁵.

However, not only is the potential penalty limited by the terms set out in the EC Regulation as described above, there may also be additional administrative costs, for example, in validating livestock numbers.

Using Article 68 to the advantage of Scottish agriculture

If there is a desire to redirect some of the current historic SFPs to address some of Scotland's emerging issues, it seems that the only practical way to achieve this in the short-term is the use of Article 68. Scotland took the decision last summer not to use Article 68 measures nor change the Scottish Beef Calf Scheme (SBCS) for the 2010 scheme year. In the opinion of the Inquiry, this was the correct decision as the actual implementation rules were not known until very close to the decision deadline and there was no reasonable chance of stakeholder consultation or designing

³⁵ As a rule, the payment reductions will be 3% for a first time negligent breach. Depending on the seriousness of the breach, a reduction could be reduced to 1% or increased to 5%. Warning letters will only be issued for minor breaches where remedial action can be taken. Repeat breaches can see reductions increase up to 15%. Payment reductions for intentional breaches will, as a general rule, be 20% but will range from 15% to 100% depending on the circumstances.

appropriate schemes. However, Scotland can take further decisions to change the SBCS or to introduce further special support 'Article 68' measures on either 1st August 2010 or 1st August 2011, although the timescale is very tight for 1st August this year.

The intention of Article 68 (CAP Health Check Regulation 73/2009/EC) is to direct 3.5% (or in very limited situations, 10%) of the national ceiling to correct unintended outcomes of decoupling and it is worth noting that Article 68 measures apply to new entrants and others not in receipt of Single Farm Payment.

The options below assume that we can create a larger fund for new Article 68 measures by top slicing all Scottish entitlements, to a level that can be justified to Europe in terms of the UK's ceiling. However, it should be noted that before Scotland could consider using such an option, agreement from the other three regions would be needed since they may also wish to use Article 68 measures in future years.

If we consider that the maximum amount that Scotland can top slice from Scottish entitlements is equivalent to 3.5% of the UK's ceiling rather than 3.5% of Scotland's share of the UK's ceiling, we can look more positively at what we might do, since the UK's ceiling is more than five times the size of the Scottish ceiling.

In 2008, the Scottish Beef Calf Scheme (SBCS) cost £23.45m before modulation³⁶ when the initial Scottish regional ceiling was £509m. This means that the SBCS accounted for about 4.6% of Scotland's regional ceiling in 2008, well in excess of the 3.5% that is now allowed for new measures of this kind. Therefore, in terms of the Scottish ceiling alone, we can do no more and, in fact, if we converted the SBCS from the existing Article 69 measure to a new Article 68 measure, the headage payments would be smaller. In addition, any continuing Article 69 types of scheme such as the SBCS must end with the 2012 scheme year, however, any new Article 68 measures could continue until the Regulation is changed.

The new Article 68 payments could apply for the 2011 scheme year. This would mean that a farmer would need to comply with conditions that would be agreed with industry prior to August 2010. The first payments to eligible applicants would then be made in Spring 2012. As is currently the case with the SBCS, the simplest way of using these sorts of measures is to decide on a top slice based on the euro payment. This means that individual sterling payments to producers under any of the proposed new schemes would vary according to the relevant exchange rate and the number of animals claimed on in a given year.

The following options are provided as a basis for discussion at the public meetings and for written comment thereby enabling the Inquiry's final report to make authoritative recommendations. The options set out some general areas where additional support of this kind could be useful but would need further work to ensure that they meet the detailed conditions set out by the Commission. The Inquiry looks forward to hearing views on the options outlined below.

³⁶ £20.4m after modulation

Beef Production

Much has been written about the reduction in beef cow numbers in Scotland since the decoupling of beef subsidies. This was an expected consequence of decoupling despite many farmers believing that “Freedom to Farm” would result in increased production. The actual fall in breeding cow numbers across Europe is believed to be less than the European Commission expected.

