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POLICY DEPARTMENT
STRUCTURAL AND COHESION POLICIES **B**

Agriculture and Rural Development

Culture and Education

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Transport and Tourism

**THE SINGLE PAYMENT
SCHEME AFTER 2013:
NEW APPROACH
- NEW TARGETS**

STUDY



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POLICY DEPARTMENT B: STRUCTURAL AND COHESION POLICIES

AGRICULTURE AND RURAL DEVELOPMENT

THE SINGLE PAYMENT SCHEME AFTER 2013: NEW APPROACH-NEW TARGETS

STUDY

This document was requested by the European Parliament's Committee on Agriculture and Rural Development.

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STUDY

Abstract:

This study summarizes the developments of the EU Single Payment Scheme, its national implementation by Member States and provides an economic assessment of the scheme. The various proposals made to change the system of direct payments are examined and possible options for reforms are identified. A new system of direct payments for the next Financial Perspective is suggested. It involves a gradual reorientation of direct payments from income support to remuneration for the provision of public goods. Reform proposals for the remaining income support include co-financing and a move towards a flatter system with a cap related to labour units. This proposal subscribes to subsidiarity, but the increased weight of remuneration for public goods would also call for a stronger harmonisation of the legislative baseline on which the system of EU payments rests.

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Acronyms

ACRE	Average Crop Revenue Election (US Program)
AEM	Agri-Environmental Measure
AES	Agri-Environmental Scheme
AMS	Aggregate Measure of Support
AWU	Annual Worker Unit
CAP	Common Agricultural Policy
CIAA	Confederation of the Food and Drink Industries of the EU
CLA	Country Land and Business Association (UK)
COGECA	General Committee for Agricultural Cooperation in the EU
CNDP	Complementary National Direct Payments (or "top ups")
COPA	Committee of Professional Agricultural Organisations
CRP	Conservation Reserve Program
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EEA	European Environmental Agency
ELO	European Landowners Organisation
ERDF	European Regional Development Fund
EU	European Union
EQIP	Environmental Quality Incentives Program (USA)
FADN	Farm Accounting Data Network
FAO	Food and Agriculture Organisation
FCEA	Food, Conservation and Energy Act
FAPRI	Food and Agriculture Policy Research Institute
FEAGA	See EAGF (French acronym)
FEADER	See EAFRD (French acronym)
FFI	Farm Family Income
GAEC	Good Agricultural and Environmental Conditions
GDP	Gross Domestic Product
GMO	Genetically Modified Organism
GNI	Gross National Income
HC	Health Check (CAP reform concluded in 2008)
HNV	High Natural Value
IEEP	Institute for European Environmental Policy
LDC	Least Developed Country
LFA	Less Favoured Area
MFN	Most Favoured Nation
NGO	Non Governmental Organisation
NMS	New Member States
NRDP	National Rural Development Plan
OECD	Organisation for Economic Co-operation and Development
OTDS	Overall Trade Distorting Support
PSE	Producer Support Estimate
R&D	Research and Development
SAF	Société des Agriculteurs de France
SAPS	Single Area Payment Scheme
SER	Social and Economic Council of the Netherlands
SFP	Single Farm Payment

SPS	Single Payment Scheme
SMR	Statutory Management Requirement
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
UAA	Utilised Agricultural Area
URAA	Uruguay Round Agreement on Agriculture
USDA	United States Department of Agriculture
VAT	Value Added Tax
WTO	World Trade Organization

Executive summary

Recent developments

The Common Agricultural Policy (CAP) has undergone several major reforms since 1992, characterised by a move away from price support towards direct payments to farmers. These payments have been progressively decoupled from production. The Single Payment Scheme (SPS) is now by far the largest component of the CAP budget (*Note that in this report the term SPS includes both the current Single Farm Payment scheme operated by 17 Member States, and the transitional Single Area Payment Scheme operated by 10 New Member States*). In parallel, the CAP budget has been partially reoriented towards rural development programmes funded by the European Agricultural Fund for Rural Development under the "second pillar" of the CAP. Pillar 1 payments like the SPS are funded by the EU budget (€39 billion for Pillar 1 direct payments in 2009, only topped by national payments in some New Member States during a transition phase). By contrast, the €14 billion of EU budget for rural development programmes under Pillar 2 require additional national co-financing.

The different types of direct payments and the different SPS models are presented, with a focus on the recent developments following the 2008 "Health Check" reform of the CAP and the progressive phasing in of direct payments for New Member States. Many changes were brought to the SPS by the 2003 reform and the Health Check reform, which nearly completed the move to decoupled forms of support for farm incomes (Regulation 73/2009 includes the key provisions). The Single Farm Payment (SFP) and the Single Area Payment Scheme (SAPS) cut across all agricultural sectors. Because the various direct payments that supported specific products are being progressively included in the SFP, there will be only very few coupled payments left after 2012. Only some payments for goats, sheep and suckler cows, themselves subject to tight thresholds and conditions, as well as some payments for cotton will continue to be linked to production. All other forms of direct income support will be integrated into the SPS and paid independently of the type of agricultural production in which the farmer chose to engage and its actual level of production (payments can also be granted to farmers who choose not to produce).

The 2003 reform has introduced a large degree of flexibility for Member States to organize the allocation of payments according to their preferred criteria. While some Member States have maintained a historical basis for allocating their envelope of payments to farmers, others have implemented a more uniform payment per hectare, on a regional basis, or are progressively moving in this direction. Eleven Member States have used the historical model, under which SPS payments are based on the level of subsidies received by individual farmers in the past, but five Member States and England have moved or are moving towards a regional flat rate per hectare. "Modulation", i.e. a lower level of payments beyond a certain threshold, provides resources that are to be used for rural development programmes. The Health Check reform has strengthened modulation, making more resources available for funding of Pillar 2.

Furthermore the additional modulation introduced for those in receipt of very large payments reduces the payments to the largest beneficiaries. The extra resources for Pillar 2, taken out of the SPS, allow Member States to fund particular rural development

programmes that they consider best suited to their local conditions. Several provisions of Regulation 73/2009 provide additional flexibilities for Member States to tailor the allocation of their Pillar 1 payments. Article 68 allows all Member States to use some of the Pillar 1 budget to fund schemes that addresses particular needs, such as protecting the environment, improving the quality and marketing of products, supporting particular types of production in economically vulnerable or environmentally sensitive areas or type of farming, or support risk management instruments. Other articles of the same regulation make it easier to redistribute payments between regions and individuals. The national implementation of these provisions at the beginning of 2010 is presented. Some Member States have used unevenly the possible flexibilities, but some of them have reallocated a significant share of the SPS payments to particular programs, such as support to environmentally friendly extensive grazing (e.g. France), risk management instruments (France, Germany, the Netherlands), or product quality improvement (Italy).

Aggregate data as well as farm level surveys show that the SPS payments account for a very large proportion of agricultural incomes in the EU in spite of annual variations (roughly half of the farm income for an average income year such as 2006). In Finland and Ireland, CAP payments (including Pillar 2 payments and national contributions) exceed half of the gross receipts (without subsidies). This shows that the current dependency of farm incomes to CAP direct payments is considerable in some Member States. It is much lower in others, particularly in the Netherlands where payments represent a small proportion of agricultural output. If the average level of payments per hectare and per worker varies greatly between Member States, with a high degree of regional and individual variation within each Member State. Even when one adds the (more evenly distributed) Pillar 2 payments, the dispersion of direct payments between farmers, on a per worker basis, is very large in Finland, Sweden, the United Kingdom and France, in particular. It is noteworthy that in some countries such as Austria, Latvia, Finland, Luxembourg, Poland, Estonia and Austria, Pillar 2 payments now contribute a greater share of farm incomes than the SPS. By contrast, Pillar 2 accounts for a small share of farm income in Spain, Cyprus, Greece, Denmark and the Netherlands.

An assessment of the SPS

The move towards direct payments has had many positive effects. The money spent by EU taxpayers now ends up in farmers' pockets to a greater extent than when the EU budget funded storage costs and export refunds. The payments ensure a stable income in times of large price fluctuations. The shift towards direct payments has removed the dramatic imbalances between supply and demand, which had led to the accumulation of costly surpluses under the "old CAP". On account of the fact that direct payments no longer encourage production and exports, they have soothed the criticisms of third countries regarding the negative effects of the CAP on world markets and foreign producers.

Nevertheless, the current SPS continues to be subject to several major criticisms, from a variety of stakeholders. They refer to the inability of the SPS to address issues such as market instability or food security; to the administrative burden imposed by the SPS and the "cross compliance" conditions (a set of standards with which farmers must comply in order to receive the payments); to the fact that the current SPS does little to improve the environmental record of the CAP; to the uneven distribution of the payments; the impact of the SPS on developing countries; and to the large budget now devoted to the SPS.

These criticisms are presented, reviewed and their validity is assessed. While some are clearly misplaced, others need to be addressed when suggesting a new model for the SPS. This is the case in relation to the scale of transaction costs, the environmental effects of the scheme and issues of equity linked to the distribution of the payments, in particular.

The proposals tabled

In the second part of the report, recent proposals for reforms of the SPS that have been tabled by the different stakeholders are reviewed. Many Member States governments, farmers' organizations, consumers, the food and the input industry, as well as Non Governmental Organizations (NGOs) and think-tanks have been discussing the future of the CAP beyond 2013. More than 40 proposals have been released that suggest changes or adjustment of the SPS – including its full dismantling in certain cases. Using a rather ad hoc typology of these stakeholders, the main proposals are classified and reviewed critically.

Certain Member States want to maintain a large budget for the SPS. The countries historically in favour of an ambitious CAP receive the support of several New Member States. They favour the continuation of a large income support scheme, financed by the EU budget, and subject to minimal cross-compliance conditions. Other Member States would like to cut the SPS budget so as to expand funding of policies currently covered by Pillar 2. Others consider that the CAP budget as a whole should be trimmed dramatically in order to fund other policies, and the large SPS budget is a prime candidate for cuts. Member States' proposals differ not only on the amount of budget that should be devoted to the SPS and Pillar 2 payments, but also on the allocation across Member States. Some New Member States plead for a reallocation of payments that would reduce the current benefits of the CAP for EU-15 Member States. There are also differences regarding the level of co-financing. While some governments plead for a more nationally funded agricultural policy, others insist on the need to maintain a EU funded policy, arguing that co-financing would lead to an uneven implementation of CAP provisions, as it is now observed for rural development programmes.

Most farmers' organizations tend to be on the conservative side regarding shifting SPS payments into programmes in line with the current Pillar 2 model. The recent fall in farm incomes has rallied even the liberal ones to the cause of maintaining an income support scheme. Many of these organizations are particularly concerned by the instability of agricultural markets, and see the SPS scheme as a poor substitute to stable (and supported) prices. The idea of adjusting payments to market conditions, i.e. turning the SPS into a countercyclical payment scheme, has been recently backed by some farmers' organizations and cooperatives.

A growing number of agricultural organizations nevertheless seem receptive to the idea that the CAP budget should be more oriented towards remunerating farmers for the provision of public goods. A few agricultural organizations – in particular young farmers and landowners' organizations - have recently made joint proposals with environmental NGOs in this direction.

Young farmers' organizations tend to favour a reallocation of payments so as to be more oriented towards payments on the basis of labour-related criteria. More left-wing oriented

farmers' organizations, which have made joint proposals with environmental activists, also advocate payments on a per farmer basis or strong caps on individual payments, as well as a reorientation of the budget towards funding family farms providing environmental and other rural services.

Environmental NGOs have been particularly active in the debate on the future CAP. Most of their proposals include a multi-tier system of payments, targeting support at High Nature Value farming systems and organic systems, as well as broader schemes helping to maintain rural vitality and to enhance biodiversity, soil and water resources and to maintain the character of cultural landscapes. Several think-tanks have also made detailed proposals for a reform of the SPS. In most cases, they advocate a major reorientation of the current Pillar 1 budget towards payments that remunerate farmers for the provision of public goods, rather similar to those envisaged by environmental NGOs.

The impact of some of these proposals is assessed, using macroeconomic and farm survey data to gauge the budgetary consequences and the resulting transfers between Member States, regions and individuals. Among the conclusions that are drawn, the authors of the report consider that, in spite of some attractive features, making SPS payments countercyclical would have many unwanted effects. Among the main drawbacks, incentives from cross-compliance would be weakened in times of booming markets, when they are needed most. Conversely, cross-compliance incentives would be reinforced when low prices would also operate towards less intensive production methods. Furthermore countercyclical payments would require shifting back to product-specific payments since the price of all commodities do not vary in a coordinated way. If the total value of direct payments over several years is fixed (in line with the stabilisation objective), it seems to involve little apparent advantage for farmers: Given a certain flow of payments farmers could use their savings or lending as a stabilisation instrument, provided that the tax system does not impede such arbitrage over time. In addition, countercyclical payments would require the possibility of large interannual variations of the agricultural budget, which is at odds with the current EU budgetary procedure. Finally there might be some inconsistencies with the EU multilateral commitments under the World Trade Organization (WTO) framework. While such a scheme would be compatible with current multilateral commitments, but the future limits on distorting support might require major changes in the market management of other sectors (fruits and vegetable, sugar, dairy) in case of a Doha agreement.

A payment per unit of labour would result in large transfers between farmers, but with some counterintuitive and sometimes undesirable consequences. Indeed, the farm structures in the EU-27 are such that large entities using a lot of hired labour coexist with family farms and part time farming. Allocating payments per farm manager would make little sense. Allocating payments on the basis of labour units (including hired labour) would lead to large reallocations between sectors, for example a transfer of the budget from extensive grazing farms to wine and fruit producers, which would go against the current orientation of rural development programmes. Should an income support component be retained in the CAP, a per hectare payment with possible variations between regions and Member States remains an attractive choice. A cap on a per worker basis on such a payment would not be easy to manage, but it would make it possible to reduce inequality in the current distribution of payments. Changes in the allocation of payments would result in large transfers between producers, however, and the

preliminary simulations presented in the report would need to be deepened. With any system of capping it appears advisable to letting Member States flexibly adapt the future scheme to the national or regional context.

The proposed model

The authors of the report consider that the EU budget for direct CAP payments should be reallocated towards the provision of public goods, which is the only uncontested reason why society should provide money to farmers in the long run. Assessments of Pillar 2 programmes show that there is scope for improvement in the management of the programmes, but the progressive shift of the CAP budget towards rural development programs is in line with the idea that public money should primarily fund public goods for society.

Given the current importance of the SPS in farm incomes, some form of income support is nevertheless needed in a transition phase. The dependency of farm incomes on the SPS is such that a sudden dismantling of Pillar 1 payments would make many farmers insolvent. A predictable horizon is necessary, in particular for farmers in New Member States who will be receiving increasing payments until 2013 or 2016. But there should be a scheduled phasing out of the SPS payments and a progressive expansion of schemes that remunerate the provision of public goods and services by farmers. Phasing in co-financing to this transitory income support scheme is also recommended. A way to manage the budget could be to define national envelopes on the basis of objective criteria.

The proposed model for CAP payments includes two main components, i.e. income support and contracts for public goods and services. This is in line with the current trajectory of Pillar 1 and Pillar 2 components of the current CAP, but several fundamental adjustments are proposed.

- The transitional income component would share many aspects with the current SPS, for example the decoupling principle, but it is proposed to further move towards flatter system. This system would rely on a per hectare basis, with caps based on labour units. Flexibility would be left to Member States to adjust this capping system or to implement other forms of means testing. The payments and cap thresholds would be allowed to vary according to regional conditions. While it is proposed that income support is progressively decreased and co-financed by Member States in similar proportions to public good payments, Member States would also be allowed to transfer funds from the income support component to the second (public goods) component from the predefined national envelope. The co-financing rates would be adjusted so that it could vary between different categories of Member States according to a set of objective criteria.
- The public goods component of the proposed scheme, scheduled to increase over time, would combine targeted payments under contracts for specific services and a more standardized payment for desirable farming practices of a more general character, both tailored to regional conditions by Member States. This would not necessarily mean that all these schemes would remain under Pillar 2. Pillar 2 involves particular programming and administration procedures and some of the more basic public goods provision could also be handled under the lighter

administrative procedures of current Pillar 1. However, the extension of co-financing would make the distinction between the current pillars mostly a managerial issue.

Assessment of the consequences of this proposal using microeconomic data suggests that the proposed criteria for allocating budgets between Member States (i.e. national envelopes based on objective criteria) and between farmers of a region (per hectare, with a cap per labour units for the income support component, and contract payments for services, without cap) would generate significant redistributions of the current budgets. These redistributions go in the direction observed by those Member States that opted for the dynamic regionalization of the SFP. The shift from the current Pillar 1 payments towards a more even payment per hectare would result, globally, in moving income support towards more extensive (i.e. land intensive) sectors and regions. The introduction of a cap per worker generates potentially large budget savings, but also some complex redistribution with potential undesirable effects. This pleads for leaving Member States with a large degree of flexibility in this area.

Implementation and recommendation

The proposed model would not raise significant compatibility issues with EU international commitments, or with other aspects of the CAP and with most non agricultural EU policies. Regarding WTO commitments, the proposed model would not pose any difficulty in the current situation. In the prospect of the conclusion of the Doha round of negotiations, the proposed model would bring little changes to existing constraints, in particular those on the Overall Trade Distorting Support. There is nevertheless a need to ensure that those "public goods payments" that maintain a link with production or production factors, remain within limits that are compatible with a future agreement, even when they are seen as legitimate cases of public goods jointly produced with agricultural products.

The flexibilities foreseen evidently involve the risk of a non-uniform implementation of CAP schemes across Member States. Given that payments would be either decoupled income support or remuneration for the provision of public goods, the risk would not involve serious distortions of competition on agricultural markets but a potential undersupply of public goods in some Member States. The definition of national envelopes on the basis of objective criteria, such as land, farm population or natural resources to protect, would define an upper ceiling to the would-be users of EU budgets and Member States may not use their envelopes fully. However, the present underutilisation of situation of Pillar 2 programmes by particular Member States is partly driven by the availability of Pillar 1 money that does not require co-financing so far. This motive for underutilisation would be eliminated, if co-financing were extended to Pillar 1. Adjustment in the rate of co-financing, which could vary across Member States and possibly programmes according to objective criteria, could help to address the risk. A criterion for variation across Member States could be GDP per capita to reflect the low funding capacity in many new Member States and some old Member States. A criterion for variation along programmes could be the EU interest compared to local benefits which would be high, for example, for climate related or global biodiversity related measures.

With the progressive shift of the budget towards support for the provision of public goods, it is increasingly important that the public goods provided by agriculture and

those that are eligible for payments are defined at the EU level, and that the boundary between what is part of the baseline (i.e. what is statutory for farmers) and what goes beyond and is eligible for EU payments remain consistent across Member States. Indeed, a common framework should be maintained for the CAP to be able to address transnational challenges and European concerns appropriately, such as climate protection, biodiversity, landscapes, food security and the vitality of rural areas. In practice, this means that far reaching renationalization of the CAP is not justified from an economic point of view. With the public goods component becoming the key element in the future CAP, it is increasingly important to have an harmonized legislative baseline with respect to what farmers are required to do. Beyond that, a high degree of subsidiarity should be given to Member States in order to better address demands for services, better known at the local level, and to tailor measures so as to match the increasingly heterogeneous structures and situations within EU agriculture.

Generalization of co-financing and extension of subsidiarity raise considerable economic as well as institutional issues. The future amounts, targets and implementation for direct payments would be accompanied by some redistribution within CAP funds and the EU budget as a whole. Consequently, distributional questions that extend beyond the confines of the CAP will arise. At the same time the CAP interlinks with other policies in the pursuit of high level objectives such as climate and cohesion concerns. These aspects are best addressed in the debate on the EU budget for the post 2013 period where the future of the structural funds, national rebates and other issues can be resolved within one package, not separately. Here the European Parliament, as a budgetary authority, has an important role to play.

1. The current situation of the SPS

1.1. The SPS scheme

Note that in the following text, **we consider that the Single Payment Scheme (hereafter SPS) includes two components, the Single Farm Payment (hereafter SFP) and the Single Area Payment Scheme (hereafter SAPS)**. This corresponds to a broader definition of what is often called the SPS.

1.1.1. Background

Changes in the CAP

The Common Agricultural Policy (CAP) has undergone several major reforms since 1992. These reforms have followed a consistent trajectory, characterised by a move away from the public management of agricultural markets. Indeed, in the 1980s, the setting of institutional prices by the Council created some major imbalances between supply and demand. This resulted in high budgetary costs as well as a poor efficiency of transfers, with a large share of the money spent by EU taxpayers and EU consumers leaking into storage costs or export subsidies rather than increasing agricultural incomes. These effects are well-documented, including in publications from the European Parliament.²

The 1992 reform and the Agenda 2000 package resulted in a reduction in support to the agricultural sector provided by (high) guaranteed prices, themselves supported by a system of public purchases and export subsidies. Institutional prices were reduced progressively and the system of intervention (i.e. government purchases when prices go below a certain threshold) was made explicitly or *de facto* inactive for several major commodities including beef, sugar and coarse grains. In the cereal, oilseed, protein seed and beef sectors, the corresponding losses in income were compensated by "compensatory" direct payments to ensure the economic viability of EU farms. These payments were either linked to fixed areas (or fixed yields) or to a fixed number of animals throughout the 1990s.

In parallel, it was increasingly recognised that certain types of agriculture delivered environmental benefits and that farmers providing these benefits needed to be remunerated via public support. The Agenda 2000 reforms served to deepen the reform process, with greater support for rural development. It resulted in the emergence of a "second pillar" of the CAP. In the beginning, Pillar 2 of the CAP consisted of a heterogeneous collection of former structural measures. An administrative and financial framework - with common objectives and a single set of programming, financing, monitoring and auditing rules - was progressively implemented for EU rural development policy.³

Today's CAP comprises Pillar 1 "Agricultural Markets", which includes market measures as well decoupled direct payments supporting income (including the Single Farm Payment

² See EP (2007); Bureau (2008); Ritson and Harvey (1997) for an introduction to these issues.

³ Regulation 1257/1999, and latterly Regulation 1698/2005. All citations of 'Regulations', 'Directives' and 'Decisions' relate to EU legislation that is collected in the references section of this study.

scheme or SFP, the Single Area Payment Scheme or SAPS, available to new Member States) and a few coupled payments remaining. Pillar 1 is funded under the European Agricultural Guarantee Fund (EAGF), the main expenditures being direct payments to farmers and measures to regulate agricultural markets such as intervention purchasing, and the remaining export refunds. The second component of the CAP Pillar 2 - "Rural Development" - is a common policy with strategic objectives set at the EU level. It is directed at enhancing the environment and countryside, improving competitiveness of EU agriculture and forestry and improving the quality of life in rural areas and is funded under the European Agricultural Fund for Rural Development (EAFRD) for the programming period 2007 – 2013.⁴ Pillar 2 includes four axes: Axis 1 "Improving the competitiveness of the farm and forestry sector"; Axis 2 "Improving the environment and the countryside"; Axis 3 "Quality of life in rural areas and diversification of the rural economy"; and Axis 4: "local development in rural areas".

Overall, the move from the "old" CAP of the 1980s, a very centralized policy under which most prices and some quantities were set administratively, to the current CAP, with less public intervention in markets but a large budget devoted to direct payments has been rather successful. Major disequilibria have been solved, including the market imbalance for cereals, whose high price induced large volumes of production but provided incentives for the livestock sector to replace local feedstuffs with cheaper, imported substitutes. Direct payments as well as the gradual pace of reforms have made the transition relatively smooth from a social perspective. The CAP has become more oriented towards rural development and environmental issues, accounting now for close to 24% of the total CAP budget. There are nevertheless significant disparities between the old and new Member States. For the entire EU-27, Pillar 1 is worth just over three times as much as Pillar 2 over the 2007-2013 period. Whilst the level of expenditure is relatively balanced in the EU-12 (where the level of spend on both Pillars is almost the same), the EU-15 is allocated five times as much for Pillar 1 as Pillar 2.

While the budget devoted to agricultural policy has remained large (accounting for approximately 40% of the total EU budget, compared to 75% 20 years ago), reforms have reduced some of the expenditure that brought relatively few direct benefits to producers for each euro spent by taxpayers, such as storage costs. Payments now benefit farmers more directly, and their decoupling has reduced international foreign criticisms with regard to the negative effects of the CAP on world prices and third country producers. Reforms have also increased the legitimacy of the policy, with a change in objectives making the policy more in line with societal demands and the needs of rural areas.

