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How can Europe reap the environmental rewards from subsidy reform and align with the Paris Agreement?

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Agricultural subsidies – incentives paid by governments to farmers and agricultural businesses – are used to support farmers, ensure a stable supply of affordable food, and keep rural economies alive. Yet they can have unintended consequences, including promoting forms of farming that harm the environment and have a negative impact upon climate change.

Globally, reform of agricultural subsidies can help align the land-use sector with the Paris Agreement on climate change, promoting enhanced carbon mitigation and negative emissions. This can also serve to enhance resilience for climate adaption, biodiversity and global food security. For the European Union, aligning the Common Agricultural Policy (CAP) with the **European Climate Law** offers a chance to demonstrate international leadership and catalyse reforms in key food-producing countries such as India, China, Brazil, UK and the US.

Proposals to reform the CAP from 2021-2027 are a step in the right direction, although we believe they will not go far enough before their complete integration in 2023. Four key recommendations that we think the EU could consider in order to unlock the potential for public finance to transform the agriculture and land-use sector and to align the CAP with the EU Climate Law and Green Deal are:

1. Encourage use of enforceable performance-based targets that link support to member states and farmers, commensurate with the cost of delivering public good or environmental services;
2. Shift away from incentives that prioritise yields at the expense of the climate and environment, and balance this with new monetary incentives that put a value on sustainable agriculture;
3. Decouple support from production metrics for single commodity transfers with high associated greenhouse gas emissions (e.g. beef and dairy);
4. Apply the Just Transition Mechanism to support farmers' social and economic well-being, where impacted by CAP reforms.

Why is this important?

a. What is the issue?

Agriculture contributes approximately 12% of global greenhouse gas emissions. While EU agricultural emissions have dropped compared to three decades ago, the downward trajectory has stalled in the last 10 years. However, farming and land use are different from other hard-to-abate industrial sectors in that they have the capacity, if managed well, to serve as a 'carbon sink', accumulating and storing carbon and thereby lowering the concentration of carbon dioxide the atmosphere. This potential is emerging at the forefront of the climate debate, with appetite for 'natural climate solutions' which could deliver up to an estimated 37% of the required mitigation to stabilise warming to below 2°C.

Subsidies are central to designing how land is used and which commodities are produced, with the 20 leading producing countries paying more than $620 billion annually to the agricultural sector between 2015 and 2017. Subsidies often comprise a large percentage of governments' total financial output. In the case of the CAP, this rises to nearly a third of the EU annual budget, with €291 billion of the fund dedicated to income and market support, and €95.5 billion supporting rural development.

The subsidy strategies currently employed by the largest agricultural producing nations often provide perverse incentives for unsustainable approaches to farming, propping up large-scale production rather than prioritising environmental and ecological sustainability. At the national scale, these subsidies may render the overuse of pesticides and fertilisers mainstream, and contribute to the expansion of farming into marginal lands. Internationally, poorly designed subsidies have the potential to suppress commodity prices, driving trade in unsustainable commodities, the production of which mismanages water, biodiversity and soil.

b. What can investors and businesses do?

Investors and businesses are acutely aware of the systemic risk that climate change poses to long-term, resilient and sustainable economic growth. As long-term stewards of their clients' assets, many investors are integrating climate risks into their investment processes and have been engaging with businesses, including in the food and agricultural sector, on risks and opportunities related to climate and the environment. However, while investors can influence food manufacturers and distributors through such strategies, they are often unable to achieve sufficient influence further upstream in the agriculture, forestry and other-land-use value chain. Reform of agricultural subsidy packages to help achieve a sector-wide low-carbon transition would help.

Why now?

The opportunity provided by the conjunction of reforms to the CAP and the first stages of the implementation of the European Green Deal cannot be understated. The COVID-19 pandemic has provided further impetus for change, creating a crucial window for bringing subsidies into line with climate and other goals.

An ambitious agricultural policy reform package would keep up the momentum generated from the Green Deal and allow the EU to follow through on its ambitious plans to restore biodiversity, reduce pollution and transition to a circular economy. At the same time, the COVID-19 crisis has provided an external paradigm shift in the way national governments support key industries through central finance. This is highlighted by the EU's approval of approximately €2 trillion for a recovery plan to be spent over the next seven years. The CAP has the potential to build on the EU's progressive green recovery, helping to secure a more resilient and healthier food and farming system for the future.

The CAP post-2020: What is proposed?

The EU Council reached a consensus on the general approach to the post-2020 CAP reform package at the October 2020 Council meeting; negotiations continue on the details. The proposal goes some way to promoting a sustainable agricultural transition for the region, but it is still not aligned with the EU Green Deal.