Whilst the drop in beef production in Scotland is more or less in line with the rest of the UK and Europe and, in many countries in the rest of the world, it has more significance for Scotland due to the importance of the industry to Scottish agriculture and the Scottish economy and the world reputation of the Scotch Beef brand³⁷.

At present, Scotland operates the Scottish Beef Calf Scheme (SBCS) under the national envelope measures specified in Article 69 of EC Regulation 1782/2003. The SBCS is funded by applying a 10% top slice to the euro entitlement value of claimants in the beef sector and it currently accounts for just over 4.6% of Scotland’s regional ceiling. The top slicing generates a supply of funding which is used to make headage payments on suckled calves. In effect, the SBCS redirects funding from beef finishers to beef breeders as it was aimed at securing the supply of suckler calves into the supply chain.

The recent publication of the CAP Health Check Regulation 73/2009/EC³⁸ allows us to reconsider whether the Scottish Beef Calf Scheme is still the right approach. Scotland can decide to change the SBCS or to introduce further special support ‘Article 68’ measures for beef on either 1st August 2010 or 1st August 2011.

There are four options presented below, each of which addresses specific issues in the livestock industry. If any one of the new Article 68 measures were to be adopted it is proposed that the SBCS would be ended. Under the terms set out in EC Regulation 73/2009, the existing ten per cent top slice currently being applied across the beef sector for the SBCS would be returned to the original claimants thereby producing a small boost for beef producers. A new top slice would then be applied to Scottish entitlements to generate the funds needed for the new scheme. It is not envisaged that more than one beef scheme would be put forward for final consideration.

Suggestion 1: Maintain cows in the Less Favoured Area

The Inquiry was specifically tasked with considering how to halt the loss of breeding cows and ewes. Breeding cows, despite their methane production, contribute to a wide range of public goods in disadvantaged rural areas. A new scheme could be considered to stabilise breeding cow numbers in the LFA where cows rely mainly on rough grazing and permanent grass – a food source which can only be utilised by ruminants. A new measure could be developed under Article 68 (1) (b) to address

³⁷ QMS, 2009, The importance of livestock production to the Scottish economy, <http://www.scotland.gov.uk/Resource/Doc/278281/0090717.pdf>.

³⁸ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:030:0016:0016:EN:PDF>.

specific disadvantages in the beef sector for economically vulnerable types of farming.

It is thought that the proposed support needs to be around £150 per cow up to a maximum of 40 cows per registered business to be effective. Specific details and eligibility conditions would need to be worked out but they would need to be on a historic basis since it will be essential to ensure that existing businesses with cow herds over 40 head do not have the opportunity to sub-divide into multiple cow herds and that it is LFA units that are supported. Restrictions must apply immediately even though the recommendation made here is for discussion and further analysis prior to the completion of the Inquiry final report.

Initial estimates suggest that 200,000 cows (about 43% of Scottish total at June 2009) would qualify for this payment. Under the current favourable exchange rate, this would require a total budget of around £30.0m equivalent to an initial 5.9% top slice of Scotland's regional ceiling.

Suggestion 2: Extended Beef Calf Scheme

Over the last few years the production of beef cross calves from the dairy has greatly reduced due to the demand for dairy heifers, mainly because of the high replacement rate in dairy herds rather than the national herd increasing. To provide an incentive to increase beef from the dairy one suggestion is to include all calves with a beef sire in the calf scheme with a corresponding lift in the ceiling for payments.

A new measure could be developed under Article 68 (1) (b) to address specific disadvantages in the beef sector for economically vulnerable types of farming. For example, it could provide specific support to livestock producers who produce calves of between 50 – 100% beef breed. The new payments would be in the form of a headage payment per calf to all qualifying animals which are registered with BCMS with the scheme rules as similar as possible to the current SBCS.

This new payment could provide an incentive to farmers in both beef and dairy sectors to produce calves with a proportion of beef genetics in order to maintain the supply of good quality beef to the supply chain.