The context of the next reform

The future of the SPS in the post 2013 period is part of a broader redefinition of the CAP. Because direct payments now represent the largest share of the CAP, they are likely to be under particular pressure because of budget constraints. The new Treaty on the Functioning of the European Union (TFEU) involves significant changes for the CAP (Massot-Marti 2008, Blumann 2008). With the end of the distinction between compulsory and non-compulsory expenditure and the now legally binding multi-annual financial

⁴ Regulation 1290/2005 established a single legal framework for financing CAP spending. See also Regulation 1698/2005.

framework, the CAP budget will be subject to the same discipline as other expenditure. Because of the current economic crisis, it is unlikely that a large increase in the EU budget will take place for the post 2013 financial framework, and the CAP budget will face strong competition for resources from other policies.

1.1.2. The 2003 reform and the SFP

The 2003 reform included several general provisions including market management, a reform of direct payments and strict financial control for CAP expenditures (if there a danger of overspending based on forecasts, some cuts are made to Pillar 1 direct payments).

Decoupling through the Single Farm Payment

The major change introduced by the 2003 CAP reform is the decoupling of a majority of direct payments from production.⁵ Direct payments were provided on a hectare basis or per head of cattle and have been transformed into a single payment, the SFP, linked to entitlements based on the value of historical subsidy receipts. The objective was to make farmers more reactive to market price signals, but also to make the large transfers from consumers and taxpayers more acceptable for third countries. Other WTO members had long claimed that the CAP resulted in unfair distortions of competition. Decoupled payments are less open to challenge under the current and future WTO discipline on international trade.

The decoupled direct payment ensures a basic income support for producers. The payments are linked to adhering to environmental standards and standards related to animal and plant health (see Box 1.1.). An entitlement to receive a payment does not depend on actual production or on the acreage planted with a particular crop (the 2003 restrictions for fruits and vegetables were subsequently removed). In order to "activate" this entitlement, the farmer must own or rent a corresponding number of eligible hectares (Regulation 1782/2003, Article 44). The farmer must also keep the land in good agricultural and environmental condition, even if the land is idled. That is, even though the modalities of implementation of the payments vary across Member States, in most cases, a link has been maintained between the decoupled payment and the land input (see Box 1.1.).

Since 2003 those payments that remained coupled have been merged increasingly into the SFP by reforms of particular market organizations. Since 2003, payments for arable crops, payments for rice, grain legumes, rice, seeds, dried fodder, milk and milk products, as well as some beef and veal payments have been merged into the SFP. This is the also the case of payments designed to compensate for changes in various market organizations (tobacco, hops, olive oil, sugar, etc.) and eventually to the move to a single Common Market Organization. By the end of 2009 roughly 85% of direct payments were decoupled.

Flexibility

⁵ Regulation 1782/2003 is the basic legal framework for establishing common rules for direct support schemes (its provisions were later amended by the CAP Health Check Regulation 73/2009). Regulation 796/2004 defines more precisely the rules for cross-compliance, modulation and the control system.

Member States had some flexibility to choose how the entitlements for payments would be designed and allocated between farmers. In some countries, the direct payment was granted on an individual "historical basis". In other countries it was granted on a "regional basis" (i.e. the same amount per hectare in the region) or moved towards this model during a transition period. In other countries, intermediate solutions were developed. Member States had the freedom to allocate national envelopes between farmers of a particular region according to the modality of their choice.

Under the 2003 reform, each Member State also had the possibility of maintaining some link to production in certain sectors, in the form of coupled direct payments for arable crops, beef and sheep (this provision was modified in 2009 under the Health Check). A Member State could also keep up to 10% of the national ceiling for payments in order to support those types of agriculture that are considered particularly favourable to environmental protection or product quality. A large degree of freedom was left to Member States for managing the transfers of entitlement between farmers. A national reserve was implemented by siphoning the global envelope with subsequent transfers between farmers, in order to be able to provide entitlements for new farmers and those that were granted an abnormally low entitlement.

Conditionality (cross-compliance)

In order to make income payments more in line with the idea of multifunctionality or sustainable agriculture, the receipt of the SFP is conditional on a farmer's compliance with Statutory Management Requirement (SMRs) and Good Agricultural and Environmental Conditions (GAECs). This is often referred to as "cross-compliance".⁶ These practices are defined in a set of Regulations and in GAECs specified by the Member State within a common framework. Conditionality to SMR requires that farmers comply with existing EU legislation. The corresponding Directives refer to the environment (conservation of wild birds; protection of groundwater against pollution caused by certain dangerous use of agricultural sewage sludge; protection of waters against pollution caused by nitrates; conservation of natural habitats, fauna and flora); to the registration of animals, their marking and labelling of beef; to public health; animal health and animal welfare. GAECs include minimising soil erosion (minimum coverage, minimal management reflecting the specific local conditions, terraces, etc.); to maintain soil organic content (crop rotation, stubble management, etc.); to maintain soil structure and to ensure minimum levels of maintenance on agricultural land (minimum of livestock density, permanent pasture protection, maintenance of topographic characteristics; preventing unwanted scrub encroachment on agricultural land, etc.). The GAEC standards were introduced partly to ensure a minimum level of maintenance of agricultural land in order to deter land abandonment, a potential threat in an era of decoupled subsidy payments. The reform also sought to maintain the area of pasture in the EU, partly to temper a mass conversion to arable production if incentivized by market prices, and, less directly, to preserve the environmental benefits associated with certain grasslands. In addition, the area of permanent pasture had to be maintained at at least 90% of its 2003 level.

⁶ The cross-compliance standards of agricultural land are set out in Annexes III and IV of Regulation 1782/2003. Art. 51 of Regulation 1698/2005 sets out the application of cross-compliance in Pillar 2.

In the event of failure to comply with these obligations, payments can be reduced by 5% and by 15% if the breach is repeated. The reduction may however be up to 100% for a deliberate breach. A system of agricultural advice aimed at helping farmers comply with standards and implement standards of good agricultural and environmental practice was also developed. More specific policies are under the second pillar, such as the Agri-Environmental Schemes (AES), under which environmental actions can be co-financed by the EU budget and the national budget.

Modulation

Direct payments were initially provided to compensate for income losses following a reduction in institutional prices. This resulted in a large inequality in the level of payment per hectare or per farmer, between as well as within sectors and regions, which raised criticisms. This issue was addressed through the introduction of "*compulsory modulation*", i.e. a lower payment beyond a certain threshold.⁷ The siphoned budget is used for Pillar 2 measures.

After the 2003 reform, the once uniform and centralized CAP became characterised by a greater degree of subsidiarity. Member States have had significant freedom in the implementation of the SPS, in choosing those sectors where coupled payments continue to apply, in designing national GAEC standards, albeit within a common framework and in designing the degree of linkage between SFP entitlements and land transactions. Member States also had the option to retain 10% of their national ceiling for direct payments in the form of national envelopes and to allocate the budget for "specific types of farming which are important for the protection or enhancement of environment or for improving the quality and marketing of agricultural products" (under Art. 69 of Regulation 1782/2003 which was later amended by the Health Check). While it is not technically part of the 2003 reform, note that some particular countries were allowed to transfer additional resources from Pillar 1 to Pillar2 up to a maximum of 20% through imposing additional *voluntary modulation*.⁸

⁷ Article 10 of Regulation 1782/2003.

⁸ Regulation 378/2007. One of the provisions of the Agenda 2000 agreement was to allow Member States to voluntarily modulate direct payments to farmers based on one of a number of criteria, e.g. size of a farm workforce, prosperity of the farm or total payments granted. Modulation was limited to a maximum of 20% of the payments made to individual farmers. Voluntary modulation was applied across the United Kingdom from 2001, but was not used in other Member States. The issue was discussed again during the financial perspectives debate in 2005. The Heads of States enlarged the possibilities for *voluntary modulation*. This decision met opposition from the European Parliament and in 2006, a Presidency compromise was found. Eventually, Regulation 378/2007 allowed Member States to continue to apply voluntary modulation in addition to compulsory modulation. This regulation, however, restricts the use of voluntary modulation to those Member States where voluntary modulation is already applied according to Regulation 1655/2004. As a result, voluntary modulation is currently operated in only two Member States, the UK and Portugal.

Box 1.1. How the SFP works

Currently, 17 Member States have adopted the SFP (see Table 1.1). In those Member States that opted for the historical model, the SFP entitlement was calculated on the basis of the level of direct payments before the 2003 reform. On the basis of this past reference a *unit SFP value* was calculated (this is an entitlement per hectare) as well as a *number of entitlements* (i.e. a certain number of hectares). In France, for example, the *reference payment* was the average direct payment received for acreage in cereals, oilseeds, protein seeds and set-aside land and the payments received for animals (some other payments were subsequently added after 2003, including payments to compensate for reforms in various sectors such as sugar and dairy). The *reference acreage* was the number of hectares benefiting from direct payments, plus the hectares of fodder. The *unit SFP value* was calculated by dividing the *reference payment* by the reference acreage. In those Member States that opted for the regional model, the main difference has been in the allocation of the SFP entitlements, which was not based on individual historical references, but on a flatter rate per hectare in a given region (see section 1.2.).

Each farmer can request the single payment up to the limit of entitlements that he/she holds. This number of entitlements is equal to the number of hectares in the *reference acreage*. The single farm payment is therefore the product of the number of entitlements by the *unit SFP value*. But for each entitlement, the farmer must show that there is a corresponding eligible hectare to activate this entitlement. The eligible hectare now includes all land under crops, fodder and pasture. Therefore the farmer has no obligation to produce in return for receiving the payment, and has complete freedom in terms of the crops planted.

1.1.3. The Health Check Agreement and the SFP

A review of the CAP was undertaken at the end of 2007 under the banner of the CAP Health Check. A European Parliament report provides an in-depth analysis of this review process (see EP, 2008 for details, see also Cooper *et al.*, 2007; Velasquez 2008). The legislative texts were published in January 2009.⁹

The main goal of the CAP Health Check was to complete some issues deferred in the 2003 reform and to make adjustments of the CAP for the 2009-2013 period. National "budgetary envelopes", i.e. the set of payments currently provided to each Member States under the CAP, were left intact until 2013, for example. However, some important decisions were taken regarding market management (e.g. abolishing of *compulsory set-aside*, progressive dismantling of the dairy quotas, limiting *public intervention* as a safety net to the three products of wheat, beef, and dairy).

In the area of direct payments, some significant adjustments were made, including extra flexibility to Member States in managing direct payments and abolishing the premium for energy crops. The main consequences of the Health Check Agreement for the SFP are in the area of i/ a further step towards decoupling; ii/ additional modulation; iii/ changes in

⁹ Regulations 72/2009, 73/2009, and 74/2009.

conditionality/cross-compliance; and iv/ a much larger flexibility for Member States, with particular provisions relying on subsidiarity.

Further decoupling

The Health Check strengthened the move towards greater decoupling. The 2003 agreement allowed Member States to maintain some of the payments per head of cattle or per hectare of arable crops, rather than including them in the SFP. With the implementation of the Health Check agreement, the suckler cow and sheep and goat premia as well as payments for cotton will be the only formally coupled payments still allowed to remain in 2013.¹⁰

So far, Member States have unevenly chosen the option of coupling suckler cow and sheep and goat payments coupled. Belgium, Spain, Hungary, Austria and Portugal are the ones that have maintained the maximum amount of payments coupled (Finland and Portugal for goats and sheep). Others have chosen options where a greater share or all these payments are decoupled and included in the SPS. The European Commission estimates that, even when one accounts for possible coupled payments under Article 68 (see Box 1.2.), 94% of Pillar 1 payments will be decoupled in 2013 at the EU level, even though the percentage will be lower in particular Member States such as Portugal.

Member States were also encouraged to move their SFP model towards a flat-rate per hectare payment per region and away from the historically-based model that some Member States had implemented. There is, however, no obligation to do so. As a result of a proliferation of very small claims since the 2003 reforms, minimum thresholds for the receipt of SPS or SAPS were introduced. Member States can establish their own figures and these will be calculated using a coefficient that reflects the situation of the Member State.

Additional modulation

The 2008 agreement led to a progressive increase in the previous rate of *compulsory modulation* (initially 5% to 10% in 2012). Those farmers receiving less than €5000 in direct aid continue to be exempted, as are all producers in the 12 New Member States, whose direct payments are being phased in to be equivalent to payment levels in the EU-15 Member States over 10 years. The funds collected through the 10% rate of compulsory modulation must be used for rural development programmes, including for "new challenges" identified as climate change, renewable energy, water management and - introduced by the final Council decision – the milk market. The corresponding funds can also be used to fund innovation related to these "new challenges". Funds collected through the increased rate in compulsory modulation will remain in the Member State budget, preserving the "national envelope".

In addition, a progressive component was added to compulsory modulation, i.e. farms receiving more than €300 000 in direct support every year face an additional 4% shift in funds from 2009 onwards (note that initial propositions of a cap on individual farm payments were abandoned in favour of this "*progressive modulation*" component). It is

¹⁰ Note, however, that some particular provisions under Article 68 of Regulation 73/2009 allow some degree of recoupling for very specific productions, see section 1.3. and Box 1.2. for details.

noteworthy that the progressive modulation element will only affect a tiny proportion of farms across the EU-27 (roughly 0.04 per cent according to 2005 figures). However, it is concentrated in a limited number of Member States such as Germany.

The funds generated through modulation provide extra resources to finance measures under Pillar 2 of the CAP, and equate to more than a billion euro in 2012. This transferred money will be co-financed by the EU at a rate of 75 percent and 90 percent in convergence regions where average GDP per capita is lower.

The extra voluntary modulation facility granted to the UK and Portugal can still be applied but the maximum 20% modulation still applies so voluntary rates have to decrease while additional compulsory modulation rates increase. The financial resources collected by this voluntary modulation (i.e. on Pillar 1 budgets) are retained by the Member State concerned and can only be spent on rural development initiatives. While funds retained under compulsory modulation spent on rural development programmes must have additional co-financing from individual Member States, voluntary modulation does not require co-financing.

Changes in cross-compliance

The Heath Check agreement also includes changes to the conditionality of payments. Compulsory set-aside was abolished. The modifications apply to both SMRs and GAEC standards. Some of the Articles under the Wild Birds (79/409/EEC) and Habitats Directives (92/43/EEC) have been removed from the SMRs. The original objective of adding water to the list of new issues has not fully materialized since the Water Framework Directive (2000/60/EC) has not been added to the list of statutory requirements. Water management related provisions have nevertheless been included in GAEC standards.¹¹

An important change is the division of standards into mandatory or voluntary standards depending on the nature of issues in individual MS. Since the introduction of cross-compliance in 2005, there has been some confusion as to the status of the standards, and whether they are in fact optional or mandatory for Member States to implement. Recently, however, legal opinion has meant that they have been treated increasingly as mandatory. Somewhat controversially, the CAP Health Check agreement now divides the standards into those which are 'compulsory' and those which are 'optional'.¹²

¹¹ In relation to GAEC standards, the new common rules Regulation (73/2009) includes two new 'issues' in relation to the 'protection and management of water' and to 'protect water against pollution and run-off and manage the use of water', with associated new related standards: (i) the 'establishment of buffer strips along water courses'; (ii) where use of water for irrigation is subject to authorisation, 'compliance with authorisations procedures'. The existing standard relating to the retention of landscape features has also been extended to include specific mention of which landscape features should be retained.

¹² Existing standards which have become optional appear to be the retention of terraces to protect soils; setting standards for crop rotations; the use of appropriate machinery to retain soil structure; the application of minimum stocking rates; as well as the prevention of the grubbing up of olive trees, and the maintenance of olive groves and vines in good vegetative condition. Under the pressure of some Member States, a new optional standard has been introduced, which allows for the 'establishment and/or retention of habitats', now offers the possibility to introduce a national set-aside mitigation scheme.

Greater flexibility for Member States (Articles 68 and others)

The flexibility left to Member States on how to spend the EU funds available for direct payments was broadened. Before the Health Check Agreement, EU-15 Member States and Malta and Slovenia had the option to divert up to 10 per cent of the national ceiling for any sector of Pillar 1 payments into national envelopes which could be "granted for specific types of farming which are important for the protection or enhancement of the environment or for improving the quality and marketing of agricultural products".¹³ The Health Check made these options more flexible. It expanded the possibility, introduced in 2003, for Member States to use 10% of their direct payment national envelopes for more targeted issues within Pillar 1 (i.e. without co-funding requirement) under what became Article 68 of Regulation 73/2009. The money will no longer have to be used in the same sector, but can be reallocated to options offered under Article 68. The funds can now be used for five purposes: i/ protecting the environment, improving the quality and marketing of products or for animal welfare support; ii/ payments for disadvantages faced by specific sectors (dairy, beef, sheep and goats, and rice) in economically vulnerable or environmentally sensitive areas as well as for economically vulnerable types of farming; iii/ top-ups to existing entitlements in areas where land abandonment is a threat; iv/ support for risk assurance in the form of contributions to crop insurance premiums; and v/ contributions to mutual funds for animal and plant diseases. Countries operating the SAPS have become eligible for the scheme. It is noteworthy that Article 68 offers flexibility in addition to other provisions under Articles 63 and 47 (see Box 1.2.).

Because these new options include potentially coupled compensatory payments for sheep, dairy, beef and rice farming, and public contributions to crop insurance or mutual funds to combat animal and plant diseases, the Regulation sets strict conditions to avoid any recoupling at the Member State level which could undermine international EU commitments. In particular, the amount of coupled payments (or more exactly potentially "non-Green Box" support as defined within the WTO) is limited to 3.5% of the national envelope (Article 69 of Regulation 73/2009).

The budget saved by abolishing the energy crop premium is to be divided up among the New Member States. For the EU-15 Member States, it was also agreed that they could have more flexibility to use "unclaimed" direct aids from their national envelopes. This additional funding can be used for the targeted payments under "Article 68". Finally, Member States applying the SPS will be allowed either to use currently unused money from their national envelope for Article 68 measures or to transfer it into the Rural Development Fund.

Appendix I summarizes the main provisions of the Health Check Regulations (see Regulations 72, 73 and 74/2009 of 19 January 2009 for more details).

It is worthy noting that in spite of the flexibilities introduced by the Health Check that allow Member States making the level of SFP more uniform in the (i.e. changing the historical model for a flatter rate of payments), no Member State has used this possibility in 2010.

¹³ The legal basis for the process was originally laid down in Article 69 of Regulation 1782/2003, which was replaced by Article 68 of Regulation 73/2009.

The provision (Article 28 of Regulation 73/2009) that allows Member States to exclude from the SPS those farmers whose agricultural activities form only a marginal part of its overall economic activities has not yet been used by any Member State either in 2010. By contrast, most Member States (23 of them in 2010) have adopted minimal thresholds for payments, as allowed by Article 28 in Regulation 73/2009.

Box 1.2. National flexibility under in the SPS

The Health Check introduces a larger degree of subsidiarity in the CAP. The "old" CAP was a very centralized policy (Article 39 of the Treaty of Rome included provisions to guarantee a uniform treatment of producers within the Community, including a single system of prices and payments). The 1999 and 2003 reforms introduced flexibility, in particular for payments devoted to rural development. Given that these measures do not encourage production, the risk of distortions of competition was considered to be limited. The Health Check reform goes further by allowing Member States to use a series of national provisions when managing and allocating direct payments, including some Pillar 1 payments under Articles 47, 63 and 68 of Regulation 73/2009. In practice, a Member State now has a "tool box" through which to influence the allocation of the CAP budget between Pillar 1 and Pillar 2 measures as well as within Pillar 1, giving national authorities a large degree of freedom for allocating direct payments to farmers.

- **Article 68** of Regulation 73/2009 allows a Member State to siphon up to 10% of the direct payments under Pillar 1 and to reallocate this budget to five objectives, i.e. i/ support to specific types of farming which have a positive environmental impact, improve the quality and the marketing of products, or improve animal welfare; ii/ address specific disadvantages affecting farmers producing livestock or rice in disadvantaged areas; iii/ act against land abandonment; iv/ contribute to insurance premiums; v/ fight animal or plant diseases. Measures for smoothing the impact of the end of dairy quotas were added to the list of measures that could be funded. Note that the payments that are considered as linked to production cannot exceed 3.5% of national ceilings.

- **Article 63** of Regulation 73/2009 allows a Member State to use part or all of the financial resources from the decoupling of formerly coupled payments to establish entitlements that benefit particular types of farming (e.g. grass fed livestock production) provided that it is based on objective and non discriminatory criteria.

- **Articles 51, 52, 53** of Regulation 73/2009 allow Member States to choose the degree of decoupling of the payments that are allowed to be partially coupled (e.g. sheep, goats, fruits and vegetables) within EU limits.

- **Articles 45, 46, 47 and 48** of Regulation 73/2009 allow Member States that used the historic model for allocating the SFPs to farmers to shift completely or partially to a regional model. In particular, Article 47 allows changes in the entitlements, i.e. to modify the allocation of payments between farmers by redistributing only a share of payments in a way that provides a top up to some of the existing entitlements owned by a farmer. Article 48 permits making progressive modifications to payment entitlements. Article 49 allows defining different per unit values for grassland and for permanent pasture.

• **Article 72** include transitional provisions that allow Member States to make old "specific measures" (i.e. the ones provided under Article 69 of Regulation 1782/2003) compatibles with the new Article 68 or alternatively to reallocate the corresponding funds to the SPS.

The example of France shows that these flexibilities can potentially lead to a large degree of budgetary subsidiarity. Chatelier and Guyomard (2009) calculated that the combined use of these provisions gave the French government the capacity to reallocate €3.3 billion of its SFP using Article 63 and 68 only (to which the extra modulation introduced by the Health Check added €310 million that could also be reallocated). This amount can be compared to a total SFP budget of €5.8 billion, a coupled payments budget of €2.7 billion and a Pillar 2 budget of €1.8 billion in 2008.

1.1.4. The SPS and the New Member States

The Single Area Payment Scheme (SAPS)

Following the 2003 reform and the EU enlargement in 2004 and 2007, the direct payments in the new Member States are being gradually introduced in the period 2004-2013 (2007-2016 in the case of Bulgaria and Romania) through the mechanism of "phasing-in". This is taking place over a 10-year transition period, before reaching the full EU-15 rate, from 25% of this full rate in Year 1 (i.e. 2007 for Romania and Bulgaria and 2004 for the other New Members States).

In Malta and Slovenia, which shifted to the SPS in 2007, as well as in the EU-15, the SPS replaced all the premiums that existed under Common Market Organization. The other ten Member States that joined the European Union in 2004 and in 2007 have implemented a specific transitional scheme, the SAPS. The SAPS is a uniform payment per hectare, up to a national ceiling.

The ten Members States which apply the SAPS can do so until the end of 2013 (or shift to the SFP regime before this date, Hungary being in the process of doing so in 2010). Member States shifting from the SAPS to the SFP must adopt the regional model under the SFP (which is still optional for EU-15 Member States). Under a regional SFP, New Member States are allowed to apply partial decoupling on the same basis as EU-15 Member states under the regional model.

Under the SAPS, each hectare receives the same rate of payment (as in those countries that use the regionalized option for the SPS), but it is set at the national rather than at a regional level. One exception is that payments relating to the reform of the sugar regime may be reserved to hectares that have historically held sugar production quotas, and payments introduced by the reform of the fruit and vegetables regime can be paid on a historical basis. Unlike with the SPS, there are no payment entitlements. The flat rate area payment is calculated by dividing the annual financial ceiling of the Member State by its national utilised agricultural area. Farmers have no obligation to produce but land should be maintained in good agricultural and environmental condition.

Note that modulation will be applied in the new Member States (excluding Bulgaria and Romania) from 2012, at a point when payment levels reach 90 per cent of those in the EU-15. The basic rate of modulation will start at 3%.

Complementary National Direct Payments

New Member States have a derogation possibility to complement any direct payment with a complementary national direct payment (CNDPs or "top-ups"). They are funded by national budgets, and can be granted as supplements to the SAPS or, within limits, as commodity specific area or headage payments. That is, some CNDPs are coupled to particular types of production while some others are not. CNDPs were capped to 30% of EU full rates. Hence, the total payments could reach 55% of the EU full rate in Year 1. Because the total payments (SAPS/SFP and top ups) cannot exceed 100% of the EU payment rates the CNDPs will fall to 20% in 2011 and 10% in 2012 when the EU funded payments will reach 80% and 90% of the EU full rate. As a result, while coupled CNDPs can currently be linked to the actual level of production such as on the basis of the actual number of hectares, animals or tonnes of milk quota or tonnes of leaf tobacco delivered, the whole system of direct payments will eventually be decoupled in New Member States as well as in the EU-15.