A key element of the post-2020 CAP is that member states will control national-level budgets themselves. This gives countries the policy flexibility to implement reforms according to their own agro-ecological conditions. However, the EU must ensure that agreements with individual member states provide national-level targets which are ambitious enough to meet the aspirations of the post-2020 CAP reform package.

Embracing investment in innovative agricultural practices can enable local decarbonisation. At the member state level, this could take the form of funding for more innovative subsidy programmes, such as opt-in eco-schemes that are ecosystem-specific and provide access to more environmentally friendly machinery and training. The EU's commitment to knowledge and innovation in the food, agricultural and rural development sector, through the Horizon programme (€10 billion additional funding levied), should be celebrated and supported further within the bloc to ensure success in this arena.

Proposed environmental reforms to the CAP need to be met with imaging technologies to monitor and assess farming conditions to ensure that the targets are being met on the ground. The updated Copernicus Sentinel Satellites have improved the capacity for remote monitoring of CAP performance, but the European Court of Auditors recommends that the EU Commission could provide further incentives to member states to access this data for monitoring purposes.

Recommendations for aligning the reform of the CAP with the Paris Agreement

1. **Encourage use of enforceable performance-based targets that link support to member states and farmers, commensurate with the cost of delivering public good or environmental services.**

   The EU's steps to impose a performance-based subsidy system rather than a strict compliance-based approach can help to manage the decarbonisation of the land-use sector. The CAP post-2020 has seen good progress on this front, with wider conditions that encourage member states to meet a range of environmental targets (covering water, biodiversity, land and climate) to access more funding. This further decouples subsidy payments from purely production metrics. However, too many practical requirements (e.g. which farming practices to follow, what production techniques should be used) within these conditions may make it excessively burdensome for farmers to shift to greener production methods, while EU-wide conditions do not take into account the different agricultural conditions within the bloc. As such, a results-based approach determined at the national level that establishes clear and measurable targets (e.g. GHG reduction or biodiversity protection) should be encouraged. The financial support for achieving these goals should be commensurate with the cost to farmers of preserving biodiversity and reducing GHG emissions and linked to indicators of success. There are two key challenges to overcome to achieve this. First, actionable monitoring systems put in place to measure progress against clearly signposted national targets must be created. Secondly, consensus over the amount of money transferred for the provision of biodiversity or climate benefits must be generated between member states, in line with different agro-ecological conditions throughout Europe.

2. **Shift away from incentives that prioritise yields at the expense of the climate and environment, and balance this with new monetary incentives that put a value on sustainable agriculture.**

   The CAP should reflect a greater shift away from direct financial transfer in proportion to production which encourages inputs that are environmentally degrading (excessive use of fertilisers and pesticides, for example) and which are aimed at increasing efficiency of commodity growth. In the process, the CAP can contribute to targets set in the Green Deal, which is aiming for a 50% and 20% reduction in pesticides and fertilisers respectively by 2030. This would see a shift away from prioritising production to a system that values 'systems efficiency', delivering healthy and environmentally sustainable food. In the process, this could help deliver triple wins for climate, biodiversity and healthy ecosystems.

3. **Decouple support from production metrics for single commodity transfers with high associated greenhouse gas emissions (e.g. beef, dairy).**

   The CAP should continue to disconnect financial support from production indicators (hectares or animal count), especially in highly carbon intensive commodities. Taking red meat as an example, the EU accounted for more than a third of global beef and pork subsidies in 2015 and more than a quarter of global sheep meat direct subsidies in 2016. In the reformed CAP, the Voluntary Coupled Support mechanism can provide aid to specific sectors or products that are undergoing market difficulties. The EU should continue to gradually decouple payments to discourage over-production.

4. **Apply the Just Transition Mechanism to support farmers' social and economic well-being, where impacted by CAP reforms.**

   The transition to a climate- and environment-friendly agricultural system is unlikely to take place at the same pace across countries or agricultural sectors, but the EU is well placed to rise to the challenge. By applying the €150 billion Just Transition Mechanism to the agricultural sector, the EU can support farmers' economic and social well-being and ensure they receive the funding and training they need so they are not left behind. The timelines for CAP reform and the Just Transition Mechanism are well aligned, with tranches of funding in both strategies to be released between 2021 and 2027.

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Background

These recommendations emerged from a joint investor workshop hosted by Legal and General Investment Management and the Hoffmann Centre at Chatham House. This thought partnership and the event and subsequent research comes out of a collaboration between organizations committed to a sustainable future. This paper is the first in a series of policy recommendations co-created by LGIM and the Hoffmann Centre.

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