Currently dairy cows have a relatively short lifespan with herd replacement rates of over thirty per cent not uncommon. Providing an incentive to produce beef cross calves rather than pure dairy animals is a further, if minor, reason to increase dairy cow longevity and to promote the demand for sexed semen at a reasonable price.

At present, many dairy males are kept entire and finished on intensive diets. It is believed that a higher proportion of beef cross dairy males will be castrated and grass reared providing further environmental benefits for Scotland. Indeed, there may be an argument for only paying on dairy/beef crosses which are castrated. The proposed measure is therefore projected to have economic, environmental and animal welfare benefits.

It is suggested that this extended Article 68 beef calf scheme, including beef calves from the dairy, would operate in a similar fashion to the SBCS, but would have a new ceiling established which allows for the additional calves. First estimates would suggest that an extra 70,000 calves would probably qualify for payment resulting in a budget increase of £2.5m. Therefore the total sum required for the Extended Beef Calf Scheme is likely to be around £22.9m, which under current circumstances would be equivalent to an initial 4.5% top slice of the Scottish regional ceiling.

Suggestion 3: Cattle health

Diseases affecting Scottish livestock lower the welfare of Scottish herds as well as reducing productivity. Such a disease is Bovine Viral Diarrhoea (BVD), a viral disease of cattle that is widespread in Scottish dairy and beef herds. Outbreaks of the disease can cause significant financial loss both because of infertility in infected animals as well as through greater susceptibility to other diseases, in particular to respiratory infections. A good diagnostic test exists which allows BVD infected animals (PIs) to be identified and under the proposed scheme these animals would be slaughtered. Commercial vaccines exist to allow protection of uninfected animals and under the proposed scheme all animals in a herd would require to be vaccinated. Eradicating BVD from the Scottish herd would improve the welfare of the animals since they will be less susceptible to secondary infections and fertility is expected to increase. Eradicating this disease from Scotland will improve the productivity of the Scottish beef and dairy herds and thereby reduce their carbon footprint and improve the reputation of Scottish beef and dairy cattle.

It might be possible to develop a new measure under Article 68 (1) (a) (iv) to allow additional annual payments to be made to livestock farmers who are practising enhanced welfare standards by undertaking steps aimed at eradicating BVD.

Early indications are that a scheme to encourage producers to eradicate BVD from their herd, or maintain their disease-free status, would probably require an annual payment of around £30 per cow. Assuming that sixty per cent (or 400,000) of the dairy and beef cows in Scotland will be entered into such a scheme, an annual budget of about £12m would be required, which at present would be equivalent to an initial 2.4% top slice of the Scottish regional ceiling.

Suggestion 4: Addressing land abandonment in North West Scotland

The reduction in breeding cow and ewe numbers in Scotland reflects a similar pattern to the rest of the UK, the EU and the world. However, the loss of sheep in North West Scotland is much greater. This area has been characterised by many low performing ewes with lambs which reach a low terminal weight (<15kg) with very limited market opportunities. This non-sustainable production was supported and encouraged by ewe headage payments with no link to the productivity of the ewe.

The reduction in ewe numbers and, to a lesser extent, cow numbers is resulting in land abandonment particularly in the North West Highlands and to a lesser extent on the Western Isles. Whilst the increased payments for Very Fragile and Fragile LFA areas and the greater emphasis on production might help to stem the flow, it is

unlikely to result in beneficial (in terms of public goods) restocking. The suggestion that a minimum stocking rate of 0.08 livestock units per ha be introduced under GAEC might halt the destocking and possibly lead to some recovery of numbers.

Lamb production in the North West of Scotland is undertaken under challenging conditions in locations which are often far away from natural markets. Breeding ewe numbers in the North West have declined by 25% and lamb numbers by 22% between 2000 and 2008. Over the same period, cattle numbers have remained fairly constant. The high relative decline in sheep numbers in the North West provides clear evidence that this type of farming is economically vulnerable.

In addition, there is a body of evidence that supports the view that grazing by sheep delivers environmental benefits, although these benefits are different to those from grazing cattle. For example, grazing by sheep at an appropriate stocking density can be used to manage floristic diversity.