It is noteworthy that because of the economic crisis and budget restrictions, Member States that used CNDPs have lowered the level of these top up payments in 2009, in particular Baltic states and Poland.

1.1.5. Other direct payments

The SPS, i.e. the combination of the SFPs and the SAPS payments in our terminology, is not the only direct payment in the EU. A reform of the SPS must also take into account the existence of other schemes, as well as the fact that the flexibility provisions introduced by the Health Check allow Member States to shift payments between Pillars. Even though Pillar 1 and Pillar 2 are governed by different objectives, financing rules (co-financing) and principles – Pillar 2 is characterised by a strategic programming approach which is quite different from the rules governing Pillar 1, the flexibilities presented in Box 1.2. contribute to blurring the boundary between the two types of budgets.

Remaining coupled support schemes

Following the 2003 reform, several sectoral reforms led to the dismantling or reduction of instruments that supported prices or provided coupled aids to tobacco, cotton, milk, wine and sugar. In most cases this led to the transfer of past support into the SFP but some coupled payments persisted in some sectors, while some restructuring payments were provided in others.

Member States may retain coupled up to 50% of the national ceilings corresponding to payments in the sheep meat and goat meat sectors and all or part of the suckler cow payments (Article 53 and 53 Regulation 73/2009).

In the case of cotton, the regime introduced in 2004 was annulled by the European Court of Justice on 7 September 2006, so the current scheme was implemented by Regulation

637/2008 of 23 June 2008. At least 65 % of the aid was included in the SFP. The remaining 35 % is provided on the basis of a fixed yield per hectare per producer Member State and a maximum base surface split between Greece, Portugal, and Spain. National base areas that can benefit from the coupled aid are established as 370 000 ha for Greece, 70 000 ha for Spain and 360 ha for Portugal while the amount of aid per eligible hectare is €594 for 300 000 ha and €342,85 for the remaining 70 000 ha in Greece, €1039 in Spain and €556 in Portugal.

In the case of olive oil, past schemes were only partly converted into a decoupled payment (countries could choose 2 years from 2000-03 for the historic period but had to shift towards decoupled payment for at least 60 percent of the former aid since 2006). For hops, up to 25 percent of the payment may be coupled. However, the partial coupling option will be discontinued from 2010 for olive oil, tobacco and hops. The quality premium for durum wheat will also be discontinued from 2010.

There are still some transitional payments in many areas that remain coupled to production or inputs. This is the case of seed aid, protein crop premiums, rice payments, nuts area payments, potato starch production aid, potato starch premium, dried fodder aid, flax and hemp aid, and various transitional payments for strawberries, raspberries and tomatoes. However, the possibility to maintain coupled producer aid payments will end in 2011 for tomatoes and for 2012 for all other fruits and vegetables. The coupled aid scheme for rice, for seeds, for protein crops, for starch potato growers will also end in 2012, and payments will fully be integrated to the SFP.

Therefore, with the exception of sheep, goat and suckler cow premiums and cotton payments, all direct payments will be included in the SPS by 2013. It is worth noting, however that under Article 68, Member States have the possibility of providing some "specific support" which can take the form of coupled payments (see Box 1.2.).

Restructuring payments

The reform of the tobacco regime was decided in 2004 and a transition phase ended in 2010 (Regulation 1234/2007 of 22 October 2007). Since 2010, all payments to tobacco have been decoupled from production. Half of the previous coupled aid was incorporated in the SFP and the other 50% was used to strengthen rural development programs in tobacco-growing regions in order to ease adjustment to the dismantling of coupled payments (Regulation 1698/2005).

The reform of the wine sector, adopted in 2008 (Regulation 479/2008), brought major changes to the way the EU wine market is managed, but also led to changes in the system of payments. Several price support measures such as crisis distillations aid were dismantled (to be followed by must aid for enrichment and grubbing up premia). The budget was reallocated to national financial envelopes leaving flexibility for Member State adopt particular measures (promotion outside the EU, innovation, restructuring and modernisation of the production chain, support for green harvesting, crisis management, etc.), and also chose how to allocate funding to individual vineyards, including through the introduction of SFP for wine growers and those who grub up their vines. As a result, the SFP aid is only one option for Member States within a larger package of possible measures (but no coupled payment) to fit within a well defined budget.

In the sugar sector, a major reform took place in 2006, which involved a 36% cut in the guaranteed sugar price. A dramatic fall of exports and production took place. Compensation for farmers, as well as a restructuring fund to encourage uncompetitive sugar producers to leave the industry was introduced. The restructuring scheme offered producers whose production costs were too high to cope with the new guaranteed prices, a financial incentive to leave the sector. Quotas were returned against compensation from a restructuring fund to which the sugar industry contributed. Fewer quota were renounced during the first two years of the scheme than anticipated (Bureau et al. 2008). Adjustments were made to make it more attractive in 2007. Eventually, about 5.8 million tonnes of quota were returned to the fund, only 0.2 million tonnes short of the Commission's target. The restructuring fund has been closed since February 1 2009. As a result of the changes in the CMO, sugar beet producers were granted SFPs and those who ceased production benefited from the restructuring fund, the value of which that depended on the local situation but was limited to 10% of the overall restructuring payments.

Payments under the 2009 recovery package

Flexibility for national aid schemes has been increased as a result of the economic crisis. Some Member States have provided aid packages, tax exemptions, interest concessions on loans, reduced social security contributions, investment assistance or loans. Most of these aids can be considered as decoupled, or fall under policies (e.g. fiscal or social) that are not under EU competence. In this area, the Commission only tolerates aids provided that they are under a *de minimis* threshold (not requiring prior notification, i.e. €7500 per year over three years per firm in the agricultural sector).¹⁴ In order to cope with exceptional circumstances, the Commission temporarily allowed Member States to pay farmers up to €15000 in state aid in October 2009.¹⁵ Some Member States have recently granted some aid packages to farmers using this provision as well as the EU tolerance on State aids for rescuing small and medium sized enterprises in difficulty.¹⁶

In 2009, following a dairy crisis, a rescue package was put together. Market support measures included temporary export refunds for dairy products; public purchases of butter and skimmed milk powder were made in excess of regular intervention ceilings and beyond normal intervention periods; a larger set of products was included in the School Milk program). The dairy sector was also made eligible for Article 186 of the Single CMO Regulation 1234/2007, which allows the Commission to take temporary action quickly, under its own powers, during times of market disturbance. A package of €300 million was voted by the Council in November 2009, Agra Europe 2388. These payments had to be used by Member States to support those dairy farmers that are severely affected by the crisis. Money added to the Rural Development fund could be spent on dairy restructuring, with options including early retirement, investment support, payments for milk farmers in Less Favoured Areas, support for environmentally-friendly forms of milk production, and aid for practices which improve animal welfare.

¹⁴ Article 107 TFEU (ex article 87 EC) stipulates that "...any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

¹⁵ Communication 2009/C/261/02, OJ C261 31.10.2009.

¹⁶ Communication 2004/C/244/02.

National governments have used margins of manoeuvre in policies not subject to common discipline to provide their own assistance to dairy farmers. Germany is said to be in the process of giving an aid package to dairy farmers worth up to €1.1. billion, mostly as advances of direct payments, reduced interest loans and tax exemptions for agricultural diesel (source Agra Europe 2366). France also implemented a national plan in 2009 that included €1 billion in bank loans and €650 million in exceptional state aid, mostly through reductions in energy and property taxes as well as social security payments (OJ C30/04 6.2.2010).

Payments under Pillar 2

Member States also provide significant direct payments under their national and regional Rural Development Plans (NRDPs, all of them were agreed by November 2008). The budget has become significant, especially when national co-financing is considered (€16.6 billion for Italy over the 2007-2013 period, €13.2 billion for Germany, €11.9 billion for France according to OECD figures). Among the Rural Development measures, agri-environmental and Less Favoured Area (LFA) payments provide a significant source of income for many farmers. In mountain areas, these two types of payments, for example, often exceed the level of the SFP. The Health Check also led to an increase in existing special investment aids for young farmers.

National state aids

State aids have been strictly limited in the CAP, since the Treaty of Rome. They have to be coherent with the Community's policy, compatible with the EU competition policy and the EU's international obligations, in particular the WTO Agreement on Agriculture. The precise conditions are set in the Community Guidelines for State aid in the agricultural sector that entered into force on January 1, 2007. State aids should not interfere with the mechanisms of the common organisation of the market and in particular not interfere with Community support for product prices. They must make a real contribution to the development of certain economic activities or certain regions. State aid which is simply intended to improve the financial situation of the recipient, without any counterpart from the beneficiary, are incompatible with the TFEU. In practice the Commission can accept : aids for investments on farms, usually up to 40% of eligible expenses, or 50% in the less favoured areas; aids for investments in the processing and marketing of agricultural products; aids granted in return for agri-environmental undertakings given by farmers and other environmental aids; aids to compensate for handicaps in less favoured areas; aids to help the setting-up of young farmers; aids for early retirement, the cessation of farming activities, or the closure of production, processing and marketing capacity; aids for the establishment of producer groups; aids to compensate for damage caused to agricultural production or the means of production caused by natural disasters or exceptional occurrences, adverse weather conditions or outbreaks of animal or plant disease, and aids granted to encourage insurance against such risks; aids to encourage the production and marketing of quality agricultural products, the provision of technical support for producers and the improvement of the genetic quality of livestock; aids to grant specific support for the outermost regions and islands. Natura 2000 payments and payments linked to Directive 2000/60/EC; aid for meeting standards; aid for advertising of agricultural products; aid relating to exemption from excise duties as provided for in Directive 2003/96/EC (taxation of energy and electricity); aid for the forestry sector; aids for rescue and restructuring farms in difficulty.

It is difficult to assess the level of state aids in EU agriculture. The Commission keeps a state aid register (which includes all forms of state aids in all sectors) but distinctions are difficult between those that are partly co-financed. The Organisation for Economic Cooperation and Development is supposed to monitor state aids but the figures published seem partial, given in particular the difficulty to gather information at the sub-national level (regions grant aids in Germany, Italy in particular). Specialized media report government's decisions of granting state aids to farmers but often these compile existing measures (including exemptions of farmers from taxes that are actually never implemented, such as the carbon tax, which represented a significant share of the announced 2009 farm support package granted by the French government to farmers). In addition the distinction between national measures and those that correspond to a reallocation of SPS payments or EU funded agri-environmental schemes is difficult. This is particularly the case for the support to risk management instruments. While large national budgets are devoted to these schemes in Spain and to a lesser extent in France and Poland, in other Member States, the national measures are partly funded under Article 68 (France, Italy and the Netherlands).

The main national expenditures payments related to output were, in 2008 in the dairy sector (evaluated at €250 by the OECD), payments to other productions were very small. National support to insurance schemes exceeded €540 million, more than 80% of them in Spain. Fuel subsidies and fuel tax rebates were estimated to reach €3.2 billion in 2008, capital investment subsidies €1.9 billion, and grants and interest concessions €410 million and support for the setting up of young farmers at €760 million. Other items deal with much smaller amounts (source OECD Producer Support Estimates database, figures for 2008, available at www.oecd.org).

1.1.6. The economic importance of the SPS in Member States

Even though it is not fully representative of the whole EU farm population (small farms are under-represented and part time farmers are excluded), the Farm Accounting Data Network or FADN data provide a useful illustration of the proportion of farm incomes that are accounted for by direct payments.

In the 2006 FADN, direct payments (including all payments except investment subsidies) averaged €11,900 per farm in the EU-25. This amounted to an average subsidy of €7,400 per unit of full time worker. Direct payments represented 19% of the value of agricultural output (gross product) on average for the EU-25, and 48% of net agricultural returns to labour.¹⁷ First Pillar payments (SPS and the remaining coupled payments) represented 37% of returns to labour (Table 1.1.). For some particular types of farms, subsidies represent a much larger amount as shown in Table 1.1. This shows the importance of direct payments, and in particular the SPS for farm incomes, even in 2006 which was a rather average/good year for farm incomes (figures are provided for the year 2006 in this section, given that 2007 is a very peculiar year for farm incomes).

Figure 1.1 to 1.4 show that this percentage varies considerably between Member States. For example, direct payments (including Pillar 2) represent only 4.7% of the value of

¹⁷ In this section, where we refer to "income", we consider the returns to labour, i.e. the net farm income plus the wages paid to hired labour, in order to compare very different types of farms, including family farms and industrial farms.

agricultural output (without subsidies) in the Netherlands but 61.7% in Finland reflecting differences in the type of agricultural production and the structure of the farm sector. If we consider all direct payments (including Pillar 2), the average EU-25 payment was €344 per hectare in the 2006 FADN sample. The average payment per hectare nevertheless reaches €3,100 in Malta, exceeds €800 in Greece and Finland, ranges between €300 and €500 in most EU-15 Members and Slovenia, and is less than €300 in Portugal, Spain and a majority of the New Member States, the lowest payments being in Estonia at €137 per hectare. If we focus only on the SPS (including the payments that were coupled in 2006), the EU average was €265 per hectare in 2006, also with significant variation between Member States. It is noteworthy that Austria, Luxembourg and Finland no longer appear with high payments per hectare, given that a large share of the direct payments in these countries comes from Pillar 2 programmes. Appendix V provides more details on the distribution of payments and incomes in 2006.¹⁸

¹⁸ The tables underlying Figures 1.1. to 1.4. are provided in Appendix IV.

Table 1.1. Share of SPS and Pillar 2 payments in returns to labour, per type of farms in %, 2006

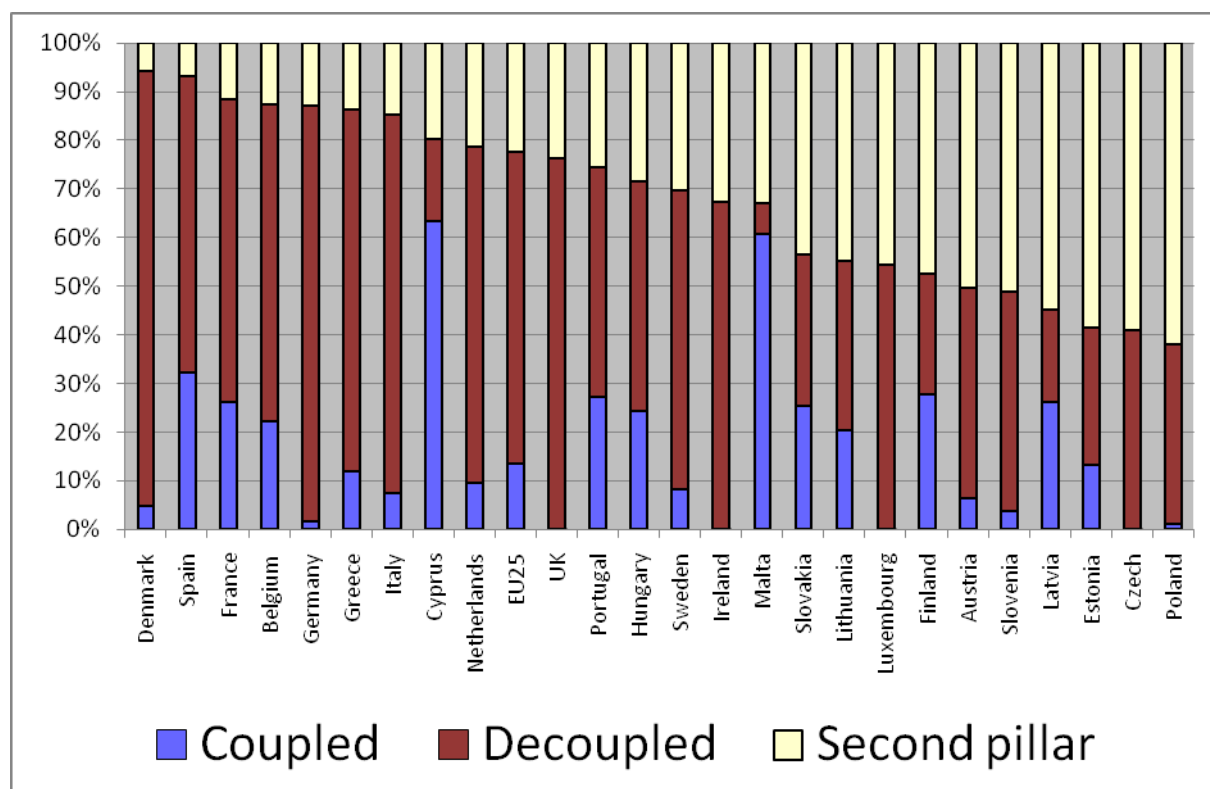
	BEL	CYP	CZE	DAN	DEU	ELL	ESP	EST	FRA	HUN	IRE	ITA	LTU	LUX	LVA	MLT	NED	OST	POL	POR	SUO	SVE	SVK	SVN	UKI	EU25	
Type of farming	Payments first pillar, as a ratio of returns to labour (net farm income plus salaries paid)																										
Field crops	33	45	61	94	73	81	49	57	97	64	62	38	45	52	46	31	23	44	20	47	144	236	585	199	68	62	
Milk	37	44	46	78	54	38	19	40	79	46	44	20	25	50	33	46	47	27	14	43	98	84	<0	52	47	44	
Other grazing livestock	64	58	65	<0	120	31	38	47	104	119	92	29	24	112	38	9	49	53	22	63	171	183	260	173	128	63	
Granivores	10	1	6	23	43	3	8	2	33	33	21	6	12	22	9	55	9	18	11	1	85	68	<0	23	7	14	
Horticulture	2	3	7	3	2	5	2	4	3	6	-	1	6	-	5	20	0	81	2	6	42	6	-	10	1	3	
Quality wine	-	150	17	-	2	176	9	-	3	7	-	1	-	3	-	-	-	17	-	5	-	-	<0	3	-	4	
Other wine	-	87	5	-	-	29	2	-	16	3	-	4	-	-	-	2	-	-	-	4	-	-	-	1	-	9	
Other permanent crops	1	59	11	4	3	31	16	5	12	33	-	12	8	26	25	22	1	7	6	23	29	<0	<0	41	1	16	
Total	26	39	49	66	53	40	24	41	60	52	69	18	34	48	33	32	16	31	15	34	104	111	<0	74	59	37	
	Total payments (pillar 1 and pillar 2), as a ratio of returns to labour (net farm income plus salaries paid)																										
Field crops	39	55	82	103	84	92	53	95	102	87	76	43	70	106	100	43	28	87	53	56	316	288	840	261	80	75	
Milk	46	48	74	87	70	47	21	66	93	60	56	23	41	93	75	58	52	70	43	54	152	131	<0	77	55	60	
Other grazing livestock	77	66	191	<0	165	42	42	104	145	151	145	38	55	203	111	13	65	106	76	83	315	325	737	316	177	90	
Granivores	12	1	13	26	52	4	9	11	37	50	24	6	19	44	15	62	10	30	39	1	119	98	<0	28	7	21	
Horticulture	5	4	10	7	3	6	3	14	5	11	-	1	15	-	8	28	3	206	5	9	43	12	-	15	2	4	
Quality wine	-	150	38	-	6	261	10	-	4	26	-	3	-	14	-	-	-	50	-	19	-	-	<0	11	-	7	
Other wine	-	106	12	-	-	31	2	-	21	25	-	5	-	-	-	3	-	-	-	23	-	-	-	1	-	12	
Other permanent crops	2	70	19	6	6	34	18	21	16	72	-	15	29	55	66	41	4	28	14	44	65	<0	<0	85	3	19	
Total	32	46	75	74	66	46	26	72	70	72	102	22	54	90	74	40	19	70	43	49	185	160	<0	121	73	48	

Source: FADN 2006. The symbol "<0" refers to cases where the returns to labour (net farm income plus wages paid to hired labour) were negative for this category of farms

If we convert the direct payments on a per worker basis (per Annual Worker Unit or AWU, including hired labour), there remains a large variation between Member States. While the EU-25 average was €7,600 per AWU in 2006, the average payment ranges from €2,100 per worker in Poland to €3,100 in Portugal, €25,000 in Luxembourg, and €29,000 in Finland, once Pillar 1 and Pillar 2 payments are accounted for (Figure 1.3).

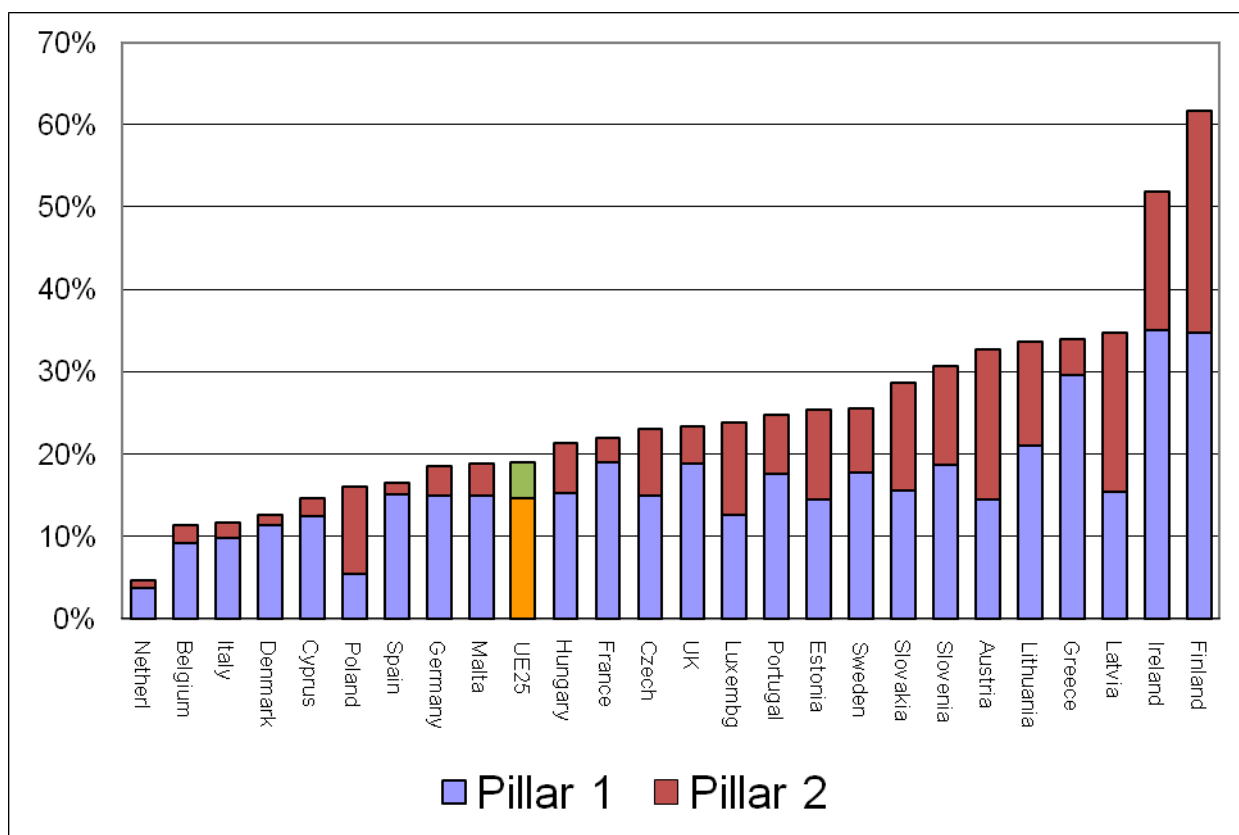
The distribution of payments per AWU is also particularly large within Member States. This is particularly the case in France, the UK, Denmark, Sweden and Finland (Figure 1.4.). If we take the extreme case of Finland, the average direct payment received by the top 20% of farms that receive the largest payments is €85,000, while the average payment received by the bottom 20% is €10,400. The figures are respectively €42,700 and €3,000 for France, €58,000 and €7,200 for Sweden for example. By contrast, the distribution is much more concentrated in Portugal, Italy and Spain and in most New Member States. In Poland the average bottom 20% payment per AWU is €400 while the average top 20% is €5,700. If we focus only on Pillar 1 payments per worker (SPS and those payments that remained coupled in 2006), a significant degree of inequality can also be observed both across Member states (Figure 1.3) and within Member States (Figure 1.4). In Portugal, Latvia and Poland, Pillar 1 payments correspond to less than €3,000 per AWU in the FADN in 2006, while in Denmark they amount to €19,000.

