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The distributional impact of agricultural policy tools on Italian farm household incomes

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Abstract

This paper analyses the impact of a set of direct payment tools of the Common Agricultural Policy on the distribution of household income among Italian farm families. It considers a large sample of Italian farm families and applies the Gini decomposition approach. The analysis accounts for direct payments of the *Pillar 1* (decoupled, coupled and modulation payments) and of the *Pillar 2* of the CAP (agro-environmental and compensatory payments). While the overall amount of direct payments reduces income concentration, the situation is very different among the tools under consideration. Furthermore, the situation differs among the three altimetry zones in which the full sample has been disaggregated.

Direct payments as a whole have been effective in pursuing a more equitable distribution of income, particularly in mountain zones. Thus any reduction of the budget for such policy will likely result in an increase of income concentration. The shift of financial resources between *Pillar 1* and *Pillar 2* will not necessarily result in a more equitable income distribution. However, instruments such as modulation, decoupled payments and compensatory allowances have been found to be promising tools for reaching this goal.

JEL classification: D31; Q18; Q12.

Keywords: Farm household income; Income inequality; Common agricultural policy; Direct payments; Disaggregation of the Gini coefficient

1. Introduction

Agricultural policies are aimed at several goals including the support of farm income (Gardner, 1992). Most of the support provided by the Common Agricultural Policy (CAP) of the EU is

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delivered to farmers by means of annual direct payments (DPs) that are granted through two policy schemes, the so called *Pillar 1* and *Pillar 2* of the CAP. The European Agricultural Guarantee Fund (EAGF) finances direct payments within the first scheme (DP1s). In 2010, DP1s accounted for 39.7 billion euros, corresponding to around 90% of the EAGF expenses, benefitting around 7.8 million farmers (European Commission, 2011). *Pillar 2* refers to all measures financed through rural development programs (RDPs) including some kinds of annual payments (DP2s). DP2s absorb a significantly smaller share of the CAP budget than DP1s.

DP policies are currently very articulated. Most DP1s are *decoupled* from production (i.e. not correlated to production levels) (DDPs) while the remaining are still somehow *coupled* to production (CDPs). DP1s in EU-15 are affected by modulation that is a system of progressive reduction of DP1s, allowing a transfer of funds from *Pillar 1* to *Pillar 2*. In particular, DP1s are decreased by 5% in all farms. However, there is a franchise of €5000 per farm so that an amount of payments is reimbursed to farmers: this amount is equal to 5% of the minimum between the total amount of DP1s originally received and the franchise (MOD). This means that modulation does not affect farms receiving less than €5000 per farm while it affects relatively more farmers receiving larger amounts of payments. The two most important DP2s are Agro-Environmental Payments (AEPs) and Compensatory Allowances (COAs) targeted to farmers located in areas with natural handicaps (i.e. *less favoured areas*).

This paper analyses the role of all these different DP tools, as well as Farm and Off-Farm incomes, in affecting the inequality of Total Household Income (THI) of a large sample of farm households in Italy. This has been done by applying the Gini decomposition approach largely used in the analysis of the distribution of income by its components (Pyatt, Chen, & Fei, 1980).

The analysis tests several hypotheses that can be used to assess the likely impact of some of the policy changes introduced by the recent reform of the CAP and to guiding EU Member States in the application of the new policy measures. This latter aspect has great policy relevance provided that the reformed CAP allows for a large room of manoeuvre in terms of the use of several non-mandatory measures, on the allocation of the financial ceiling among *Pillar* 1 and 2 and, within each of these, among the available measures[1].

In particular, the analysis is aimed at answering four main research questions. The first refers to how much CAP direct payments as a whole (DPs) have been effective in reducing income inequality among farm households. If the answer is positive, any reduction of the budget devoted to such policies is going to increase income inequality and *vice versa*. This is a policy relevant question because some of the EU Member States (MSs), such as Italy, have been allocated a smaller national ceiling of resources than in the past (Art. 4 of Reg. (EU) n. 1307/2013) to allow the convergence of payment level among MSs. The second question refers to whether *Pillar 1* and *Pillar 2* payments have been both effective in reducing income concentration. The policy relevance of this question comes from the fact that MSs are allowed to shift resource from one *Pillar* to the other (Art. 14 of Reg. (EU) n. 1307/2013). Thus, policy makers should account for, among other elements, the possible income distributional impacts of such shift before taking a decision on this issue. Third, the analysis investigates which of the specific measures within DP1s and DP2s have been more effective in reducing income concentration. Answering this question has also direct policy implications provided that MSs are asked to decide on whether to apply or not some of the non-mandatory measures and on the share of financial resources to allocate among the chosen measures. Finally, in many cases the agricultural sector strongly differs between regions

[1] The new CAP DP policy is defined by Reg. (EU) n. 1307/2003. OJ of the EU, L 347 of the 20.12.2013.