Sheep and lamb production in the North West can also be important for the continued viability of many fragile and remote communities. Farming in these areas helps to keep a viable population and a source of income for wider community activities. Thus helping to prevent further abandonment of sheep farming in these areas will have many indirect social benefits. For example, traditional sheep farming of this kind is attractive to the many tourists who visit the area each year.

Accordingly, for a designated area it might be appropriate to use Article 68 (1) (b) of the Health Check Regulation 73/2009/EC which is designed to address disadvantages in economic and/or environmental vulnerable areas – the North West of Scotland qualifies under both economic and environmental criteria.

Given the severe disadvantage of running ewes in this remote area, a headage payment would require to be significant to encourage restocking and the maintenance of existing ewes. It is considered that payments of around £12 per ewe would be the minimum carrot required. However, since it would be essential to avoid the bad old days of ewes being run as subsidy collectors rather than lamb producers, the new payments would be in the form of a headage payment of £15 per lamb to active sheep farmers for each lamb born in the north west of Scotland. Producers should be required to electronically tag qualifying lambs in order to receive the payment.

It is estimated that this lamb package would cost in the order of £10m per annum, which in terms of the 2009 budget would be equivalent to an initial 2% top slice on the Scottish regional ceiling. This is based on the assumption that there will be 650,000 lambs in the North West of Scotland eligible. It is proposed that the new payments would start to apply in the 2011 Single Farm Payment year. The first payments to eligible applicants would therefore be made in Spring 2012. A major hurdle for this support scheme could be the disproportionate administration cost for introducing it.

Summary of Article 68 Measures

The Inquiry believes that the only way to make any short-term changes to the way that European subsidies are used in Scotland is to use a new top slice to finance Article 68 measures.

The options presented are:

- Maintain beef cows in Less Favoured Areas – £30.0m. Allowing for modulation, this would mean a 5.9% top slice;
- Extended Beef Calf Scheme – £22.9m. Allowing for modulation, this would mean a 4.5% top slice;
- Cattle Health Scheme to eradicate BVD – £12m. Allowing for modulation, this would mean a 2.4% top slice;
- Sheep Scheme for NW Scotland – £10m. Allowing for modulation, this would mean a 2% top slice.

The percentage cuts shown above are based on the 2009 budget. The 2009 SFP scheme year has benefitted from a favourable exchange rate. Should this situation change and become less favourable or the numbers of eligible animals alter, then payment rates would change. The UK's ceiling is set out in Annex VII of Regulation 72/2009/EC. The UK's budget set by the EC is given in Euros, €3.975bn in 2010, €3.975bn in 2011, €3.988bn in 2012 €3.988bn in 2013). The Scottish ceiling in each of these years will depend on the exchange rate on 1st October in each year.

If a new Article 68 measure is introduced in 2011, in all cases, it is proposed that the current Article 69 measure (the Scottish Beef Calf Scheme) would be terminated at the end of the 2010 scheme year with final payments in March 2011. Under the CAP Health Check rules, the SBCS would need to cease with the 2012 scheme year with final payments being made in March 2013. However, as a further option, a new Article 68 scheme could be launched which would have similar rules as the existing SBCS but it would be financed by top slicing all Scottish entitlements by 4%.

Finally, having put these suggestions forward, we must recognise that even if a consensus emerges that one or a combination of these options is thought worth pursuing, there are several hurdles that will have to be overcome. In the first instance, Scotland would have to seek the agreement of the other three regions in the UK that Scottish farmers can use the UK ceiling. The EU would then have to agree that any proposal is acceptable within the rules and there would be significant challenges in terms of putting the appropriate administrative systems in place by 2011.

7. Next steps

This interim report sets out some of the issues and some of the preliminary thinking about the future of support for agriculture. It puts forward a range of proposals in the hope that it can stimulate further debate and so that stakeholders have another opportunity to express their views before final recommendations are made.