Figure 1.1. Share of SPS in total payments in the FADN sample, by Member State



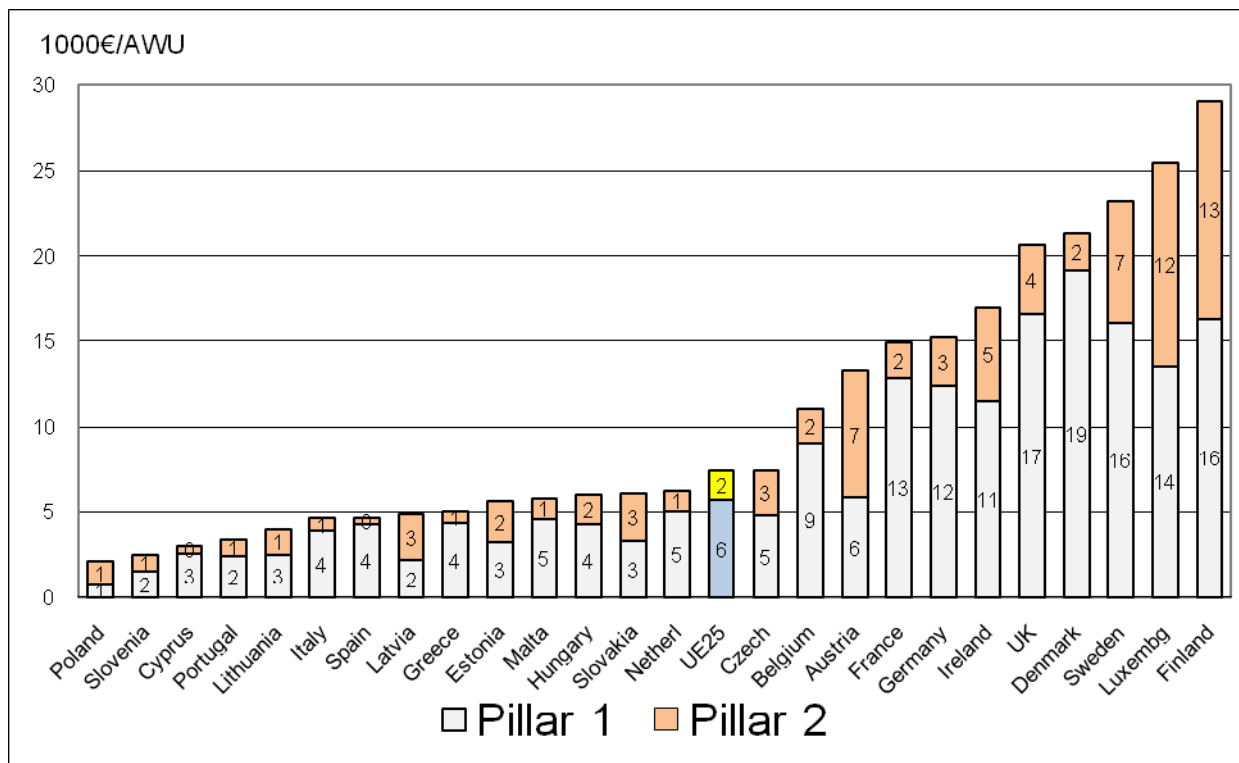
Source FADN 2007, average EU-25

Figure 1.2. Direct payments as a proportion of gross output, by Member State



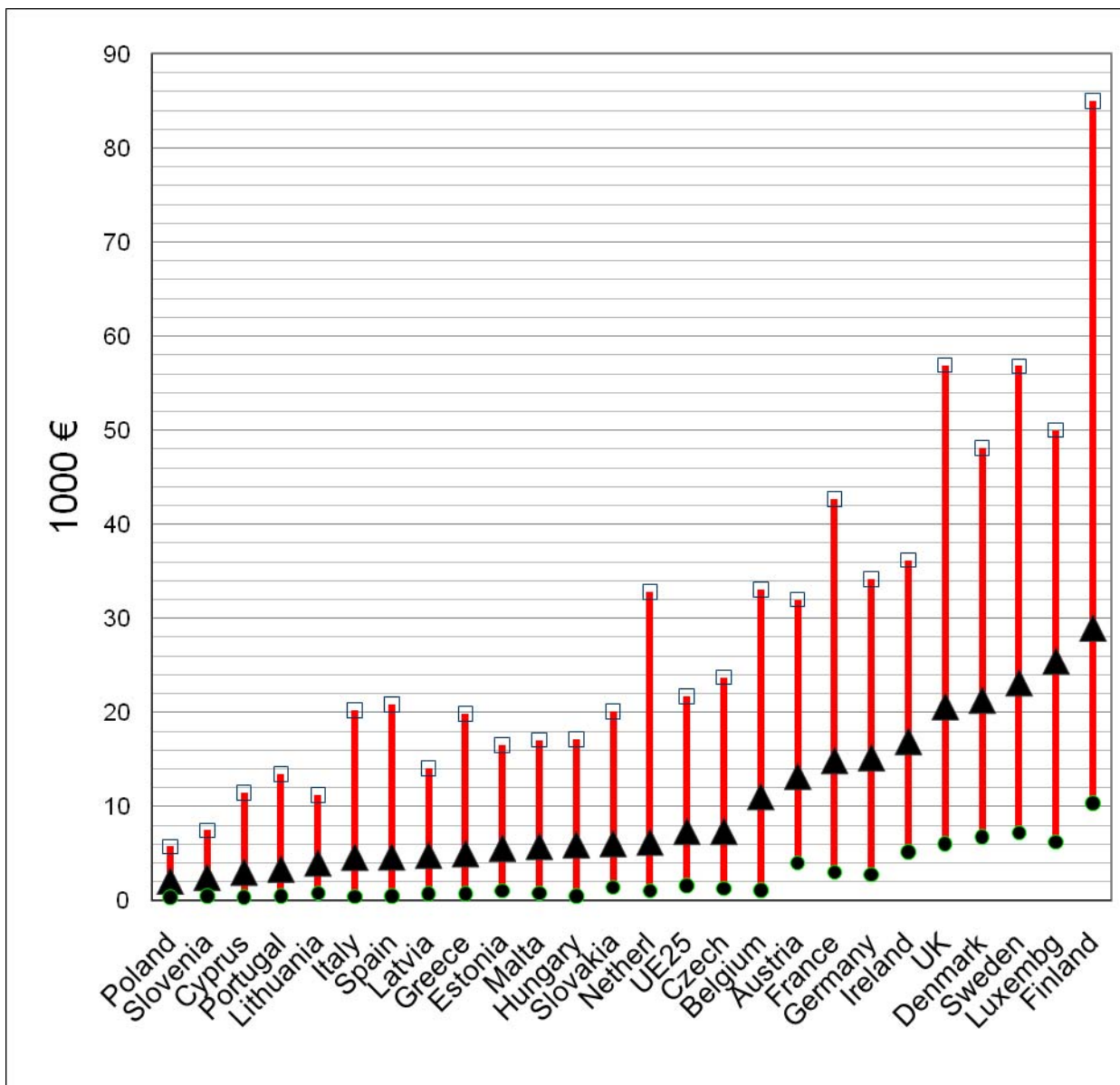
Source FADN 2006. (Pillar 1 includes SPS and coupled payments, gross output does not include direct payments subsidies included)

Figure 1.3. Direct payments per worker (Annual Worker Unit) by Member State



Source: FADN 2006, EU-25

Figure 1.4. Variation in direct payments per worker (Annual Worker Unit) by Member State



Source: FADN 2006, EU-25

1.2. National implementation of the SPS

In 2003, Member States were left with some flexibility to implement the SFPs. This flexibility has been increased significantly under the Health Check with the right to provide some specific support as explained in Box 1.2.. Two main principles were applied for the allocation of payment entitlements, the historical references and the regional references. These two approaches could also be combined in a "mixed model".¹⁹ The degree of flexibility left to Member States also involved other aspects of the SPS. One of them is the choice between partial and full decoupling. A second is the choice of the regional level for implementation of the SPS. A third is the management of the SFP reserve and the freedom left to trade entitlements. Finally, the degree to which the SFP has been attached to land also varies across Member States. All of this has a considerable economic impact, given that the support granted to SFPs capitalizes to varying degrees into land or other farm assets, depending on the choices made at the Member State level.

Heterogeneous models for SFP allocation

After the 2003 reform, Member States that implemented the SFP scheme chose both the type of model (historic, regional, hybrid or mixed) and the geographical level of regionalization. They were then bound by this choice. The 2008 Health Check Agreement allowed them to opt out of the historic and mixed models and to move closer to the regional one. The case of the United Kingdom is unique given that the model chosen (regional or historic) differs between England, Wales, Scotland and Northern Ireland. In other Member States there is a single model in all provinces or regions. Denmark, Finland, Germany, Sweden as well as England opted for full regionalisation, i.e. with an identical level of SFP per hectare within a particular region starting from 2005 or gradually moving towards a flatter rate (Table 1.2). Luxembourg, Slovenia as well as Northern Ireland opted for partial regionalisation. Austria, Belgium, France, Greece, Italy, Ireland, Netherlands, Spain, Portugal, Spain, as well as Scotland and Wales chose historic individual references.

Multiple forms of regionalization

EU Regulations leave a large degree of freedom for implementation but also for defining what is meant by "regionalization".²⁰ As a result, Member States have defined their own zoning for allocating SFPs, and have either designed a uniform payment per hectare within an administrative region, or within a region with similar agricultural potential. In the latter case, the difference between the regional and historic model is perhaps not so great given that historical references reflect the production potential of land. For example, Germany chose an allocation that differed between administrative regions (Bundesländer). The German allocation nevertheless includes a horizontal component that generates some transfers between the Länder, rather than allocating the former

¹⁹ In the historic model, the number and value of the entitlements per farmer is based on the support he/she received in a historical reference period. Because these references differ across farms of similar structure, this model is also referred to as the "individual approach". In the regional model, a flat rate value per hectare is set.

²⁰ Regulation 1782/2003 stated that "*The Member State shall subdivide the ceiling referred to in Article 41 between the regions according to objective criteria*". In the new regulation, it is said that regionalization can be based on institutional, administrative and agricultural potential (Article 45, Regulation 73/2009).

"regional envelope" per hectare, so that regionalization includes a national solidarity. In the first phase (hybrid model), the calculation of entitlements includes different unit values for arable crops and pasture in Germany, combined with individual farm top ups based on the main parts of "historic" beef, suckler cows, milk and sugar premia. In the UK, Scotland and Wales opted for the historic model, Northern Ireland for a mix of historic and a flat rate regional payment, England opted for a regionalization based on the EU zoning for LFAs, without a direct reference to local administrative units, a way of reflecting differences in agronomic potential.

In those Member States that have opted for regionalization, the implementation is either fixed (Slovenia, Luxembourg) or "dynamic" in the sense that a gradual transition from historical references ensures that payments will be fully regionalized by 2013. In Germany, this transition is accompanied by a significant redistribution between the Länder based on allocation shares of 65% for direct payments and 35% of agricultural used land. As a result, in 2013, there will be full regionalization in the sense that eligible hectares will end up activating a single rate of payment, but the shift to this system will have reduced the disparities of payments between the Länder (Table 1.2).

Preferences for decoupling

While some Member States had chosen full decoupling for all possible payments in 2003, others tried to keep as many payments coupled to production as allowed.

- Luxembourg, Ireland, Malta and the United Kingdom applied the maximum degree of decoupling available, and therefore included most direct payments into the SFP after 2003.
- Germany, Greece, Italy chose to maintain a few coupled payments on some very specific products (tobacco, hops, olives, seeds).
- Austria, Belgium, Denmark, Finland, the Netherlands and Slovenia chose to maintain some coupled payments for the beef, sheep and goats sectors.
- Spain, France and Portugal opted for maintaining the maximum amount permitted of coupled payments, both in the livestock sector and the arable crop sectors.

Under the 2009 Regulation 73/2009, all Member States will have to include payments other than those for suckler cows, sheep and goats in the SFP by 2013 (see section 1.3). The possibility is still maintained for a Member State to decouple all these payments, given that Articles 52 and 53 only imposes a ceiling for the budgetary envelope that may remain coupled.

Heterogeneous choices regarding transfers and reserves

Regulation 1782/2003 left some flexibility for implementing a national reserve (Article 42) even though it defines the main objectives, which are to grant, in order of priority, reference amounts to newcomers, to ensure equal treatment between farmers and to avoid market and competition distortions. All Member States have implemented such a reserve, but the design of national provisions suggests that in those countries that have gone for both a large degree of decoupling and regionalization (i.e. Germany and the

UK), the reserve is seen as a way to correct initial unfair situations; while in countries such as France, Italy or Spain, the national reserve is seen more as a permanent way to manage the single farm payments. Indeed, France, Italy, Slovenia and Spain have opted for siphoning a considerable percentage of the sales of single farm payment entitlements if there is no simultaneous transfer of the land to which these entitlements are attached. In such cases, 50% of the entitlements are confiscated and go to the national reserve in France for example (10% is siphoned if the entitlement is sold with the land). By contrast, such transfers are not siphoned in the UK and Germany.²¹

Overall, both the national reserve and the transfer policy have led to the maintenance of a stronger degree of government intervention in the SFP in France, Spain and Portugal, resulting in a tighter link between entitlement and land. By contrast, the UK and Germany have separated as much as was allowed under the EU Regulation 1792/2003. As a result, there are signs that a market for entitlements has emerged in the UK, while transfers have remained closely tied to land in France.²²

²¹ One interpretation is that the possibility of transferring entitlements without land might lead to purchase of such entitlements as a financial asset (i.e. a right to receive a future flow of payment), including by non-farmers. However, the risk of large transfers of entitlement as financial asset is more limited in countries that opted for regionalization given that all agricultural land is entitled (and that land is needed to "activate" the payment, as explained in Box 1.1). In countries that opted for a historical reference, where entitlements vary significantly per hectare between farms, there is more scope for sales of entitlements as financial assets (which could be activated by buying cheap land somewhere).

²² UK real estate agents typically propose "single farm payments" trade on their website. See http://www.cdproperty.co.uk/quota/sfp_market.html as an example, where the real estate agents explain that "*Farmers who have low value Entitlements may wish to trade up to higher value Entitlements to obtain a higher annual income per hectare*" and that "*farmers who have set aside Entitlements in mainly dairy and stock rearing areas may wish to sell these and replace them with standard Entitlements as they find them inconvenient. These are likely to be purchased by farmers on marginal arable farms as the capital value of set aside Entitlement is likely to be much lower than standard Entitlements although the annual income per hectare is likely to be higher*" (accessed December 2009).

Table 1.2. Options chosen for SPS implementation in Member States

<i>Member State</i>	<i>Regions</i>	<i>Model</i>
Belgium	Two regions: Flanders + Brussels, Walonia	SFP, historical
Denmark	One region	SFP, dynamic hybrid
Germany	By Bundesländer	SFP, dynamic hybrid
Greece	-	SFP, historical
Spain	-	SFP, historical
France	-	SFP, historical
Ireland	-	SFP, historical
Italy	-	SFP, historical
Luxembourg	One region	SFP, static hybrid
Netherlands	-	SFP, historical
Austria	-	SFP, historical
Portugal	-	SFP, historical
Finland	Three regions based on reference yield	SFP, dynamic hybrid
Sweden	Five regions based on reference yield	SFP, static hybrid
United Kingdom	England (three regions according to soil)	SPS, dynamic hybrid moving to flat rate
	Scotland	SFP, historical
	Wales	SFP, historical
	Northern Ireland	SFP static hybrid
Bulgaria	-	SAPS
Czech Republic	-	SAPS with separate sugar payments
Estonia	-	SAPS
Cyprus	-	SAPS
Latvia	-	SAPS with separate sugar payments
Lithuania	-	SAPS with separate sugar payments
Hungary ^a	-	SAPS with separate sugar payments
Malta	One region	SFP, regional model
Romania	-	SAPS with separate sugar payments
Poland	-	SAPS with separate sugar payments
Slovenia	One region	SFP, static hybrid model
Slovakia	-	SAPS with separate sugar payments

^a Hungary indicated its intention to change to a static hybrid SFP model in 2010

Source: European Commission, DG Agriculture

1.3. Evolution of the SPS between 2010 and 2013

Evolution of the SPS

Progressively, all existing direct payments will be included in the SPS, with the possible exception of suckler cows, sheep and goats premia and some remaining payments for cotton: Arable crops area payments, hops area aids, durum wheat quality premiums and olive oil aids will be included in the SFP in 2010. Seed aids, protein crops premia, quality premium for rice, nuts area payments, potato starch production aids, potato starch premia, aid to dried fodder processing, aid to flax and hemp for processing, transitional soft fruit payment for strawberries and raspberries, transitional payments for tomatoes, transitional fruits and vegetable payments other than annual crops as well as the special male beef premium and the slaughter premium for bovine animals will be included in 2012, even though Member states have the option to integrate most of them earlier. Clearly, considerable simplification is being introduced in the complex system of CAP payments.

Other changes that are forecast between 2010 and 2013 refer to the national implementation of the various provisions of the Health Check. This includes possible changes in the SFP model. The 10 New Member States that have implemented the SPS are supposed to shift to the SFP by 2013 (Hungary has announced that it intends to implement the hybrid SFP model in 2010). Some Member States might revise their historical system, using flexibilities for partial or complete regionalization.

Changes in the SPS by 2013 also arise from the flexibilities for reallocating some of the SPS budget. Significant amounts are being reallocated as a result of additional rates of compulsory modulation (see 1.1.3.). And some Member States have already implemented significant reallocation of payments using the new provisions under Articles 63 and 68 of Regulation 73/2009). While there is still no comprehensive source of notifications for the use of such flexibilities the following examples show that the budgets are significant, but that in most cases, the reallocation of payments has not led to more coupled payments as it was feared when Article 68 was introduced.

France

On February 23 2009, the French government announced a series of national adjustments for the SFP, taking advantage of the various forms of subsidiarity allowed under the Health Check reform (see Box 1.2). The government has not followed the "encouragement" of moving towards the regional model, and has maintained the allocation of payments according to individual historical references chosen by France after the 2003 reform. However, the use of the possibilities offered under Articles 63 and 68 of the Regulation 73/2009 led to a significant reallocation of direct payments between producers. Overall, some €1.4 billion per annum will be reallocated (including national co-financing for payments shifting from Pillar 1 to Pillar 2 due to modulation), i.e. roughly 18% of the direct payments received by farmers. These €1.4 billion can be compared to the €12.2 total budget devoted to agriculture and rural development in France, including €5.7 billion of SFP (from the EU budget), €2.7 billion of coupled payments, and €1.8 billion of Pillar 2 budget in 2008.

The French implementation of the Health Check provisions target four political orientations, i/ redirect payments towards extensive livestock production based on grazing (the budget reallocated amounts to €970 million including national co-financing); ii/ support territorial development through coupled support to particular types of production (€265 million including national co-financing); iii/ develop instruments in order to cope with climate and sanitary risk (€140 million); iv/ strengthen the support to environmentally friendly production methods (€129 million, including national contribution).

Some of the resources that have been reallocated come from changes in compulsory modulation (from 5% to 10% under the compulsory scheme) together with the reallocation of the budget corresponding to the direct payments that had remained coupled (Article 63). Article 68 was also used to move part of the decoupled payments towards farms involved in extensive sheep, goat and beef production, as well as organic farming. Article 68 will fund some measures that target a particular production system in the extensive sheep sector, provided that farmers comply with particular constraints, as well as organic farming and some extensive grazing production in the beef sector.

Italy

The Italian government notified the European Commission of some national measures for which it will reallocate a proportion of the SPS budget under Article 68. These are mainly i/ measures to improve the quality of agricultural products in the beef, sheep, olive oil, tobacco sectors (€146 million per annum); ii/ some aid to specific agricultural activities with value added in the agri-environment area (€99 million); iii/ and some funding for insurance schemes (€70 million). Overall, Italy intends to use Article 68 to allocate roughly €320 million per annum, of which half will come from reduced Pillar 1 payments and the rest from unspent amount or funds.

Spain

The Spanish government notified the European Commission of some national measures for which it will reallocate a proportion of the SPS budget under Article 68. These are mainly i/ measures to promote crop rotation for agronomic and soil conservation reasons (€60 million per annum); ii/ pre-existing measures (under former Article 69), which mainly included payments to the durum wheat and suckler cow sectors, in favour of more environmental friendly practices, organic farming and labelling, as well as support to extensive ewe and goats sectors, and incentives to use oilseeds to produce bio-ethanol (€97 million); iii/ payments to producers of local breeds of cows and ewes (€14 million); livestock producers in less-favoured areas (€63 million). Other measures include nuts support in dry areas and grain legume promotion for rather marginal budgets. Overall, Spain intends to use Article 68 for some €248 million per annum.

Greece

The Greek government notified the European Commission of some national measures for which it will reallocate a proportion of the SPS budget under Article 68. These are mainly i/ funding of a whether insurance scheme for farmers (€74 million per annum); ii/ measures to improve the quality of products, in particular olive oil and durum wheat

(€37 million); payments to farmers in less favoured areas. Overall, Greece intends to use Article 68 for some €182 million (per annum).

Germany

In July 2009 Germany notified the European Commission that it will be using Article 136 of Regulation 73/2009 so that it will transfer some of the budget to the EAFRD rather than targeting particular support of particular sectors under Article 68. Some €43 million of should be transferred to Pillar 2 programmes. However, in October 2009, the package unveiled by the new government coalition involved €750 million in farm aid for the next two years, in the form of a grassland premium (€500 million), farm accident insurance and additional liquidity aid seems to be partly funded under Article 68 (source AgraEurope, 30.10.2009). The German government is not using the Health Check flexibility for the further redistribution and re-coupling of direct payments (the harmonisation of entitlement levels from 2010 to 2013 towards regionalized flat rates as part of the 2003 reform results in a large redistribution of payments, with negative impacts on the intensive milk and beef producers).

New Member States using the SAPS have decided to make a significant use of the flexibility under Article 68. Hungary will use it to reallocate some €77 million to specific support in less favoured areas (focusing on the dairy sector), aid for restructuring the tobacco sector, and the fruit and vegetable producing regions. Poland will use some €90 million to reallocate payments to tobacco producers, and to support extensive cow and sheep production in particular regions, as well as a programme to support the cultivation of pulses and herbage legumes. Romania will use some €33 million per annum to promote organic farming and to target support at less favoured areas.

Other countries

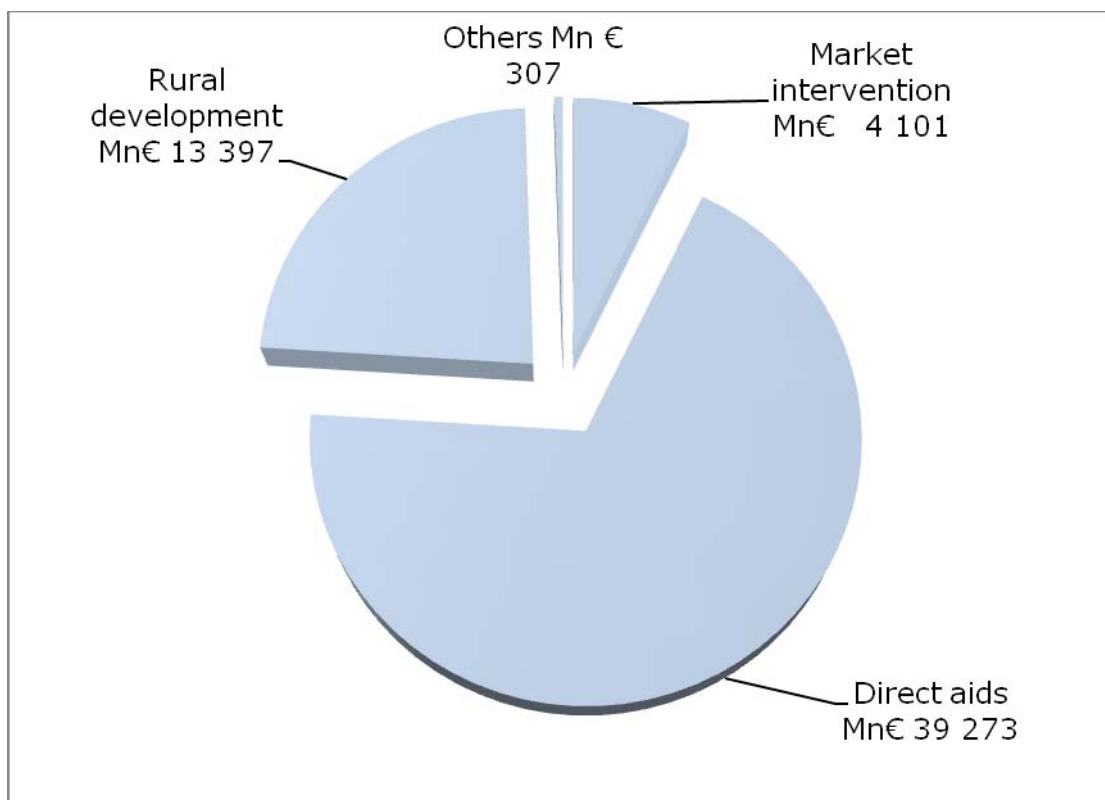
Other countries are making less use of the various provisions bringing flexibility in the allocation of payments. Ireland will use Article 68 to support a grassland sheep scheme and some dairy quality and efficiency programmes, as well as developing an environmental scheme for the region of the Burren which is highly popular with tourists (a total of €15.8 million per annum). Austria's notification of the Health Check implementation includes reallocating some of the funding towards dairy restructuring (€41 million), climate change (€22 million) and biodiversity (€22 million). Finland's implementation of the Health Check results in a significant reallocation of the budget to water management issues (€31 million) and smaller amounts to climate change and biodiversity issues. Finland will also use some €56 million under Article 68 to support particular productions namely proteins and extensive beef and sheep production, and to improve the quality of slaughtered lambs.