The Inquiry is keen to hear from individuals and organisations on any issue about the future of support for agriculture and to facilitate further engagement a further consultation document accompanies this report and a series of events are planned in the near future.

Consultation

The report is accompanied by a consultation document that can be found on the Inquiry website: www.scotland.gov.uk/BrianPackInquiry. The Inquiry invites interested organisations and individuals to respond to this consultation, responses should reach the Inquiry team as soon as possible and **no later than 5 March 2009**.

Events

Events are taking place around the country so that as many people as possible can hear about the proposals and have an opportunity to have their say. The events are scheduled as follows:

January

Tues 26 – Haddington – Town House
Wed 27 – Dumfries – Cairndale Hotel
Thurs 28 – Ayr – Western House Hotel

February

Mon 1 – Inverurie – Thainstone Centre
Tues 2 – Inverness - Ramada Inverness Hotel
Wed 3 – Benbecula – Dark Island Hotel
Thurs 4 – Stornoway – Caberfeidh Hotel
Tues 9 – Thurso – The Park Hotel
Wed 10 – Kirkwall – The Albert Hotel
Thurs 11 – Lerwick – Clickimin Leisure Centre
Mon 15 – Oban – Corran Halls
Tues 16 – Perth – Dewars Centre

Meetings will start at 7:30pm, further details will be available shortly on the Inquiry website: www.scotland.gov.uk/BrianPackInquiry.

Final report

To allow time for an analysis of the responses to the consultation and for any supporting research to be undertaken, the final report will be delivered in June 2010.

Contact

If you have any queries about the Inquiry, the interim report, consultation or events please contact John Brownlee, Inquiry Secretariat at the following details:

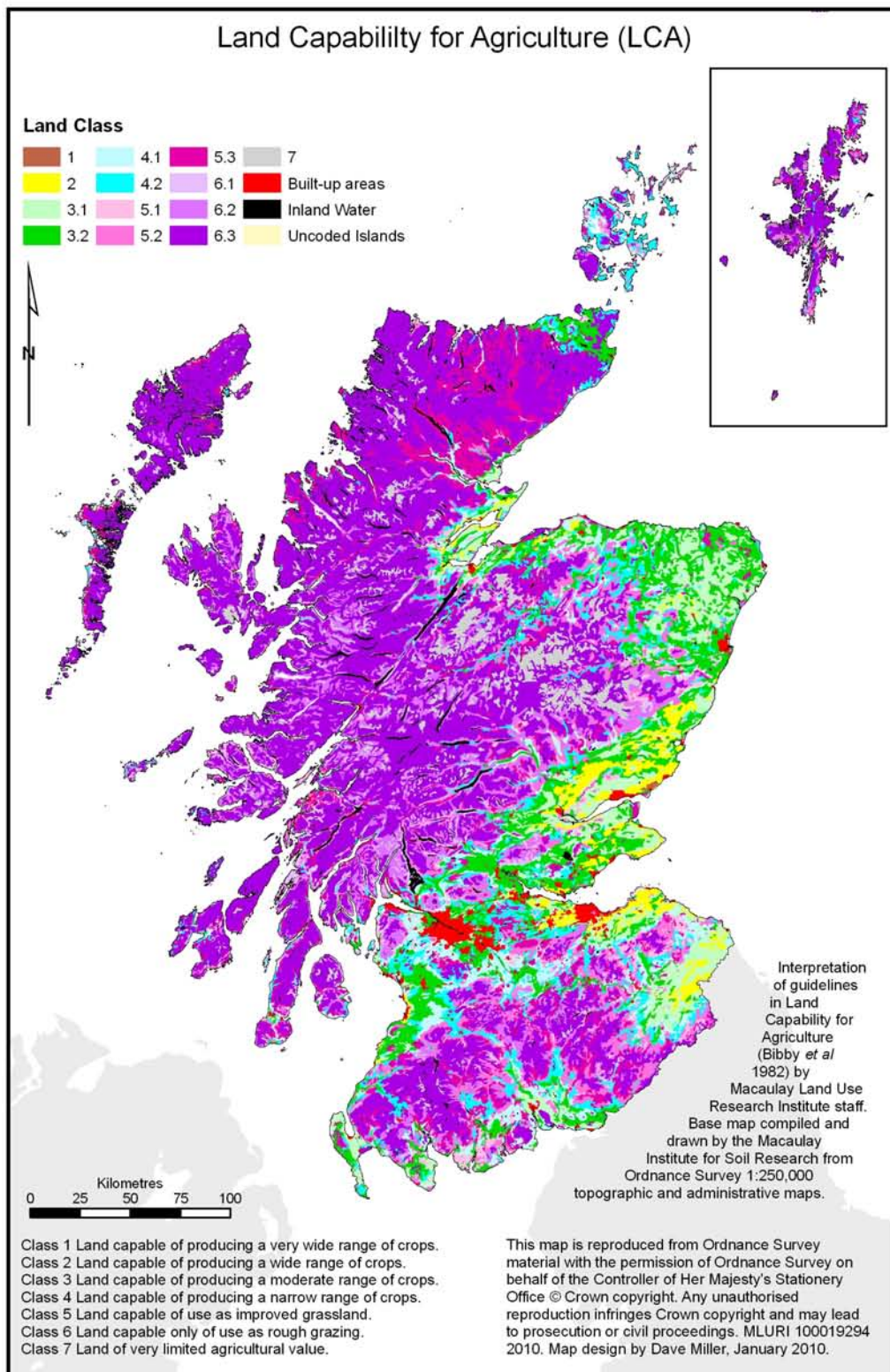
By email to: BrianPackInquiry@scotland.gsi.gov.uk

By post to:

John Brownlee
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Room 259
Pentland House
47 Robb's Loan
Edinburgh EH14 1TY

By telephone: 0131 244 6357.

Annex 1: Land Capability for Agriculture Map³⁹



³⁹ Details of individual farm LCA classification are not available at this time, but they are not considered necessary for discussion of the principle of using the LCA classification.

Annex 2: Overview of responses to the first call for evidence

The initial call for written evidence to the Inquiry ended in October 2009. This call for evidence was conducted to canvas the views of organisations and individuals on the remit of the Inquiry and test the stakeholders views of the options for going forward.

Overview of responses

The Inquiry invited respondents to consider 3 general questions followed by 10 more detailed questions relating to the future support of agriculture

A total of 105 responses were received, comprising 58 responses from individuals and 47 from organisations. Some respondents addressed all of the questions asked in the call for evidence while some focused only on those within their remit or field of interest. Amongst the organisational responses received, the highest number came from within the farming sector.

The following section shows the main themes which emerged in relation to each question.

Delivering sustainable economic growth

The key theme to emerge in relation to the first question was the need for a broad definition of sustainable economic growth. Other key themes included:

- That future funding needs to be structured around achieving specific public benefits.
- That financial support should be tied to specific outcomes.
- The need for a variety of support mechanisms aimed at innovation and better business practices.
- The need to move away from the historic system of entitlements.
- That payments should be targeted at those involved in active farming or production.

Ensuring high productivity

Over half of those responding to this question acknowledged that agricultural production and biodiversity protection can go hand in hand.

Many thought sustainable or optimal production, rather than high productivity, should be the target for future support. Many respondents noted that good land management can produce both the food and fuel needed as well as public goods and benefits; incentives and rewards should be aimed at farmers and land managers who manage their land in a way that produces these benefits. Others felt that support should be targeted both at environmental measures and at ensuring viable farm businesses. There were also calls (from around one fifth of those respondents who answered this question) for the diverse nature of Scotland's farming land to be considered when assessing future support schemes and respondents thought that areas should be used for the production they are best suited to.