1.4. Current distribution of CAP appropriations between Member States

The SPS is now by far the largest component of the CAP budget (Figure 1.5). The direct payments under Pillar 1 amount to roughly 68% of the total CAP budget, including administration and audit (Title 5, Agriculture and rural development budget, 2010). This makes the SPS a central issue in the calculations that each Member States carries out

when considering its net contribution to the overall EU budget. This also explains why, for those who consider that the EU budget should shift funds towards other policies - such as research, infrastructure or foreign policy - the SPS is a prime target as a source of potential funds to be reallocated. However, it is noteworthy that, when expressed as a proportion of the total EU budget, direct payments account for 33% of all expenditures and rural development for 11% (figures budget 2010, allocation for payments).

Figure 1.5. Budget share of CAP payments



Source: EC (2010)

The allocation of CAP direct payments still reflects how much a particular Member State benefited from the CAP when payments were still coupled with production. Countries that produced a lot of highly-subsidized crops or meat therefore received – and still receive – the largest share of the CAP budget. Countries with an agricultural sector that specializes in products that were less subsidized, such as fruit and vegetables tend to benefit less from Pillar 1 payments. This is only partially balanced by the allocation of rural development budgets.

Table 1.3 shows how much each Member State has spent in 2008 on Pillar 1 direct aids from EU sources (the figures include the SFP, SAPS, coupled direct aids). To give a more complete picture, it also shows how much money each Member State was entitled to commit for Pillar 2. This is accompanied by a preview of direct aids and second pillar commitment entitlements for 2013. Table 1.4 provides the information on a per hectare

basis. Note that for New Member States, the actual payments for 2008 are higher due to national top ups that are not included in Table 1.3 and Table 1.4.

Table 1.3. Distribution of EU funded of CAP payments budget between Member States (Million Euro, scheduled for 2013)

Member States	2008 Pillar 1 payments	2008 Pillar 2 payments	2013 Pillar 1 payments	2013 Pillar 2 Payments
Austria	709	595	752	533
Belgium	560	64	615	78
Denmark	972	129	1049	106
Finland	544	319	571	289
France	8081	959	8521	1279
Germany	5496	1187	5853	1387
Greece	2405	463	2217	672
Ireland	1276	355	1341	352
Italy	3813	1617	4370	1441
Luxembourg	35	14	37	13
Netherlands	794	73	898	103
Portugal	570	588	606	611
Spain	4921	1549	5139	1284
Sweden	718	277	771	267
United Kingdom	3422	736	3988	749
Bulgaria*	166	581	580	396
Cyprus	19	25	53	21
Czech Republic	380	393	909	424
Estonia	41	96	101	113
Hungary	543	538	1319	585
Latvia	62	301	146	151
Lithuania	158	249	380	254
Malta	2	24	5	11
Poland	1248	1933	3045	1851
Romania*	422	1147	1264	1356
Slovakia	156	287	388	320
Slovenia	56	140	144	113
EU-15	34316	8925	36728	9164
EU-12	3253	5714	8334	5595
EU-27	37569	14639	45062	14759

*Note that Bulgaria and Romania will only have their full payments phased in in 2016.

Source: European Council and European Commission

It can be seen that the "old" Member States receive a much higher share of direct aids. By contrast, new Member States have privileged access to Pillar 2 payments. Since the Pillar 1 budget is much larger, the overall structure of CAP payments tends to be more beneficial for the EU-15 Member States. This remains the case in 2013 when the direct

payments for ten New Member States are fully phased in (direct aid for Bulgaria and Romania in 2013 is only 70 % of the full premium level to be reached in 2016).

These patterns become even more pronounced when looking at payments per hectare of Utilized Agricultural Area (UAA). Differences are considerable. For instance, Greek farmers received €590 per hectare in direct aids in 2008, compared to just €31 for their Romanian counterparts. But significant differences also exist among EU-15 Member States, with Portugal at the lower end receiving just €164 per hectare. Hungary, the New Member State with the highest endowments, comes close to this figure with €128 per hectare.

Table 1.4. Distribution of EU funded CAP payments among Members per ha of Utilized Agricultural Area (Million Euro)

Member States	2008 Pillar 1 payments	2008 Pillar 2 payments	2013 Pillar 1 payments	2013 Pillar 2 payments
Austria	222	186	236	167
Belgium	408	47	447	57
Denmark	365	48	394	40
Finland	237	139	249	126
France	294	35	310	47
Germany	325	70	346	82
Greece	590	114	544	165
Ireland	308	86	324	85
Italy	299	127	343	113
Luxembourg	264	104	283	101
Netherlands	415	38	469	54
Portugal	164	169	174	176
Spain	198	62	206	52
Sweden	230	89	247	86
United Kingdom	212	46	247	46
Bulgaria*	55	191	190	130
Cyprus	133	170	366	144
Czech Republic	108	112	258	121
Estonia	45	105	112	125
Hungary	128	127	312	138
Latvia	35	169	83	85
Lithuania	60	94	143	96
Malta	155	2320	494	1032
Poland	81	125	197	120
Romania*	31	83	92	99
Slovakia	81	72	200	165
Slovenia	115	586	295	231

*Note that Bulgaria and Romania will only have their full payments phased in 2016.

Source: European Commission, Eurostat

The Health Check has left the allocation of the total CAP budget across Member States largely unchanged. Money that becomes available through modulation of the SFP and reduced market intervention is distributed to the Member States where it is generated. Accordingly, the Pillar 2 entitlements of the EU-15 Member States grow as a result of modulation but there is no substantial redistribution between countries. The increasing share of New Member States in direct aids is unrelated to the Health Check, dating back to earlier decisions on the gradual phasing-in of these payments after enlargement.

1.5. The main criticisms to the Single Payment Scheme

1.5.1. The critiques – a heuristic synopsis

The 2003 reform has been praised by some stakeholders but harshly criticized by others. Farmers' organizations criticized the decoupling of direct payments on the basis that agriculture was excessively left to market forces. Environmental organizations considered cross-compliance conditions to be too weak, arguing that they mostly required a respect of current legislation. Other stakeholders criticized the fact that large budgetary outlays were provided to farmers in a way that led larger and better-off farms to receive the biggest share of the payments.

Rather similar reactions were expressed after the November 2008 Health Check Agreement. The dismantling of most intervention mechanisms and the lack of commitment for handling price fluctuations with other instruments at the EU level upset many farmers' organizations. The fact that national budgetary envelopes had been preserved until 2013 was criticized by those who consider that too much money was channelled into the CAP. Environmental groups criticized the fact that the end of compulsory set-aside was not compensated by measures to protect biodiversity. Those Member States and organizations that wanted a larger rebalancing of the budget towards Pillar 2 also expressed disappointment.

In the following sections, we try to identify the main criticisms of the current system of direct payments, and to explain which stakeholders support them. Box 1.3 provides an *ad hoc* typology of the different groups that have expressed an opinion on the Health Check reform and/or have made proposals for a reform of the SPS after 2013. We do not intend to provide a comprehensive overview, but simply to illustrate the positions of a range of stakeholders.

While our purpose is to identify the criticisms made of the SPS, it is worth stressing the importance that particular stakeholders might have in the future, due to the new provisions of the Treaty on the Functioning of the European Union (TFEU). Indeed, in addition to a shift in decisional power between institutions, it is noteworthy that under Article 24 of the TFEU, a particular stakeholder gathering some 1 million signatories might well trigger officially the questioning of some aspects of the SPS, if not the whole organization of the direct payments (Thurston, 2009).

Box 1.3. An *ad hoc* typology of the various stakeholders

A variety of stakeholders have expressed their views on the main provisions of the recent reforms of the CAP (i.e. the 2003 reform and the Health Check). In addition to Member States governments, whose views differ significantly, the European Parliament and the European Commission, the list of stakeholders includes producers organizations, think-tanks and other Non Governmental Organizations (NGOs). For the sake of simplification, we distinguish several groups:²³

- **Mainstream and conservative farm groups.** Under this item, we include most of the traditional farm unions, many of them being members of the COPA (Committee of Professional Agricultural Organisations), even though not all the national members of the COPA share the same position.²⁴ In some countries one can distinguish **Liberal farm groups** defending a more market oriented model of agriculture, in which there is less state intervention. While this is the position of the mainstream farmers' union in some Member States, these organisations are quite distinct in others.

- **Landowners interest groups.** While being close to the Liberal farm groups in many aspects, landowners are concerned by the impact of the CAP on the value of the real estate and the relation with forestry. **Forest owners**, often claim they get little from the CAP.

- **Left wing farm groups and NGOs.** In several Member States, a fraction of the farmers' organizations have joined some left wing non-governmental organizations, sharing concerns about the defence of family agriculture as well as the environment. In some countries, these organizations have often taken stances against globalization or genetic engineering for example. One illustration is the various groups belonging to the *Via Campesina* network.²⁵

- **Environmental NGOs.** Like in the other groups, there is a large heterogeneity in the positions of environmental NGOs. Even though some share some positions that make them close to the "left wing farm groups" mentioned above (in particular with some convergence on genetically modified organisms, or in the defence of family agriculture), the position of other groups is closer to the more liberal/non interventionist governments. The main environmental NGOs see the CAP mostly in terms of its positive or negative

²³ This typology is freely adapted from Zahrnt (<http://www.reformthecap.eu/>, accessed November 2009). See Keeler (1996) and Mazey and Richardson (1993), Hervieu and Viard (2001) for a more comprehensive typology of the various pressure groups.

²⁴ Examples include: Fédération Nationale des Syndicats d'Exploitants Agricoles (France), Landwirtschaftskammer Österreich (Austria), Boerenbond (Belgium), Fédération Wallonne de l'Agriculture (Belgium), Asociace Soukromého Zemědělství (Czech Republic), Deutscher Bauernverband (Germany), Irish Farmer's Association (Ireland), Confederazione Nazionale Coldiretti (Italy), Land- en Tuinbouw Organisatie Nederland (The Netherlands), National Farmers' Union of England and Wales (UK), Federatiei Nationale A Producatorilor Agricoli (Romania), Krajowy Związek Rolników, Kólek i Organizacji Rolniczych (Poland), etc.

²⁵ Examples include : Confederation Paysanne (France), Coordinadora de Organizaciones de Agricultores y Ganaderos (Spain), Sindicato de Obreros del Campo de Andalucía (Spain), Arbeitsgemeinschaft Bäuerliche Landwirtschaft (Germany), Associazione Rurale Italiana (Italy), Federation Unie de Groupements d'Eleveurs et d'Agriculteurs (Belgium), Confederação Nacional da Agricultura (Portugal), Confédération Nationale des Syndicats d'Exploitants Familiaux (France), Nordbruk (Sweden), Österreichische Bergbauernvereingung (Austria), Sindicato Labrego Galego (Spain), Euskal Herriko nekazarien Elkartasuna (Spain/France), Vlaams Agrarisch Centrum (Belgium), Mouvement d'Action Paysanne-(Belgium), Assocjazzjoni Tal-Bdiewa (Malta), Frie Boender (Denmark), NEAK (Greece), Nederlandse Akkerbouw Vakbond (The Netherlands), etc.

impacts on fauna, flora and resources.²⁶ Other NGOs focus on rather limited areas, such as *Animal welfare activists* or *anti-GMO* activists.

- **Development oriented NGOs** have often expressed their views on the CAP, focusing in particular on the effects on third countries. As in the case of environmental NGOs, some of them have developed advanced analytical capacities.²⁷ **Fair Trade activists** have similar concerns regarding the harm that European agricultural policies might do to developing countries, but with a narrower agenda.

- **Food industry interest groups** also have an original point of view on the CAP, expressed in particular by the Confederation of the Food and Drink Industry (CIAA). In this group, **Cooperatives** representatives often have positions that are closer to the mainstream farmers' organization, in particular through the COGECA (General Committee for Agricultural Cooperation in the European Union), which is associated with the COPA mentioned above.

- **Consumers organizations** have expressed positions on the CAP. Some of them focus on particular CAP issues, such as food safety, labelling, GMOs or designation of products' origins, whilst others have a broader vision of the CAP. Many of them are members of the BEUC, the European Consumers' Organisation.

- **Trade unions**, including those of farm workers and the food industry have a unique position on CAP reform.

- **Economic think-tanks and academics** have offered their own views on the future of the CAP. Obviously, this group includes very different organizations, with divergent points of views on issues such as subsidiarity and the role of government intervention, in particular. Some of these think-tanks are close to the free trade groups. In this group, **Pro-Europeans** are concerned that the CAP, once the cement of European integration, may be a divisive issue.

1.5.2. Criticism 1: Food security and market stability at risk

Some of the critiques of the SPS refer explicitly to CAP objectives mentioned in the Treaty of Rome, i.e. productivity, availability of supply and market stability, which have been included in the TFEU (Article 39). This leads to two main criticisms of the SPS. The first one is that decoupled payments no longer provide the right incentives to EU farmers in view of the demand of a growing world population. The second one is that the SPS has led the CAP away from market regulation resulting in the prospect of greater market instability.

²⁶ Among the groups with remarkable expertise on CAP issues, BirdLife Intl, WWF International, Friend of the Earth Europe, France Nature Environnement, European Environmental Bureau, and Forest and Environment Network have expressed their views on CAP reform.

²⁷ This category includes Oxfam International, CAFOD, Concern, Trocaire, the Comité Catholique contre la Faim et pour le Développement, the CTA (Centre technique de coopération agricole et rurale focusing on the CAP and African-Caribbean and Pacific countries), and the International Centre for Sustainable Development, as particularly representative of the NGOs with significant expertise on CAP issues.

Europe needs to produce more and the SPS does not help

The point that Europe must be more self-sufficient and that Community preference should be strengthened is often expressed by conservative farmers' organizations and cooperatives.²⁸ It is also an idea shared by left wing farm groups and anti-globalization NGOs and by right-wing agrarian political parties. Some of these organisations go further and suggest that the CAP should be an instrument to help EU farmers produce for the world market. The need to feed a growing world population and the idea that European production should be supported to solve malnutrition and address food crises is often implicit, if not clearly stated.²⁹

Some Member States also share this position in part. In several declarations, French officials have stressed that the first goal of the CAP is to ensure food security, that dependence on imports (in particular of proteins) should be reduced, and that an "ambitious" CAP should help to mobilize Europe's production potential in order to address the increase in global food demand.³⁰ Spanish officials have also maintained that increasing European production is a major target to achieve food security. Finnish officials have also often referred to food security to support an ambitious CAP, but in a way that is more based on the idea that it is necessary to maintain production in all EU areas. Like many New Member States (Latvia and Estonia being among the exceptions), Poland also stresses the need for regulated markets and food security, but is less keen than France, Ireland and Spain on public coupled support. By contrast, Sweden, the UK and Denmark believe that greater deregulation is required to maintain the competitive position of the EU in world market.

The SPS does nothing against market instability

Even those who do not believe that Europe should feed the world agree that a major negative consequence of the move towards the SPS is that markets may become less stable. Many producers' organizations would like the CAP to go back to more stable prices, or at least have some kind of income stabilization that adjusts to price variations. Consumer's organizations and the food industry have also expressed worries during the recent period of peak prices. They saw the fact that SFPs have remained unchanged when prices peaked in 2007/08 as a serious flaw of the SPS: European citizens had the feeling they were paying twice, as consumers and as taxpayers even though they benefited from much lower prices in 2009.

²⁸ The COPA-COGECA (2008) declaration on the Health Check stresses the need for the CAP to go back to providing "a stable framework for the development of agricultural production, through increased productivity and competitiveness, as well as the proper functioning of the market, so that the EU's strategic independence of supply in all its key production sectors is maintained and consumers are thereby assured secure, stable and safe food supplies and so that the EU is also able to contribute to meeting the rising world demand for food".

²⁹ See the communications at the Conference "Who will feed the world", European Parliament, Brussels, 3rd July 2008, in particular the speech by Kati Partanen, the representative of the European Council of Young Farmers.

³⁰ French Agricultural Minister Le Maire often expresses the view that "strong regulatory instruments" are needed to "guarantee stable and decent revenues for farmers" (July 3 2009). The conclusions of the "Assises de l'Agriculture", a major consultation of the French stakeholders under the auspices of the Ministry of Agriculture are illustrative of a French "consensus". In the four major objectives listed for the CAP, the first one is to "ensure food independence of the EU", the second one is to "contribute to food supply in the world", while the first two main principles for a future CAP are "Respect community preference" and "Stabilize markets to ensure that prices are the main component of agricultural incomes" (Ministère de l'Agriculture, 2009).

Validity of the criticisms

Food security of the EU population is a popular post-war argument that is still invoked when deploring low EU self sufficiency in certain agricultural products. This is questionable given that the EU is a net exporter of most staple foods. Furthermore, emergency plans including storage seem more efficient than coupled support to ensure food provision to consumers in crisis situations. A valid argument is that there is an "option value" of the EU production potential for the future. However, securing production potential is likely to be better achieved through regulations on urban sprawl, on groundwater management, through funding scientific research, and through the adoption of measures to prevent soil degradation, erosion and sustainable water use. The argument that EU farmers require more support to meet the world's demand for food is also questionable. A strong demand should result in higher prices and require less, not more market support. If world prices declined again and thereby increased competitive pressure on EU farmers, this would indirectly indicate that foreign competitors are able to satisfy world demand at lower prices than EU farmers. Problems of competitiveness of EU producers might call for additional investment in research or other measures, but would not indicate a danger for global food security. Finally, food insecurity in poor countries is mainly a consequence of insufficient purchasing power rather than unavailability of food. Aid to develop local agriculture would be a more promising solution than support to EU agriculture.

The fact that the SPS has not helped to regulate markets is unsurprising, given that one of the main objective of the reforms since 1992 has been to solve the market imbalances that have resulted from high institutional prices that led to the emergence of structural surpluses. The fact that so many farmers' organizations demand less direct payments but "prices that cover production costs" (i.e. at all times) is understandable from their perspective. But institutional prices should provide a lower floor to EU market prices for extreme downward fluctuations, rather than significantly raising the average price. They have to be set at a level low enough to avoid a return to the problems generated by the "old CAP". As a side remark, the mere idea that prices should be set so as to cover production costs is a bit of an economic heresy, given that costs are themselves a function of prices.³¹

The claim that the SPS does nothing to help farmers to cope with price volatility is less substantiated if one focuses on incomes rather than prices. Direct payments cushion the impact of price fluctuations on farm incomes, at least for the share of farmers who do get a high level of payments. Finally, it has been a common criticism by trading partners that the old CAP achieved a gain in EU price stability only at the cost of increased international instability, because the EU refrained from absorbing shocks originating in the EU and world markets such that the rest of the world had to adjust more. In particular with respect to the food security argument, it does not appear that the old CAP had a lot of beneficial services to offer to developing countries.

³¹ According to microeconomic theory, producers equal marginal costs to marginal revenue, i.e. output prices. More intuitively, producers use more inputs if output prices are high, as the increase in fertilizer and pesticide consumption in 2008 showed.

1.5.3. Criticism 2: Obstacles on competitiveness and bureaucratic burden

The regulatory burden of the CAP and the need to level the playing field

Many farmers' organizations criticize the move towards cross-compliance on the basis that, not only does decoupled support do little to encourage investment and production, but it is linked to major technical constraints, from buffer strips to animal welfare. This adds to many other regulatory issues that, according to farmers' organizations, as well as some Member States, put European producers at a competitive disadvantage, from restrictions on the use of GMOs to those on particular pesticides (see Appendix II regarding a list of issues that are raised by farmers' organizations). Overall, it is argued that by moving away from price support and border protection, the CAP has left EU farmers to compete with other countries on an unfair basis.

Administrative costs of management of the CAP are also seen as a significant burden, which falls not only on the European budget, but also on Member States administration and farmers. These administrative costs are even more of a problem in the case of the more complex Pillar 2 payments. It is claimed that this adds a costly layer of bureaucracy which hampers the competitiveness of EU agriculture (Falconer and Whitby, 2000). Cross-compliance also induces particular production methods that are not always the most cost effective. For example, French farmers' organizations complain that the obligation to leave soils covered all year long under the GAEC has raised technical difficulties that make the whole policy rather ineffective (such as the difficulty of planting crops for cover when autumn is dry). Again, while farmers' organizations are vehement on this issue, they are joined by some Member States, especially by those who joined the EU in the 2000s.³²

Validity of the criticisms

The consequences of regulatory constraints such as those presented in Appendix II cannot be addressed in detail in this study. The issue of how level is the playing field remains controversial. One question is whether the current SFPs help EU farmers to cope with the extra costs imposed by demands of EU citizens regarding, in particular the prohibition of most GMOs and the need to comply to high animal welfare standards. Some recent studies suggest that the level of SFPs and SAPs largely cover the extra costs of meeting cross-compliance requirements (Jongeneel et al, 2007; Carpy-Goulard et al, 2006). However, because of the increasingly decoupled nature of these payments, they do not correct distortions of competition on the production side.

The shift to SFPs from a price support policy has resulted in higher administration costs, especially if one takes into account the costs at the farm level and at the national level.

³² The Czech Republic has often expressed some reservation regarding the high administration costs related to the direct payments, and the fact that cross-compliance requirements are too demanding. Poland also perceives the need to implement full cross-compliance before Poland reaches full payment levels is unfair. Romania complains that the principle of the individual CAP payments is ill-suited to the very large number of small farmers, especially if these payments require monitoring of various performance indicators. For those countries that are most critical of the current CAP, namely the UK, Sweden and Denmark, the cost of the CAP is seen as a burden and what is left from market management hampers the competitiveness of EU agriculture. The Dutch government complains that way direct payments are designed "freezes flows of subsidy money that were determined in the past" not doing justice to dynamism of certain regions (Dutch Ministry, 2008).

The need to revise repeatedly the SFP calculation in order to include payments as a result of the various reforms that took place between 2004 and 2008 has not helped. Nor have the cross-compliance conditions and modulation. One can argue that the Member States complaining most about the excessive burden imposed to farmers and government officials by the SPS are often those Member States that have implemented the most complex options among the possible ones. In those countries that opted for historical references and for partial decoupling, administration costs have been particularly high. The extensive use of Article 68 is also leading to a considerable complexity in the system after the implementation of the Health Check. However, the administrative burden and the transaction costs imposed by the current SPS system are genuine.

Regarding the overall impact of the SPS on productivity of the EU farm sector, there are contradictory effects at stake. The SPS support incomes, but by maintaining farmers in place, especially ageing farmers to whom they provide a flow of income that deters early retirement, payments can be seen as an obstacle to consolidation and to building a more competitive sector. It has also been suggested that they might have a negative impact on the restructuring of production structures in the new Member States (Ciaian and Swinnen 2007). By contrast, because they provide financial security, payments alleviate some of the credit constraints that reduce innovation. Hence, the literature is hardly conclusive on the overall impact of the SPS in terms of productivity and competitiveness of the EU farm sector.

1.5.4. Criticism 3: Limited environmental record

The limited scope of the environmental orientation of the Health Check

The 2003 and 2008 reforms were partly designed to improve the environmental record of the CAP which had been found to be questionable by several evaluations (see ECA, 2000, 2005). As far as direct payments were concerned, this orientation was achieved through cross-compliance, and through modulation that led to higher budgets for Pillar 2, especially for the Agri-Environmental Schemes (AES) under Axis 2.