Delivering targets on Climate Change

The majority of those responding to this question identified encouragement for renewable energy or alternative fuel production by farmers and landowners as being a desirable area to support. The main practical measure, identified by over one third of respondents in relation to delivering the Climate Change targets, was the role of carbon sequestration or carbon storage. Respondents also expressed opinions on farming methods and practices in relation to meeting the Climate Change targets. In addition, respondents discussed sources of, and conditions for, funding and financial assistance to help achieve the changes needed to meet the Climate Change targets.

Distribution of Pillar 1 funds

Many responses directly mentioned the need to move away from an historic base for calculating payments. Again, a main theme to emerge was that support should only be directed at those actively farming or managing their land. More respondents felt that payments should be tied to the land, or the person actively farming the land, than felt they should be tied to the landowner.

Many respondents mentioned that any system introduced should be fair, transparent and/or simple with clear objectives with support targeted at producing social, public, economic and environmental benefits as well as at food production. Around a fifth of respondents were in favour of an area-based system than were against the idea and felt the use of Macaulay Land Use Classifications should be explored. Others suggested that land types could be used as a basis for distribution. Whichever system is to be used, respondents wanted to see support targeted at those areas in most need. With help for new entrants and restrictions of trading in entitlements also being key themes.

While many respondents felt that the current system should be changed as soon as was practical to enable a long changeover period, over a third asked for a transition period and emphasised the importance of ensuring that farmers have adequate notice of changes.

Securing public benefits

The majority of respondents felt Pillar 1 payments should be conditional on meeting some standards. Building on the current cross compliance system was seen as important by over a fifth, while a slightly smaller number saw current conditions as sufficient. The main theme to emerge, once again, was that support should only be given to land under active management. One quarter of respondents also mentioned the need to ensure support was directed at those producing food.

Pillar 1 and the Less Favoured Area Support Scheme

Respondents were fairly evenly split over whether Pillar 1 and Pillar 2 payments should remain separate or be merged into a single scheme or payment source. One quarter of respondents commented that the Less Favoured Areas Support Scheme (LFASS) should be used to support land in High Nature Value land, disadvantaged or marginal areas. One main theme to emerge in relation to the LFASS was the importance of support for livestock farmers in these areas.

Payment levels and activity

Many respondents noted the need to link payments to farming activity or that the payment should be focused on those individuals who are genuinely active in farming. Over 10% of respondents also mentioned the need to link payments to delivered public benefit or the provision of public goods. Slightly fewer felt payment should be related to productivity.

Inclusion in future schemes

Almost all respondents agreed that future schemes should cater for agricultural holdings currently outside the SFP scheme. A main theme emerging at this question was that future schemes should cater for anyone who can meet eligibility criteria and comply with the relevant environmental conditions attached to payments. Support for active farmers or land managers was again highlighted as important and, again, some (one fifth of) respondents felt that schemes should encourage new entrants into Scottish agriculture.

Diminishing budgets

Many respondents stressed the need for any support payment schemes to be more focussed or targeted with clear objectives. Other key points included:

- The need for stringent negotiations with a view to retaining as much funding as possible.
- Advance notice of any changes was seen as important.
- The importance of paying support only to land under active management was reiterated.
- One other key theme was the importance of securing food production in the face of diminishing budgets.

Balance of Pillar 1 and Pillar 2

Respondents were split over where the balance of funding should be, with similar numbers favouring each Pillar and a similar number again in favour of a move away from the Pillar system. Over 10% of respondents commented on the complexity and inaccessibility of Pillar 2 measures and 10% suggested delivering enhanced public benefits through Pillar 2 measures with Pillar 1 support remaining for basic activity.

Targeting of future support

The majority (around two thirds) agreed that future support be targeted and that transformational change needs to be supported to address the challenges of agriculture in Scotland. The need to develop collaboration was also seen as important by around one third of respondents.

Scottish priorities

The priority mentioned by the highest proportion of respondents (one third) was identified as food security and production while another was the need to recognise the differences in Scottish land types and climate and the high proportion of HNV land in Scotland. The importance of support for rural communities, economies or sustainable rural development was also highlighted, as was the importance of halting the decline in livestock numbers, climate change and sustainable land use.

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