The main criticisms of the SPS from an environmental point of view come from the groups that we classified as environmental NGOs and left wing farm groups. Some also come from think-tanks and academics, including some rather free trade oriented ones, who consider that there is a strong economic rationale for paying for positive externalities, provided that the negative ones are taxed. Landowners and forest owners also criticize the CAP on the basis that payments are mostly directed to farmers while other stakeholders in rural communities also provide public goods. Among Member States, the United Kingdom is perhaps the one that insists more on the failure of the SPS to achieve ambitious environmental goals, in particular in the area of biodiversity. New Member States and Mediterranean countries are less vehement with respect to this aspect of the CAP.

The provisions introduced by the Health Check have not silenced these critiques. Indeed, abolishing compulsory set-aside is seen as a source of environmental regression. Environmental NGOs claim that it has been matched by remarkably unambitious measures that are unlikely to prevent environmental losses, in particular as far as biodiversity is concerned (very sharp declines in farmland bird populations in the last few

years are cited as evidence, see BirdLife 2006). Rendering certain GAEC standards voluntary, and therefore more subject to contestation at the Member State level, is seen as a way to reinforce opponents to cross-compliance (IEEP, 2009). Some NGOs are particularly critical of the new SPS, arguing that structural weaknesses of the instruments prevent them from delivering expected benefits regarding biodiversity and the environment.³³ More generally, a major criticism of the current SPS scheme is that those systems that are crucial for biodiversity, such as extensive livestock systems, often face high compliance costs (e.g. traceability of animals) while receiving lower payments than intensive farms. Similar criticisms apply to ill-designed management requirements such as standards to prevent scrub encroachment on agricultural land, which has resulted in damage to habitats in certain New Member states. One major criticism of the current cross-compliance conditions is that most farmers do not have to take any action beyond respecting the law (WWF 2008, FNE 2009, EEB 2008). This is also an issue raised by animal welfare groups.

Another line of criticism comes from those who claim that public goods are intrinsically linked to agricultural output, and who claim that decoupled payments break the linkage between the commodity and non-commodity output. This group includes some of the left wing NGOs, in particular in France and Germany, but also some of the farmer's organizations representing marginal areas, as well as governments such as Finland (Groupe PAC2013, 2009).

The validity of the criticism

Cross-compliance conditions for the SPS are criticized from both side, some arguing that they are too lenient, some arguing that that they impose excessive administrative costs. The European Court of Auditors has recently concluded that there are major insufficiencies in cross-compliance conditions, that made the whole SPS conditionality rather ineffective (ECA, 2009).

Defining useful cross-compliance standards is difficult, especially when these are defined at the EU or national level. Pillar 2 measures are more easily tailored to local conditions. But cross compliance has achieved a baseline level of sustainable land management upon which Pillar 2 measures rest. Part of the issue is perhaps not the SPS but the fact that some Member States have sometimes designed rather inappropriate terms of references in the GAECs, and have been rather lax in their controls and sanctions. In any case, the limited effectiveness of the current SPS as far as environmental issues are concerned is a genuine problem.

1.5.5. Criticism 4: Transfer-inefficiency

Leakages to non intended beneficiaries

The "old CAP" showed poor efficiency in the transfer of income to producers. It is well documented in the academic literature that only a fraction of the funds devoted to export subsidies, storage costs and price support actually increase farmers' incomes. With the

³³ BirdLife (2009) complains about a lack of clear policy objectives, targets and mechanisms to monitor and evaluate the results, therefore conclude that the SPS is not in line with the principles of efficiency and effectiveness that must apply to EU budget spending.

SFPs, the deadweight losses associated with CAP budgets have certainly been reduced and more of the money spent reaches farmers. However, a criticism made by various academics, as well as Member States such as the UK or Denmark, is that a significant share of the SFPs is indirectly passed to non-intended beneficiaries. It is argued that SFPs and SAPS are *de facto* passed on to the owners of primary factors such as land or production rights. In particular, the capitalization of support in land prices mainly benefits non-farmers in several NMS where land has recently been redistributed to absentee landowners retrieving property rights lost to 20th century collectivization. The same holds in general if a large proportion of land is rented. Because of the inflationary effect on land prices and particular credit constraints in a number of New Member States, farmers receive little benefit from these payments. Even in countries where farmers own the land they cultivate, land ownership makes little difference to the global picture. Labour keeps only a fraction of the support, given the transfers of assets out of the sectors at each generation (payments to siblings entitled to inheritance, purchase of quotas or land from farmers leaving the sector). Because direct payments tend to increase the cost of farming in the long run and raise barriers to entry, the SPS is criticized for being a policy that "favours those who leave the sector rather than those who enter farming" by pro-market academics and think-tanks, as well as some farmer organizations.³⁴

Validity of the criticism

The conclusion that direct payments are capitalized in the price of land and therefore benefit landowners, to siblings in the case of inheritance and to those who leave the sector, is widespread. It is, however, not fully supported by the evidence. Examination of land values and land rental rates suggest that there is only partial capitalization of SFPs into land in most EU countries. The value of the SFPs and SAPs capitalised into land rents seems to depend on the ratio of the number of entitlements to the number of hectares of agricultural land as well as on the payment model (historic, regional or hybrid) in place, and on land market regulation (Isermeyer 2003; Kilian and Salhofer 2007, Isermeyer et al 2006). The freedom to trade entitlements affects the capitalization of the benefits of direct payments in assets, and hence the leakage of public support outside the farm sector. In practice, the actual capitalisation in land prices depends to a large extent on the option chosen by Member states, on the possibility left to transfer SFP entitlements without land, and on whether there is land available without entitlement in the Member State. Econometric studies and data evidence conclude to the existence of some degree of capitalization, but not a full transmission (Meze 2003, Duvivier et al. 2005, Courleux et al 2008).³⁵

³⁴ Duvivier et al (2005), Ciaian et al (2008), Ciaian and Swinnen (2007)'s findings support the idea that the SFPs and SAPS benefit asset owners rather than producers. The idea that CAP support leaks to non-intended beneficiaries is a criticism of the reformed CAP made by free market activist think-tanks such as the European Centre for International Political Economy (ECIPE), the Centre for European Policy Studies (CEPS) and the Swedish Institute for European Policy Studies (SIEPS). The more radical "Open Europe" or the "scrap the CAP" movement that includes a variety of UK organisations that criticize CAP payments, see them as a way to subsidize wealthy landowners. The fact that the SPS acts as a barrier to entry is criticized by young farmers' organization but also by those groups classified as "left wing farm groups and NGOs" in Box 1.3.

³⁵ The exact measure of the transmission of the SFPs and SAPS to asset owners is made difficult given that land prices are affected by a range of other factors than policy support, including planning regulations, demand for non agricultural use and expectations of capital gains; and that the value of land rents is affected by specific legislation on land tenure, which introduces a considerable viscosity in the pass-through of prices and payments to land rents and hence land values. The capitalization of SFPs in the value of the virtual asset, which can be observed in the sale price of the SFPs entitlements also seems limited given that

The leakage of farm support to asset owners seems to be an issue in New Member States, in particular in countries like Slovakia and Hungary, where farmland is rented to a large degree. However, Matthews (2008) points out that, given that the number of entitlements is less than the number of eligible hectares in most of the EU-15 Member States, the value of the SFP is unlikely to be reflected in the price of land. This is particularly the case given that the direct payments which the SFP replaced were coupled payments, and that decoupling should result in even lower land values, something that has been observed in France where some land is sold without SFPs entitlements.

Given the very different national regulations in this area and the absence of comprehensive studies, it is difficult to measure the degree of capitalization of the payments in asset values. Where the SPS results in higher (even though partial) capitalization of farm support than under the old CAP, the SPS creates additional impediments to newcomers to the sector, while farmers exiting the sector are able to benefit. The claim that SPS are ineffective because they end up supporting only landowners seems excessive, but capitalization of the SPS in asset values is an issue that must be accounted for when designing a future model.

1.5.6. Criticism 5: Unfair distribution within the EU

The uneven distribution of the payments

A frequent criticism of the SPS is the unequal distribution of the payments. This is raised as a major issue by a number of farmers' organizations, including those whose members benefit little from the CAP (such as fruit and vegetable growers in many EU Member States) and those that we grouped under the category "left wing farmers organizations and NGOs", by some Member States that fight for lower CAP budget as well as many CAP opponents in academia and think tanks. Anecdotes of wealthy aristocrats or large corporations receiving direct payments are the sign that the current distribution of payments is perceived in a negative way by the public opinion.

The introduction, and the subsequent increase in the rate of modulation, has been preferred to capping payments initially proposed by the EU Commission (note that modulation will only be introduced in 10 New Member States in 2012). This has been perceived by some of the think-tanks and left wing farmers' organizations as a minimalist way to counter the most outspoken criticism of the present allocation of payments, by limiting the amount of money received by the most visible recipients. Some claim that it does not address the core distributional issue, i.e. that payments should be provided per worker, rather than on a per hectare basis (Groupe PAC2013, 2009).

the limited anecdotal evidence suggest that SFP entitlements sell at a price between 0.8 to 2.5 times the annual level of payment (these figures must be interpreted with care given that it is based on a very small number of transactions reported on internet websites in the UK and France). Explanations are perhaps the limited faith of farmers in the future of payments, the need to match entitlements with the corresponding number of hectares to activate the SFP, and the many national regulations that cap or siphon sales of entitlements (e.g. a siphoning of 50 percent in France if entitlements are sold without land).

Validity of the criticism

Anecdotal evidence on payments received by particular beneficiaries has shocked public opinion. But the fact that the payments (at least in Member States that opted for the historical model) is a simple evolution of "compensatory" payments, that were provided to mitigate the effects of cuts in institutional prices, explain a lot of the existing disparities. The shift to direct payments has simply made the uneven degree of support that existed previously more apparent. In addition, the observation that most of the SPS budget is concentrated on large farms masks a more complex reality. Large payments may be granted to former collective farms with a large labour force (e.g. in some New Member States). Finally, the image of payments channelled to wealthy arable crop farmers in fertile areas should not overshadow the fact that in Less Favoured Areas payments often exceed agricultural income.

However, the concentration of the payments cannot be denied (Box 1.4.) and whilst the reasons for the present distribution are understandable, it does not provide a compelling justification for disparities. The rationale for payments as "compensation" for changes to past policies could be seen as an implicit contract with farmers in return for reforms. However, the decrease in support price mostly took place in 1992 and 1999. With each passing year it is becoming more difficult to explain to European taxpayers why agriculture is still entitled to such payments.

Save, perhaps, the payments for less-favoured areas, the CAP never aimed to reduce existing "natural" disparities. Finding an EU-wide common point of view on what constitutes a "fair" distribution and on how "equity" should be introduced in a sector-based policy would be difficult. There is no consensus regarding what "fair" transfers should be within the EU and whether or not the CAP should have any distribution objective within the sector itself. In some countries, the fact that large farmers reap most of the benefits is not an issue, while it is seen as shocking in others. The fact that less public support is given to smaller, barely viable, farms in less fertile areas than to efficient farms is not seen as particularly illogical in some Member States. Indeed, the very issue of "compensating for natural handicaps" even appears bizarre to some Member States, while others believe that maintaining farmers all over the EU territory is a fundamental cohesion objective.

Because of the lack of consensus on the difficult issue of how even should the distribution of payments be, there is little alternative to leaving Member States the choice of designing the allocation of payments. This is largely what has been done since the 2003 reform, with the various possibilities for Member States to reallocate the payments under Article 68 and other flexibilities. These provisions offer freedom for tailoring the CAP to the degree of aversion of inequality that corresponds to the social values of a particular Member State. Going further in this area is an option. However, in such a case, it would be necessary to leave some subsidiarity for a Member State to allocate a pre-defined envelope of payments, whose amount should be calculated by common rules and based on objective criteria at the EU level.

Box 1.4. The current distribution of payments under the SPS

Well-publicized cases of wealthy aristocrats or large corporations receiving direct payments contribute to turning public opinion against the CAP. Beyond anecdotal evidence, the concentration of the CAP benefits is genuine. Because they result from the compensation of past cuts in gross incomes, the largest amounts of money transferred through SFPs go to large farms in relatively well-endowed areas and well-off individuals.

Figures on the allocation of direct payments across beneficiaries show that the 880 largest beneficiaries, i.e. 0.02% of EU farms, received more than €500 000, i.e. 2.5% of the payments. At the other end of the spectrum, more than 50% of beneficiaries, i.e. 2.5 million farms received less than €1250 Euros and 77% of beneficiaries (3.7 million farms) received less than €5000 Euros (source: EU Commission, 2008 figures). Because these figures only consider those who actually receive payments, they are biased in the sense that a significant number of farmers do not receive SPS payments. That is, the actual distribution of the SPS is likely to be even more uneven.

An alternative data source is the FADN, which covers all types of farms and not only the beneficiaries of direct payments. Indeed, according to the 2006 EU-25 figures, 11% of the FADN sample did not receive any direct payment (including Pillar 2 payments). The FADN nevertheless suffers from another bias, which is that it is not representative of the entire farm population, except in a few Member States.³⁶

Appendix V. provides some elements based on the 2006 FADN regarding the distribution of direct payments. Direct payments are on average larger on a per hectare basis in the dairy sector and in the field crop sector. On a per AWU basis, it is in grazing livestock sector that they are higher. There are large differences across Member States in both cases.

Measures of inequality (Gini coefficients) on the FADN sample show that there is a significant concentration of the payments. Even when one compares payments per unit of labour (in order to account for the fact that some large farms are societies or cooperatives), the 20% of farms that receive the largest amount of direct payment per unit of labour receive 45% of the payments (source FADN 2006, average EU-25). The Gini coefficient for Pillar 1 payments per farm is 0.67, showing a rather concentrated distribution of the payments. The Gini index of payment per AWU is 0.71 and the Gini coefficient for incomes per AWU is 0.61 at the EU level. Concentration of payments per AWU was greater in the Netherlands, Spain and Portugal, while the distribution is more even in the Czech Republic or Slovakia. The Theil inequality index, which makes it possible to decompose inequality according to sources of variations, suggests that the uneven distribution of payments per unit of labour in the EU is explained first by a Member State effect, then by the size of the farm and then by the type of production. This largely reflects that the convergence of payments between New Member States and the EU-15 was not yet complete in 2006, and that countries have chosen different models for the SFPs.

Source: authors' calculations from FADN 2006

³⁶ Indeed, the FADN mainly includes full time farms, while some part time farmers can receive direct payments as well. In addition, the sample is biased in particular countries where data are collected on a voluntary basis, and where large farms as well as very small farms are underrepresented.

1.5.7. Criticism 6: Unfair distortions for third countries

The effects on third countries

Many development-oriented NGOs have accused the CAP of negative effects on developing countries. Their criticisms target EU export refunds, which they accuse of destroying the agricultural sector of poor countries by competing in an unfair way. A subgroup also criticises "fortress Europe", claiming that EU border protection (tariff as well as non-tariff barriers) impedes agricultural exports from developing countries. This group is also very critical of the considerable level of farm support that allows EU farmers to compete unfairly with developing countries. Similar arguments have often been used by think-tanks and academics that are critical of the allocation of the EU budget to agriculture or of the CAP in general. While the SPS is rarely targeted *per se*, direct payments fall into the category of subsidies that are more generally accused of distorting markets and competition.

Validity of the criticism

A great part of the NGO criticism of the negative effects of the CAP on developing countries seems to be grounded on analyses that are now clearly outdated. Export subsidies are no longer a serious issue. As shown by Bouët et al (2005), the impact of the few remaining export refunds on developing countries is very small. The poorest countries, as well as the African, Caribbean, Pacific, Andean, and Central American countries, have an almost fully duty free access to the EU market for agricultural products.³⁷ This is also the case for large exporters such as Brazil and Argentina for a large share of their exports (soybeans, coffee, etc.). The issue of non-tariff barriers, in practice, often refers to the inability of developing countries to obtain a contagious disease free status for exports of animal products or fresh vegetable products. Overall, there are few economic arguments that support the idea that the post Health Check CAP really harms developing countries, with the exception of those such as Brazil or Argentina that face high tariffs. In addition, the effects of the CAP on world markets are mixed, and the statements of NGOs on the externalities of CAP subsidies on poor countries are sometimes inconsistent.³⁸

One issue, however, is whether the massive payments under the SPS still contribute to an unfair competition with farmers in developing countries and to lower world prices. The issue of the actual impact of the SPS on production is still subject to controversy. Even decoupled payments provide some incentive to produce through the credit constraint alleviation channel, through the change of behaviour of a risk adverse producer, and through the coverage of fixed costs (Bureau and Gohin, 2009). Some authors claim that because of the large level of the SPS, it still generates some distortions on the world

³⁷ This access is granted under preferential regime, such as the Everything But Arms initiative (for less developed countries), the ACP preferences including the new Economic Partnership Agreements (for Africa, Caribbean and Pacific countries) and the GSP+, i.e. a section of the Generalized System of Preference for 16 countries including most of Latin America except large exporters such as Brazil and Argentina.

³⁸ It is noteworthy that during the price peak of 2007/08, the criticism of these NGOs against the CAP has changed, sometimes in an awkward way. Indeed, some of them that, a few months before accused the CAP of driving world prices down because of its production incentives and export subsidies, have suddenly accused the CAP of no longer providing enough incentives to produce, and therefore to contribute to world food supply, due to the decoupling of payments. Examples of this confusing message about the effects of the CAP on developing countries can be found in statements by Berthelot (2008); Choplin et al (2009), or by particular papers by OXFAM at the beginning of the food crisis, in particular OXFAM (2006).

market that affect negatively developing countries (Melendez-Ortiz et al eds, 2009). However, most of the available econometric estimates suggest that these phenomena have a limited impact on production. With the decoupling of payments, together with conditionality and supply control, the effects of the EU farm support on developing countries seem limited (Féménia and Gohin 2009). According to recent simulations, a dismantling of the SPS would have little consequences on producers in poor countries (Gohin 2009; Elbehri and Sarris eds 2009).

1.5.8. Criticism 7: High budgetary burden

The level of the SPS budget

A long lasting criticism of the CAP refers to its cost. Pillar 1 payments should reach €45 billion in 2013. Because the reform has made little difference to the agricultural budget, and because direct payments now account for the largest share of the agricultural component, the SPS has remained the target of those who wish to reallocate funding towards non agricultural objectives such as research, or communication. This includes many free market oriented think-tanks and academics, a variety of anti-European institutions in the UK and the Czech Republic, as well as particular Member States.³⁹ Consumer groups have also complained about the cost of the CAP in the past, but they have been less critical on this issue in recent years, focusing more on food quality and the cost of particular policies such as biofuels. Complaints regarding the financial burden of the CAP match those regarding the uneven net returns of this policy across Member States, a long lasting issue in the Council (see EP, 2007).

Validity of the criticism

A full analysis of the budgetary costs of the CAP is beyond the scope of this report. A well known argument put forward by conservative farm groups and those Member States that support an "ambitious" CAP is that agriculture used to account for 80% of the EU budget while it is now only 32% (for traditional price and income support), and that this percentage is very low given that the CAP is one of the very few common policies. However in times of tight public budgets at the EU and national levels, even a 30% share of the budget cannot be spent without a strong rationale for why this expenditure is better invested in the CAP than in the pursuit of alternative Community policy objectives.

1.5.9. Criticism 8: The reformed CAP neglects rural vitality

Coupled support to agriculture is needed for remote regions

Fears of rural depopulation in some regions vary between Member States. European farmers organisations express gloomy outlooks from complete decoupling: there is concern that decoupling is leading to the "abandonment of production in certain regions" and "in more remote and difficult areas, vast tracts of land would become desolate and unoccupied without the mainstay of agricultural production and cooperatives, with a detrimental effect on infrastructure, tourism and landscape" (quotations from COPA-

³⁹ The documents by the UK and Danish governments repeatedly stress the need to reduce the CAP budget. According to the Czech government the "primary aim of the revision i.e. to gradually decrease the share of CAP in the budget expenditure..." (Programme of the Czech Presidency 2009).

COGECA 2008, ANEM, 2009; WDC 2009). If CAP budgets were slashed, i.e. with significant reductions in both Pillar 1 and Pillar 2 support, farmers' organizations thus fear that this would have drastic impacts on rural vitality in some regions. These concerns have met a powerful soundboard with local representatives, including within the Committee of Regions. Some Member States share these fears, expressed in particular by Finnish officials who stress the need to maintain production in all EU areas (maintaining local production was certainly also a motive for the positions of some German Länder in the debate on milk quotas).

Validity of the criticism

Agriculture makes a significant contribution to the economy in some in rural regions, even in those Member States where its weight has become tiny on the national level. The fear that a lower level of income support could leave farmers to leave the sector is legitimate. Nonetheless there are doubts over whether support to agriculture may revert or just halt depopulation processes if other amenities or non-agricultural activities are not present.

Modelling results on the regional impacts of decoupled payments sometimes gave positive impacts for the whole economy in a region like Scotland (Gelan and Schwarz 2006) but this may not hold in all regions. Statistical analyses suggest that specific rural development measures are sometimes more successful than direct payments to support the rural economy (Pecci and Sassi 2008). The Commission has acknowledged the diversity of situations, and consequence is that Article 68 of Regulation 73/2009 which permits specific support to farmers, inter alia, "(c) in areas subject to restructuring and/or development programmes in order to ensure against land being abandoned and/or to address specific disadvantages for farmers in those areas" now provides ways to support agriculture when it is seen as vital for the local economy. However, this remains an important issue, and the degree in which "rural vitality" should be a major objective of either an income support component of the future SPS or a public good eligible to Pillar 2 measures needs to be discussed further, considering that the EU may use regional policy as an alternative mechanism to support economic development in rural regions.

2. An assessment of the current proposals for a new decoupled payment model

2.1. The various proposals tabled

2.1.1. List and typology

The objective of this section is not to identify all the proposals for a post 2013 CAP by every stakeholder. Rather, we focus on selected proposals on the future of the CAP after 2013, which include specifically some detailed measures for a revised SPS. The analysis of the different proposals tabled is based on the following documents and positions.

Selected Member States positions

- **UK Government** (2005), "A Vision for the Common Agricultural Policy". London, December 2005. Department of Environment, Food and Rural Affairs and HM. Treasury. DEFRA (2009): "Impact assessment of HC of the CAP". February 2009. See also the distinct contribution by **Scottish Government** - Brian Pack (2010): "Inquiry into Future Support for Agriculture in Scotland - The Interim Report", January 2010.
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- **Polish Government**. Declarations summarized in Centre for International Relations (2009), "Polish Agriculture In The EU - A Broad Outline", www.csm.org.pl
- **Romanian Ministry** of Agriculture (2008), "Romanian Position regarding the Health Check and the CAP reform" ; "A Competitive European Agriculture Designed for the Citizens – Romania's Perspective". D. Ciolos, Minister of Agriculture. Published in EuroChoices, 7(3), 2008; "Romania and CAP Reform" by C. Alexandri and L. Luca (Institute for Romanian Agriculture, Working paper, 2008); Luca L. (2009), "Two extremes do not make one right, Romania and the reform of the CAP", Romanian Center for European Policies.
- **French Ministry** of Agriculture (2008), "What's the best way to prepare the CAP of the future?" Document presented at the Informal Council of Ministers, September 2008; CSO (2007), "Quels objectifs pour une politique agricole dans une perspective 2013?", document adopté lors du CSO du 14/11/2007; "Loi de modernisation agricole . Synthèse des travaux du groupe PAC 2013". Débats organisés par le Ministère de l'agriculture, 15 octobre 2009" (unpublished); "Memorandum sur la mise en oeuvre et l'avenir de la Pac réformée", Ministère de l'agriculture, 21 march 2006.
- **Spanish Government** - Ministerio de Medio Ambiente y Medio Rural y Marino (2009): "Elementos clave para la configuración de la PAC del futuro. Horizonte 2020.

Contribución española". Document to debate in the Council, to be presented by the Spanish Presidency.

- **German Government** - Federal Ministry of Food, Agriculture and Consumer Protection (2008): "Preparing for the CAP Health Check", March 2008. See also Lindemann G. (2009). Die Europäische Agrarpolitik aus der Sicht des Bundes, Presentation by federal state secretary Gert Lindemann on the Symposium "Gemeinsame Agrarpolitik nach 2013".
- **Danish Government.** The Future of Agriculture, Ministry of Food, Agriculture and Fisheries (2008). See also The Danish Government Contribution to the 2008/2009 Budget Review, April 14 2008.

Farmers and landowners' organizations

- **COPA-COGECA** (2008), "Visions for the Future Of Agricultural Policy in Europe". Declaration, Congress of European Farmers. September 2008; "COPA and COGECA's reaction to the Communication on the "Health Check", 2007.
- **CEJA** (2009), "Young Farmers And The Cap After 2013". Declaration, European Council of Young Farmers, 2009; "European young farmers' priorities for the CAP after 2013" (2008). Also "CEJA's own Health Check of the Common Agricultural Policy" (2007).
- **LRF-SSNC-CoS** (2006), "Agricultural Policy and International Solidarity". Federation of Swedish Farmers, Church of Sweden and Swedish Society for Nature Conservation
- **Confédération Paysanne** (2008), "Il faut une autre politique agricole européenne. Positionnement de la Confédération paysanne sur les orientations de la PAC"; Confédération Paysanne (2009). "Loi de Modernisation Agricole: Propositions de la Confédération paysanne", 14 octobre 2009.
- **SAF** (2009), "160 recommandations pour une nouvelle orientation de l'agriculture / 160 recommendations for a new direction in agriculture". Société des Agriculteurs de France.
- **ELO** (2008), "The 21st Century Land Use Challenge ". European Landowner Organization; "A renewed ambition for a new CAP" by T. L'Escailles, ELO, Paper presented at the Stockholm conference, September 16, 2009. ELO-BirdLife (2010). "Proposals for the future CAP: a joint position from the European Landowners' Organisation and BirdLife International", January.
- **CLA**, "The Next Steps in CAP Reform", Land Use, Country Land and Business Association by A. Buckwell (2007).

Food Industry

- **CIAA** (2008), "Reaction to the Commission's Communication on the Health Check of the CAP", Confederation of the Food and Drink Industry in the EU. CIAA (2009) "CIAA Priorities for the CAP after 2013".
- **FEFAC** (2009), "Position On Cap Beyond 2013". European Feed Manufacturers Federation.
- **ANIA** (2009), "Priorités de l'ANIA en matière de réforme de la Politique Agricole Commune après 2013". Position, Débats sur la loi d'Orientation Agricole, Groupe PAC 2013. Association Nationale des Industries Alimentaires, Paris.

Environmental NGOs

- **Birdlife** International (2008), "New Challenges, new CAP. BirdLife International's vision for the future of the EU Common Agricultural Policy"; BirdLife (2009), "Through the Green Smokescreen: How is CAP Cross-compliance Delivering for Biodiversity?". BirdLife International, European Environmental Bureau, European Forum on Nature Conservation and Pastoralism, International Federation of Organic Agriculture Movements EU Group, WWF (2009) "Proposal for a new EU Common Agricultural Policy". December 2009.
- **WCL** (2008), "Beyond the Pillars: Wildlife and Countryside Link's policy perspective on the future of the CAP". – Wildlife and Countryside Link, March.
- **WWF** (2008), "Reforming the CAP. WWF Vision for Rural Europe: 2013 and beyond. November.
- **EEB** (2008), "EEB'S Vision For European Agriculture 2008 – 2020". Environmental Bureau, 2008/007. October.
- **France Nature Environnement** (2009), "For a Common Agricultural Policy Reform guaranteeing the self-sufficiency in food for Europe, whilst respecting a natural balance".
- **Groupe PAC2013** (2009), "Priorités des organisations du groupe PAC 2013 sur les choix de mise en oeuvre nationale du bilan de santé de la PAC".

Rural development and regional development organisations

- **CoR** (2009), "A Simplified CAP for Europe, a Success for All". Draft Opinion of the Committee of the Regions, Rapporteur O. Bertrand. DEVE-IV-043, 81st Plenary Session, 5 and 7 October 2009.
- **EEAC-NCEA** (2009), "Land Use in an Era of Global Change". European Environment and Sustainable Development Advisory Councils, European Network of Heads of Nature Conservation Agencies. Brussels, 5 June 2009.
- **WDC** (2009), "The shape of the Common Agricultural Policy after 2013". Western Development Commission, Ireland.
- **ANEM** (2008), "Déclaration à l'attention des Ministres de l'agriculture de l'Union Européenne". Association Nationale des Elus de la Montagne, France. n° 39.08 PB/HB.

Think-tanks

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- **SIEPS** (2009), "The CAP and Future Challenges", by Brady, M; Hoggard, S; Kaspersson, E; Rabinowicz, Swedish Institute for European Policy Studies, European Policy Analysis N°11.
- **Conseil d'Analyse Economique** (2007), "Perspectives agricoles en France et en Europe", Bureau D., Chalmin P. Conseil d'Analyse Economique du Premier Ministre, La Documentation Française, Paris.

- **Notre Europe** (2008). "CAP reform beyond 2013: An idea for a longer view". By Bureau J.C. and L-P. Mahé, Notre Europe. Studies & Research 64, April 2008.
- **OCEI** (2007), "Future of the Agricultural Policy in the Light of the European Union Budget Review", by Burkiewicz W., Grochowska R., Hardt L., Office of the Committee for European Integration Warsaw, February.
- **Groupe Saint-Germain** (2009): "Refonder la PAC", France (complements in "Du bilan de santé à la refondation de la PAC" Terra Nova). "L'agriculture à tout prix" (Cahiers du Groupe St germain, 2008).
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- **SER** (2008), "CAP Reform and Public Services of Agriculture", Advisory Report, Sociaal Economische Raad July 2008.
- **CIR** (2007), "Polish Agriculture in the EU: a Broad Outline". Centre for International Relations, Warsaw.
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2.1.2. Proposals tabled by selected Member States

Note: in this section, the references quoted refer to the list of documents shown in section 2.1.1.

The proposal by the UK Treasury and Department of Food and Rural Affairs

The UK government, through a joint text by the HM Treasury and DEFRA published one of the first proposals for a longer term future of the CAP. In May 2008, the UK Chancellor Darling expressed a rather extreme position regarding the future of direct payments, which was taken as a summary of the position of the UK government. He proposed to phase out "all elements of the CAP that are designed to keep EU agricultural prices above world market levels" and to put an "end to direct payments to EU farmers (which cost EU taxpayers EUR34 billion - 32 per cent of the whole EU budget - in 2006)".⁴⁰ HM Treasury and DEFRA (2005), as well as DEFRA (2009) call for full decoupling of the direct payments in the short term, and in the longer term for a "considerable reduction in spending by the EU on agriculture". The diagnostic that payments capitalize in assets as well as the cost of cross-compliance for farmers are seen as two major reasons to dismantle the SFP scheme. The only payments that should remain are Pillar 2 payments provided that they are "targeted, non production distorting, defined and applied at Member State, regional and local levels to achieve these goals in accordance with local priorities and consistent with EU competition policy".

Although the above document suggests that the budget should focus on Pillar 2, there is little elaboration of how these payments should be managed. The keywords seem to be the end of the SPS, the reduction in the overall CAP budget, and subsidiarity regarding agri-environment payments. Regarding implementation, progressive changes are suggested, given that "time-limited payments to producers to compensate for income foregone, or to landowners to compensate for reduced asset values could be considered. In both cases, de-linking such payments from land would better facilitate adjustment; and early notice of reforms helps farmers to plan in advance".

The proposal of the Dutch Government

The Dutch government tabled a very precise proposal for a reform of the CAP, including the SPS, at an informal meeting of the Council in 2008. One major orientation is that the growing world demand for food requires "setting free the production potential of the EU to materialize through market forces", rather than continuing subsidize the sector. Regarding the SPS, the proposal is to convert gradually direct support "into a system of market oriented payments to farmers and other rural enterprises with agricultural activities for creating and maintaining socially desirable values, e.g. "nature", "environment", "landscape" and/or "animal welfare"; by: a/ actively guaranteeing basic

⁴⁰ May 13 2008 letter to A. Bajuk by A. Darling.

quality in socially valuable areas, and/or; b./ active delivery of performance that goes beyond that required of every entrepreneur (i.e. that exceeds statutory minimum requirements)". In parallel, the Dutch government proposal includes a "disappearance of generic income support" which directly refers to the suppression of the SPS. It calls for targeted payments for individual socially desirable performance and services.

Transition from the present situation involves gradually levelling out the present differences in generic support, gradually running down support. A consequence is that the role of cross-compliance will be decreased further, but SFP budgets would be progressively directed towards improvement of environmental quality, measures to prevent groundwater depletion, sustainable soil management organic farming, and nature and landscape management, etc. A central principle is that "justification will ultimately be based on the visible and accountable socially desirable performance delivered by farmers". The proposed scheme for Pillar 2 payments distinguishes several types of social services as well as "blue" and "green" services (following an earlier proposal by SER, 2008).

The Dutch government calls for tailor-made provisions at national/regional level. Even though the document states that the CAP should remain a European policy, many sections call for a renationalization of agricultural support, or at least some co-financing. It is not clearly stated that the size of the CAP budget should be drastically reduced. It is suggested that the CAP budget should be set as a function of the money available for other policies, and following a broad appraisal of all European policy priorities. A consequence of the proposed reform is that Pillar 1 budget should significantly decrease and what is left should be merged to what is currently under Pillar 2. The Dutch Government view is that non-agricultural activities that contribute to the quality of life in rural areas or to the rural economy should no longer be covered by the CAP, but included in cohesion policy, suggesting that Pillar 2 should be streamlined.

The proposal of the Finnish government

The general position of the Finnish Ministry of Agriculture suggests that the CAP should still have a role in market intervention, but also that direct payments should contribute to "equalise the competitive situation between the production within the EU and that coming from third countries".

The SPS is defended because of its role in stabilizing farmers' incomes in case of changes in market prices or rapid rise in the input costs. SPS payments are seen as an important source of basic income for the producers. According to the Finnish Government, both Pillar 1 and Pillar 2 have positive externalities, in the sense that Pillar 1 also reduces pressures to migrate to urban areas and contributes to cohesion both within and between the regions. The SPS is seen as playing a role in some of the major objectives of the CAP that the Ministry defines as ensuring food security in all regions of the Community, ensuring the income level of farmers, and ensuring sustainable use of renewable natural resources in the EU. More precisely, the proposal is to maintain the current two Pillars. However, the current funds shifted to Pillar 2 through modulation should be transferred on a permanent basis, and the SPS should evolve towards the flat rate per hectare model, given the imperative need for simplification. The SFP should remain the main source of CAP payments, but some coupled payments should complement it in "sensitive

regions where there is the risk that production might either stop completely or the diversity of farming would be seriously reduced".

The proposal states that the EU CAP budget, including that of the SPS, should stay at its current level. The suggestion that no ceilings should apply for Less Favoured Areas would require rebalancing some of the budget, so that payments "reflect the differences in the production caused by the different natural conditions".

The proposal of the Polish Government

The Health Check debate has given the Polish ministry of Agriculture the opportunity to clarify its position regarding SPS. A central issue for Poland (as well as for the Czech Republic) is the harmonisation of payment levels throughout the EU. Poland is opposed to renationalization of the CAP and attached to financial solidarity (CIR, 2009). However, it supports the idea of further moving away from coupled support and market management, towards a flatter system of decoupled payments. Simplification of the payments is a major objective. Poland is in favour of modulation during the Health Check debates (its position was broadly in line with the Commission's proposals regarding the Health Check).

The proposal of the Romanian government

The Ministry of Agriculture of Romania stresses the social dimension of farming, which still represents a large share of Romanian employment. It is argued that the CAP must have specific provisions for New Member States such as Romania, where considerable restructuring and investment is needed. Because the memories of food scarcity are less remote than in some other Member States, food security is also described as a major objective for the CAP. The position of Romania is overall, to preserve "a substantial CAP budget", even though it should be managed with more subsidiarity (Romanian Ministry of Agriculture, 2008).

The position of Romania regarding the SPS is that payments should be more evenly distributed, meaning in particular that they need to target the New Member States more. Payments should match ecological objectives, in particular the preservation of agricultural land fertility, so that conditionality of payments to such criteria should be maintained. Declarations from government officials suggest that Romania favours an increase in the Pillar 2 budget. It is noteworthy that in the sums allocated (not necessarily spent) for Romania for the period 2007 – 2013, Pillar 2 accounts for more than half of the total agricultural expenditure. Regarding modulation, Romania rejected at European level any attempt to limit the amounts allocated to large farms (Romania joined the UK, the Czech Republic and Slovakia on this issue during the Health Check). However, there are signs that this position is changing (Luca, 2009).

The proposal of the German government

The coalition agreement of the conservative-liberal government stresses the need to maintain both Pillar 1 and Pillar 2, and that reforms should be based on the subsidiarity principle. All support should be limited and digressive in time, and a gradual restructuring might be carried out in favour of common European future projects. A more detailed proposal has been tabled by the Ministry of Food, Agriculture and Consumer Protection

(Lindemann, 2009). It states that the SPS should remain an essential component of CAP, but that payments they must be decoupled completely. The SPS should fulfil in future primarily three duties, i/ contribution to income protection and stabilisation; ii/ compensate for higher production costs and reduction of market protection; iii/ reimbursement for external effects. Part of direct payments should be granted as an all-inclusive flat rate payments related to land, while another part could be transferred in a national upper limit. Member States could grant so-called decoupled "top up" according to their priorities. Pillar 2 budget should be strengthened, so as to preserve support to rural areas while developing programmes to meet the 'new challenges', i.e. climate change, biodiversity, animal welfare, water management, increasing need of renewable energy. The increase in Pillar 2 budget should nevertheless not be achieved by modulation, which should be phased out after 2013.

The French government position

France reacted to early proposals of radical CAP reform by launching a memorandum in 2006 on the implementation and future of the CAP. Agriculture was seen as a key tool in ensuring a global strategy on food security and the memorandum called for the defence of "European model of agriculture", together with "community preference". This memorandum was signed by 18 countries, including Romania, not a Member State at the time. Since then France has attempted to gather a coalition of countries to defend an ambitious CAP, which translated into a common declaration of 22 Member States on a statement which includes no specific detail on the SPS.⁴¹ peculiarity of the French Ministry of Agriculture is the joint management of the sector with agricultural organizations through the *Conseil supérieur de coordination et d'orientation de l'Économie agricole et agroalimentaire*. In recent statements of this Council, the growing demand for food and bioenergy at the world level is stressed, together with the issue of price fluctuations. This lead to four major conclusions, i.e. i/ the need for "preserving an ambitious budget for the CAP"; ii/ the need for border protection; iii/ the need to "stabilize market prices"; and iv/ the need for rural development measures.

Regarding the SPS, which is still seen as a poor substitute for market regulation and guaranteed prices, the French position is still that Pillar 1 payments should be maintained as a way to preserve agricultural population and production potential. Cross-compliance is seen as necessary to legitimize direct payments. However, the government considers that these payments maintain an agricultural population and help compensate farmers for distortions of competition with imported products, subject to lesser constraints. There is a strong opposition to re-nationalization and the extension of co-financing. There have been some calls recently for making direct payments more countercyclical, i.e. dependant of market conditions. However, the government has not clearly expressed its position on this. It seems more supportive of the development at the EU level of risk management tools, including possible insurance schemes and public reinsurance.

⁴¹ At the end of 2008 France submitted to the Council the conclusions of a debate on the future of the CAP after 2013, but these conclusions could not be adopted as Council conclusions because of opposition of some Member States. During the 2009 milk crisis, the French government was rather successful in rallying a majority of Member States to call for more interventionist policies. In December 2009, some 22 Member States rallied France with a common declaration. However, Ministers did not draw up any list of concrete conclusions and demands. See "Appel de Paris pour une politique agricole et alimentaire commune". <<http://agriculture.gouv.fr/sections/presse5022/communiqués/appel-paris-pour>> (10.12.09)

2.1.3. Proposals tabled by farmers' organizations and the food industry

Mainstream farmers' organisations

A central idea in the proposal of the leading farmer's unions is that the CAP budget should be maintained, and that the system of payments should "defend the European model of agriculture". These organization also oppose the reduction of Pillar 1 budget and warn against further renationalization of the CAP, arguing that "financial solidarity is necessary to ensure greater economic and social cohesion and integration throughout the EU of 27 Member States and a greater rural/urban balance" (COPA-COGECA, 2007, 2008).

Regarding the SPS, the need to preserve the Pillar 1 budget is motivated by the fact that "EU farmers cannot maintain their competitive position in the face of EU policy to open markets up to imports, and at the same time meet high EU standards of sustainability, if their direct payments are constantly being cut". A shift towards Pillar 2 payments is not seen as providing the necessary incentives for maintaining sufficient EU production and to avoid being excessively dependent on imports. A majority of COPA organizations seem to oppose capping payments per farm and modulation, on the basis of equity, stating that "the purpose of agricultural policy is not to redistribute income but to apply policy in a fair and non-distortive way" and the need not to penalize farmers "who have made efforts to modernize" (quotations from different COPA documents).

The young farmers' organizations share this point of view, but also stress the need for predictable payment schemes that would give them a longer-term, stable policy framework within which to plan investments, as well as a horizontal package for newcomers that would supplement the SPS (CEJA, 2006, 2008). A noteworthy difference to mainstream farming unions is a greater openness to Pillar 2 measures, to cross-compliance and to changes in the structure of direct payments, indicating some willingness to shift to a per worker type of payments. The 2009 declaration of the CEJA, for example, distances itself from other organizations by questioning the legitimacy of "agreements that were made decades ago" and calling for a new way of handling direct payments. The stress is on direct payments that "compensate European farmers for the high production standards they have to meet", and for payments to be based on new criteria such as the capacity for job creation in rural areas. Young farmers organizations, and in particular the French Jeunes Agriculteurs, also seem increasingly open to the idea that farmers could be paid for providing public goods.

In spite of common positions at the EU level through the COPA, there are differences between national organizations. There is no common vision about decoupled payments. Decoupling matches some of the producers' willingness to be "free to farm", while coupled payments are described by others as useful for avoiding disappearance of certain types of production. Opposition to capping and modulation is also expressed in a few countries, such as some New Member States and the UK, but is far less central in the positions of farmers' unions in other Member States.

Some national farmers' organizations emphasize more than others the need to address the issue of price and income fluctuations. The UK National Farmers Union considers that farmers need to continue to receive the SFP "to give them a degree of income stability, especially faced with volatile markets" but wants a policy that focuses on markets. Many

other national farmers' organizations have called for more market regulation and "price stabilization". Because there is little hope for going back to further administrative price setting, some organizations have called for the direct payments to be made countercyclical, as a way to help stabilize incomes. Even though there is no consensus on this issue, this proposal has been gaining momentum, in particular in the recent debate on the French agricultural law, where several influential farmers' organizations have expressed their desire for a more flexible EU budget that could lead to the ability to adjust SFPs to market conditions.

Proposals from the upstream and downstream industry

Regarding the SPS, the food industry has tabled rather detailed proposals calling for an ambitious budget for direct payments for farmers (CIAA, 2009, 2010; ANIA, 2009). A major concern of the food industry is the need for payments and mechanisms that guarantee stable agricultural production and more stable prices. The food industry fears that complete decoupling could be an obstacle in this area, and that capping and modulation might hurt the competitiveness of some specialized forms of agricultural production; but nevertheless agrees with the orientations of the Health Check with respect to the move towards flatter rates for the SPS, including for fruit and vegetables producers.

Feedstuff producers, who also defend a large agricultural budget for direct payments, see the SPS as a way to balance the cost handicaps imposed on EU livestock producers, in particular in the area of GMOs restrictions. The industry stresses the need to rebalance the SPS towards livestock producers in order to avoid the risk that the "EU livestock sector is exported" (FEFAC, 2009).

Joint proposals from progressive farmers organization and NGOs⁴²

The 2006 proposal for the CAP by the Federation of Swedish Farmers, which has teamed up with the Church of Sweden and the Swedish Society for Nature Conservation, has initiated some convergence between farmers organizations and other stakeholders (LRF-SSNC-CoS, 2006). It still stands out for defining a common vision between farmers and promoters of public goods. It stresses that direct payments should support public goods, i.e. that they should be targeted at farmers that deliver natural and cultural amenities and services to the benefit of the ecosystem, but also that they should be provided to compensate for "additional costs associated with the fulfilment of public goals such as rural development, rural employment, environmental conservation, animal welfare, etc". In practice, it is explicitly called for decoupled payments that do not distort markets and trade and do not hurt developing countries. Because of the higher production costs that have been identified, in particular in Swedish livestock production, direct payments are seen as an implicit contract between taxpayers and producers to maintain a rural population, but also a particular model in which farmers commit to environmental preservation, maintenance of landscape and well being of animals.⁴³ Overall, the implicit recommendation is a major shift towards Pillar 2 payments and LFA payments.

⁴² Under this category, we group the proposals tabled by farmer's organizations that share some common characteristics with environmental NGOs, religious groups or left wing political parties, or with landowners. It is noteworthy that there is a broad range of point of views and that this classification is rather arbitrary.

⁴³ The statement that "Producing an attractive rural landscape, cultivating heirloom species, providing opportunities for recreation and so forth must be recognized as valuable services that farmers can "bring to

Among the liberal farmers' organizations, some have acknowledged that environmental issues are crucial for acceptance of the CAP by the European public. This is typically the case of the Société des Agriculteurs de France (SAF), a network of entrepreneurial farmers. The SAF proposes that payments move towards a remuneration for the provision of environmental services, even though some other policies should play the role currently played by the SPS, in particular for stabilizing incomes (such as an active price stabilization policy based on market mechanisms but also public storage and a pluri-annual fiscal flexibility). A major distinction with other progressive farmers' organizations supporting the move towards Pillar 2 measures is that the SAF stresses that payments should be proportional to the provision of a public good, rather than also trying to pursue other, more social objectives. This is an important issue, since a central question is whether public good payments should be capped and designed to encourage a particular model of family farms, an issue on which most NGO's statements are unclear. For the SAF, it is legitimate that if a large farm supplies a large amount of public goods, the size of the payment should be commensurate. In that sense, the SAF position is perhaps closer to the organizations such as the UK's Country Land and Business Association (CLA) than of other farm groups. (the SAF as well as the CLA are members of the European Landowners Group, hereafter ELO, which has recently released a common set of proposals with BirdLife, a federation of environmental organizations, ELO-BirdLife 2010). Young farmers organizations, and in particular the French Jeunes Agriculteurs, also show some openness to the idea that the SPS should evolve towards a remuneration for the provision public goods, but stress the need to design payments that maximize farm employment.

Several other farmers' organizations share common objectives with environmental and developing NGOs, but they tend to support more market regulation and border protection. Some think-tanks have also had some rather similar positions. The proposals of the Groupe Saint-Germain (2008) focus on making European agriculture less dependent on imports, and making the direct payments more oriented towards the management of ecological systems. They can be seen as a link between the Swedish proposal mentioned above and those of more interventionists, left-wing NGOs.

Proposals from left wing organizations

Left wing farmers' organizations such as the French Confédération Paysanne, a member of the Via Campesina international network, have developed a common platform with environmental NGOs and workers' unions. They place greater emphasis on the need for regulated prices and border protection. Rather than developing the SPS, the EU should go back to a system of guaranteed prices. The apparent contradiction between price support and some other of their other objectives (such as avoiding export refunds and distortions of market) leads some of the left wing farmers' unions to defend the generalization of a system of production quotas and guaranteed prices, together with border tariffs. Payments should be designed so as to encourage low food miles food supply, encouraging a production that is closer to consumers. Payments must also be designed so as to end the specialization of particular forms of production in specific European regions (Confédération Paysanne 2007). The whole system should aim at relocating the production of staple food within Europe. Another suggestion is to provide

market" (...) The benefits of these services are shared, social, and it is therefore reasonable that society as a whole pay for the services, at least in part" illustrates the whole philosophy of this contract (LRF-SSNC-CoS, 2006).

coupled payments but up to a certain quantity of production only (Confédération Paysanne 2008, 2009).

The alliance of environmental NGOs and European left wing farmers' organisation called for an ambitious reallocation of the Pillar 1 payments to livestock producers that use extensive techniques based on natural pastures and organic farming (Groupe PAC2013, 2009; EFNCP, 2008). Their proposals also includes special (coupled) payments to support the protein production in Europe, again using extensive production techniques. These groups have joined forces with other NGOs to criticize the unequal distribution of direct payments under the SPS and have called for an end to the historical model.⁴⁴ An original feature of their proposal is that these payments should have an explicit distribution objective. This involves capping, if not providing payments, on a per unit of labour basis rather than a per hectare basis, taking into account income from non agricultural sources in the household.

2.1.4. Proposals tabled by environmental NGOs

Environmental NGOs have been particularly active in the debate on the Health Check and the future of the CAP, both at the EU level and in particular Member States. Their assessment of the current system of direct payments concludes that there has been a failure to protect the environment, in particular biodiversity, wetlands and soils. In addition, environmental NGOs point out the poor enforcement of the measures, and the ineffectiveness of cross-compliance conditions (WWF, 2008). Rather than providing income support with minimal cross-compliance conditions as is currently the case, environmental NGOs stress that what really matters is whether the funding farmers receive is proportional to the environmental benefits they deliver (EEB, 2008; EFNCP 2008; BirdLife 2008). As a result, their proposals regarding the SPS involve the phasing out of Pillar 1 payments, and shifting the budget towards an EU-wide sustainable land management and rural development policy. These issues require replacing the SPS by a basic environmental sustainability payment along the lines of the present Pillar 2, i.e. moving from an entitlement based system to one based on clear public goods agreements specifying beneficiaries' commitments and their reward, and through robust implementation of existing European legislation. Among the main principles put forward are the fact that public money should only be used for the provision of public goods, i.e. sustainable water management, carbon sequestration and soil protection; provision of environmental benefits, such as the preservation of biodiversity and habitat protection and the maintenance of valued cultural and historic landscapes; and the provision of non-environmental benefits such as public access and enjoyment.

Several NGO proposals include models for future payments arranged in a series of tiers, with a baseline tier comprising a payment available to almost all farmers with limited conditions attached to it and the upper tier comparable to an agri-environment payment based on a contract, with relatively sophisticated conditions (BirdLife et al 2009; see also Box 2.1.). There may be some intermediate tiers, for example aimed at farmers facing natural handicaps or those managing High Nature Value (HNV) farmland. Recommendations include a precise definition of statutory management requirements and targeted environmental programmes through zoning of special protection areas

⁴⁴ See "Aides agricoles : autopsie d'un système inégalitaire", note de Confédération Paysanne and Agir Ici (2005) as well as Oxfam (2004).

(BirdLife 2007). The WWF defines a "Common Environment and Rural Policy", also with several layers of payments, including a first level of basic area payments for land management that delivers defined public benefits and, specific investments and financial assistance to support and facilitate rural development. A second layer of payments would be targeted at land managers undertaking activities that lead to the maintenance, enhancement or restoration of environmental goods and services. Several NGOs, including BirdLife and the European Environmental Bureau (2008), stress the importance of support for permanent set aside land and organic agriculture. The proposal by the Wildlife and Countryside Link (WCL, 2009), which brings together 17 UK voluntary organisations concerned with the conservation, enjoyment and protection of wildlife, makes a proposal, also including three layers of payments, mostly for environmental and landscape related public goods

At the EU level, the detailed proposals of a coalition of five NGOs for a reform of direct payments with several layers and options are set out in Box 2.1. There are, however, different visions between NGOs. Namely, the views on co-financing differ considerably. The main contrast is (again) that while British, Swedish and Dutch NGOs tend to focus only on the provision of environmental services, the French environmental NGOs also include the need to support more self-sufficiency for Europe, and to promote family farms.

Box 2.1. The "five NGOs" proposal for direct payments

In December 2009, five environmental NGOs tabled a proposal for a reform of CAP payments. This proposal stands out because of the large number of individual members of these organizations, as well for the degree of detail in the definition of potential future payments. The proposal is for a radical reorientation of direct payments away from an income support model towards a 'public money for public goods' principle, arguing that the current system of cross-compliance, in which farmers are apparently paid for observing the law, is not acceptable. The mandatory baseline should be raised with the addition of EU laws on water, soil, pesticides and industrial emissions. The proposal calls for targeted support at HNV and organic systems, and that payments be calculated on the basis of income foregone. The system of CAP support payments should comprise five core schemes: i/ Basic Farm Sustainability Scheme. This would be open to all farmers and land managers and would aim to achieve a 'green transition' for conventional farming and drive improvements in biodiversity, resource use and landscape character. The payment would be a flat-rate area payment, decoupled from production. The rate would vary by Member State or region, within upper and lower limits set at an EU level; ii/ High Nature Value System Support Scheme. This would support the maintenance or recovery of farming systems that deliver high levels of public goods but are threatened by marginalisation, abandonment or conversion to intensive farming. Member states would have flexibility to vary the rates of payment according to national priorities; iii/ Organic System Support Scheme. This would aim to increase the amount of organic farming in the EU through support for conversion to, and maintenance of, organic farming; iv/ Targeted Agri-Environment Schemes. These would be used to address specific problems such as species or habitat loss, soil erosion and salinisation, water pollution etc. These contracts would be very detailed and targeted; v/ Natura 2000 and Water Framework Directive compensation schemes. These would provide compensation

to farmers or land managers subject to specific restrictions arising from these two compulsory EU regulations.

Source: BirdLife International, European Environmental Bureau, European Forum on Nature Conservation and Pastoralism, International Federation of Organic Agriculture Movements EU Group, WWF (2009) "Proposal for a new EU Common Agricultural Policy". December 2009.

2.1.5. Proposals tabled by regional and rural development groups

Outside the environmental NGO world, several groups have proposed reorientations to farm support so that the CAP addresses new functions such as maintaining and enhancing landscape quality, wildlife richness and cultural heritage for both new residents and visitors, with part of the countryside becoming a multifunctional, consumption space for citizens. The idea that regardless of the source of the payments for rural public services (from farmers, consumers and taxpayers through the EU budget or national budgets) the CAP would be a vehicle for delivering these services has received the support of landowners (RISE, 2009; EAAC, 2009; ELO-BirdLife 2010).

Regarding the SPS, the proposal of these groups is related to those of the environmental NGOs, but with more emphasis on landscape and rural employment preservation. Direct payments should be subject to enhanced environmental standards and be aligned with the objectives preferred by society. A difference is in the priority given to a more general role for payments than environment, including provision of food quality, health, rural culture and landscape in addition to ecosystems; the fact that payments should only be a part of a larger scheme where tourists, firms and other stakeholders pay for these amenities, through markets, including markets for environmental goods and services; environmental certificates. Stakeholders other than farmers should be rewarded for public goods (ecosystems, quality, health and rural culture). Contract for services would be an option for farmers as well as other providers of amenities. In practice, this would also mean a shift of the budget towards Pillar 2, but also a closer link, if not a merging, with structural funds. Some of the groups also stress that these payments should be targeted to mountain, or more generally to Less Favoured Areas (ANEM, 2008).

Again, there is a variety in the views within this category of stakeholders. For example, the position of the EU Committee of Regions is perhaps closer to that of mainstream farmers' unions (with an emphasis on the need for market regulation and protection showing some commonalities with the proposal by mainstream farmers' unions, see CoR 2009). Some groups insist that the payments should be capped by holding to maximise the rural development impact (Irish Western Development Commission, see WDC 2008). The European Landowners Organization proposals stress that the different challenges suggest a need to increase Pillar 2 budget, rather than pleading for an overall decrease in the CAP budget (ELO, 2008).

2.1.6. Proposals tabled by academics and think-tanks

The proposals of academics and think-tanks range from non government intervention to payments for public goods, but few support the current SPS. For many of them, payments should only go to encourage the supply of public goods.⁴⁵ A frequent feature of the proposed schemes is that the SPS should be progressively dismantled and that the CAP budget should be partly moved to Pillar 2 and partly moved to other European priorities.

Free-market oriented groups

A rather ancient proposal, which still appeals to some governments, is that SPS should evolve towards a "bond scheme". The bond scheme is a proposal for CAP reform tabled by the Danish government in the early nineties, whose conceptual aspects were explored in particular by Tangermann (1991) and by Swinbank and Tangermann (2004). Under this scheme, payment entitlements would be made fully tradable, independently of land and hence become a financial asset. This scheme, however, is merely a way to ease the transition towards a dismantling of the SPS and can hardly be considered as a "new model" for SPS. It also raises some practical issues, given the differences between the ways in which Member States have implemented the SPS.

The proposals of other think-tanks range from positions that are close to that of the UK government, to others, closer to environmental NGOs. The Swedish Institute for European Policy Studies (SIEPS) finds that because of the capitalization of SPS into land value, direct payments do not fill their function of supporting farm incomes. Their elimination is proposed because they are detrimental to competitiveness and slow down structural change. As a result they propose steps including levelling out payments across Member States and reducing them progressively (Brady et al 2008). Eventually, budgets should be directed to research and innovation, and payments should be for the provision of public goods, covering only the extra costs to farmers.

Zahrnt (2008) proposes that Member States have a greater autonomy in allocating and topping up direct payments with national budgets. He proposes an objective formula to define national envelopes for Pillar 1 based on agricultural area and GDP per capita. Then Member States would have the flexibility to move this envelope towards Pillar 2, or to "finance all the inefficient instruments aimed at supporting farm income and production: the SFP and other income support, coupled payments, and payments for improving farm productivity" if they wish to do so.

More pro-farmers proposals

A rather dissonant approach is the one by Chalmin (2007) for the French Council of Economic Analysis. He proposes that Pillar 1 payments are co-financed and that conditionality be strengthened, leading in practice to a merging of both pillars; that payment levels are set according to the regional model but that it moves towards the idea of a contract for services. However, he regards the maintenance of some coupled payments for livestock production to be necessary due to the specificity of the world

⁴⁵ See Hofreiter et alii (2009), as well as Zahrnt (2009) and Swinnen (2009) among academics willing to restrict the use of public money to the support of public goods.

market and the extra costs imposed by EU standards, as well as the social services provided by extensive livestock systems. One solution would be to create a set of deficiency payments, or to maintain some production quota with supported prices. Finally, payments could be capped by unit of labour.

A group of Polish economists calls for a continuation of support at the EU level, arguing that renationalization of the CAP would have some undesirable effects, such as the difficulty of preventing that national authorities provide distorting support under posted public good policies (Burkiewicz et al 2007). They support a higher rate of modulation which could be subject to variations between regions, but the different rates should be based on objective criteria at the EU level. They also call for capping the payments per holding. If the SPS should remain in Pillar 1, they call for a simple and unique system throughout the EU, and stress the need to have long term, predictable policies. A single EU wide payment per hectare could be used, even though, in the longer run, a desirable goal is that the CAP moves towards more targeted payments. This shift should be accompanied, in particular, by risk management instruments funded at the EU level.

A group of German economists proposes a gradual move of the SPS toward a differentiated regional and agricultural policy (Heißenhuber et al 2008). They propose three steps. The first one would be the continuation of some degree of basic uniform premium level, the "basic payment", that aims to compensate farmers for specific demands from European citizens (animal welfare, health and hygiene standards) and works as a shock absorber of price fluctuations. This payment would be much lower than the current SFP and SAPS, and completely funded by the EU. In a second layer, voluntary measures would deliver payments for environmental and other public goods, but with a more top-down approach than the current agri-environment schemes. A third level of payments would make the link to structural and cohesion funds, at the regional level, and be extended to beneficiaries outside of the agricultural sector.

More environmentally concerned think-tanks

The Social and Economic Council of the Netherlands has tabled a detailed proposal for the reform of the SPS payments stressing the multifunctional nature of agriculture (SER 2008). Payments should be provided to support farmers in the provision of public goods as well as to reduce the ecological footprint of production and maintain high standards in terms of food safety, environment and animal welfare. An original feature of the document is that it establishes a typology of services and social values that agriculture needs to fulfil and assesses whether payments are needed in each case. Payments are useful for "blue" (i.e. water management) and "green services" (i.e. preservation of landscape and the environment, in particular for recreational values). Another feature is that the payments should be coupled to particular services, which must be valued by citizens. This matches earlier proposals by Notre Europe, another think-tank, which suggested that environmental payments under Pillar 2 be made proportional to estimated of citizen's willingness to pay (e.g. estimate of social value assessed, for example, by contingent valuation or transport costs or other techniques used to price non marketable goods, see Bonnieux 2007).

The SER sees three possible reasons for payments: i/ if there are significant natural impediments to farming that are inadequately compensated by lower land prices and that could lead to the undesirable abandonment of land in that particular area; ii/ if a policy –

for example on nature conservation or environmental protection – imposes restrictions on operations that go beyond those customary for agricultural enterprises in the EU; iii/ in order to meet a public demand for collective goods and services that can best be served by pursuing an area-specific approach. The combination of the handicap/no handicap criteria, and the one relating to the provision of public ("blue" or "green") services leads to a recommendation of a four cluster model for payments. The SER documents provide details on the possible implementation within the CAP framework.

The Land Use Policy Group (LUPG, 2009) also proposes that the CAP moves toward a "new contract" between (predominantly urban) taxpayers and those who manage rural land. In practice, the budget from the phasing out of income support should be shifted into the direct purchase of environmental services, provided by all farmers and foresters, regardless of whether land is managed intensively or extensively. The necessary support could be provided via agri-environment schemes or aid for capital investments supported by advisory services. The proposal is therefore that the SPS moves to Pillar 2 type of measures, and that to be eligible for public subsidies, farmers will need to deliver additional services over and above the minimum requirements of current cross-compliance conditions.

The Institute for European Environmental Policy (IEEP) has tabled several documents. Its main proposals are close to those of the environmental NGOs, with priority given to the protection and enhancement of biodiversity and the sustainable use of natural resources, without neglecting the ability for Europe to feed itself and the move towards a less carbon intensive economy (IEEP, 2008; 2009).

The "Notre Europe" think-tank proposes setting long term objectives to the CAP, while acknowledging that some form of income support and market regulation is necessary at least in the short run, and accounts for the difficult issue of budget rebalancing between Member States (Bureau and Mahé, 2008). The SPS would be replaced by a scheme fully co-financed by Member States. A three-stage contractual payment scheme is proposed, on the basis of a contract between farmers and society, showing some convergence with other environmentally concerned think-tanks and NGOs. The contractual payment scheme would include three levels of contractual payments: basic husbandry payments; natural handicap payments and green points payments, which would replace current payments. In practice, the SFP would be replaced by a contract which offers (decoupled) "Basic Husbandry Payments" subject to few but observable commitments regarding rural farming landscape, biodiversity and natural resources. The payment would target commercial farms in areas considered as "ordinary" – i.e., with neither high environmental importance nor the threat of rural decay. The payments might still be given per hectare of managed land as an *ad hoc* rule, but they should be tied to the commitments accepted by the operator. They should be neither tradable nor transmissible to heirs in order to avoid or minimise the capitalisation of rents. And the possibility of capping this payment on a per worker basis is proposed. The contract would cover a limited number of years, and the level of payments would be substantially lower than the current SFP average. The Natural Handicap Payments would also be contractual payments but would target farms in rural zones with natural handicaps. The payments may be coupled with production or animal heads under conditions of low inputs or low stocking rates. The Green Points Payments would be a targeted payment for farms which use certain production techniques such as organic farming, or who commit to a higher level of environmental services.

2.1.7. Major lessons from the proposals tabled

Proposals by selected Member States show large divergences, from scrapping the SPS and considerable cuts to the CAP budget, to keeping an ambitious policy either based on social considerations, or on the arguments of public goods and food security. It is unclear, though the degree to which these different proposals correspond to genuine differences in philosophical or moral values, or to differences in the economic situations of the agricultural sector, which could perhaps be accommodated by a greater use of the subsidiarity principle. Because the positions also match the net budgetary contribution of the Member States resulting from the CAP, there is the suspicion that their proposals also reflect some national financial interests.

There is also a gradient in the proposals from farmers' organizations. Some of the farmers' unions have positions that are clearly in line with those of the most conservative Member States, i.e. close to a status quo regarding the level of funding, a defence of Pillar 1 payments, and the idea that the future SPS should help European producers to maintain a strong competitive position on the world market. Other, more left-wing, farmers' organizations are close to environmental NGOs. However, they share with the most mainstream farmers' organizations the idea that there is a need for greater market regulation and border protection, which the SPS is unable to provide. Many farm groups nevertheless call for a set of direct payments that compensates for extra regulatory constraints that are imposed to European farmers and not to foreign producers. One original feature of some farmers' organizations, including the young farmers, is the need to cap payments per unit of labour. Some other farmers' organizations call for the SPS to evolve towards more countercyclical payments.

Finally, there is a large convergence between the proposals of the most market oriented think-tanks, some of the Member States (in particular the Dutch government) and many academics, on the need to phase out direct payments and to move toward remuneration for the provision of environmental goods and services. In this respect, they are in line with the proposals of the environmental NGOs. Many propose several layers of payments, from a rather simple contract for services to some more targeted payments. The main difference is in the level of payments between the layers and in the fact that some of the think-tanks and other NGOs consider that a rather basic set of payments should also include a social component.

Few of the various proposals tabled go as far as making detailed suggestions for a future SPS model. As a result, it is difficult to make precise assessments of the consequences of these proposals. Rather than inferring possible scenarios from the wording of the different texts tabled, we focus in the following sections on some benchmark cases, building on some of the proposals, in particular as far as an alternative allocation of payments is concerned.

2.2. Consequences of alternative allocation of payments

A number of the proposals listed in the previous section suggest the implementation of a uniform flat rate for the single farm payment on a regional, Member State or EU basis. Proposals differ with respect to the transition period or with respect to a temporary or permanent nature of such a scheme. Some also call for either a ceiling per worker or a

more explicit allocation of payments based on labour or employment. Here, the general distributional consequences of a flatter rate relative to the current premium allocation at farm level are analysed.

2.2.1. Method and data base

The main data used for the presented model calculations are individual farm accounting data of the EU-wide FADN database. A comparative static simulation model is used to assess the distributional consequences of (i) a uniform flat rate per Member State and UAA (Utilised Agricultural Area); and (ii) a uniform flat rate EU-wide per UAA on direct payments level and income. Simulations have also been carried out assuming a ceiling of payments on a per worker basis.

Firstly, gross direct payment levels (excluding compulsory and voluntary modulation) are calculated. Then, a projection of payments for 2013 is made, including the regional implementation of decoupling in Germany and England, as well as the upgrading of premium levels in the new Member States. The target year for the analysis is 2013, assuming a full upgrading of direct payments in Bulgaria and Romania. Neither the ongoing implementation of the Health Check decisions regarding Article 68, nor the remaining steps of the reforms of the Common market regimes for sugar, tobacco, olive oil, cotton, wine, fruit and vegetables are considered, due to the fact that it is impossible to distinguish between the payments in the data. Flat rates are calculated based on premium budgets defined for 2013 and 2016 for the EU-25 and Bulgaria and Romania, respectively, and statistical data for land (UAA) for 2007. According to the Health Check decision, a premium reduction of 10% beyond a franchise of €5000 per farm, and a further reduction of 4% for premiums exceeding €300,000 are taken into account. In the simulations, an additional restriction of €15,000 per AWU for payments exceeding €50,000 per farm is considered. This is a somewhat arbitrary choice based on previous methodological work regarding the analysis of modulation and capping schemes in Germany and in France (see Colson 1998, Kleinhanß and Manegold 1998, Chatellier and Kleinhanß 2000). The ceiling intends to provide a benchmark and could be changed easily in the simulations carried out. Partial impacts of the above-mentioned scenarios are derived referring to national implementation of decoupling (excluding modulation). Income effects are assessed using family farm income plus wage expenditure as an income indicator. The results are weighted with aggregation factors and aggregated to sector accounts.

The basic data on premium budgets, land and labour used for the calculation of flat rates, and the representativeness of EU-FADN with respect to these variables, are given in Table 1. The average payments derived from statistical data vary between €83/ha of UAA in Latvia and €575/ha in Greece. Assuming that the level of payments in 2013 is transformed into EU wide uniform flat rate, the common per hectare payment would amount to €266. It is noteworthy that in some of the simulations made on the basis of FADN data, results are somewhat different, because of problems of representativeness and the inability to distinguish those payments that have been recently reformed. Indeed, while the total premium volume is overestimated by about 4%, only 90% of UAA is represented by FADN.

Table 2.1. Statistical data used for the calculation of flat rate per hectare payments and representativeness of FADN

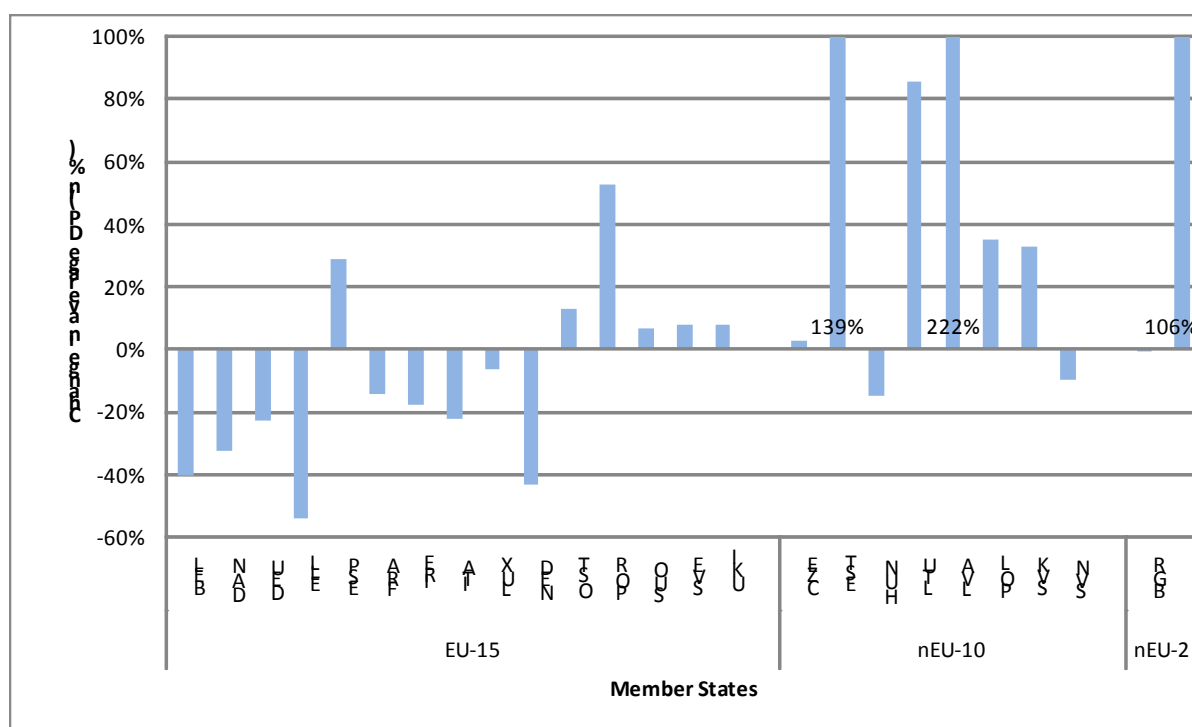
	Eurostat and Budget			Flat-rate (/ha)	FADN		
	DP Budget ¹⁾ 1000 €	UAA ²⁾ 1000 ha	Labour ²⁾ 1000 AWU		Represented by FADN % ³⁾		
					Ratio	UAA	AWU
EU-27	€49.5 bn	172 475	11 693	EU flat rate 266	104	90	74
				Member state flat rate			
Belgium	614 855	1 374	66	447	104	103	95
Denmark	1 049 002	2 663	56	394	97	99	90
Germany	5 852 908	16 932	609	346	98	92	70
Greece	2 343 800	4 076	569	575	122	93	111
Spain	5 139 444	24 893	968	206	100	84	103
France	8 521 236	27 477	805	310	106	100	85
Ireland	1 340 869	4 139	148	324	110	116	82
Italy	4 370 024	12 744	1 302	343	100	99	81
Luxembg	37 084	131	4	283	100	99	72
Netherl.	897 751	1 914	165	469	91	101	99
Austria	751 606	3 189	163	236	93	76	71
Portugal	605 962	3 473	338	174	73	82	52
Finland	570 548	2 292	72	249	100	92	82
Sweden	770 906	3 118	65	247	88	83	61
UK	3 987 922	16 130	341	247	93	87	61
Cyprus	53 499	146	26	366	159	97	90
Czech	909 313	3 518	137	258	96	99	88
Estonia	101 165	907	32	112	98	101	62
Hungary	1 318 975	4 229	403	312	84	103	37
Lithuania	380 109	2 649	180	143	76	77	44
Latvia	146 479	1 774	105	83	78	80	50
Malta	5	10	4	493	.	.	.
Poland	3 044 518	15 477	2 263	197	86	85	59
Slovakia	388 176	1 937	91	200	98	104	64
Slovenia	144 236	489	84	295	101	97	85
Bulgaria	814 295	3 051	491	267	68	98	58
Romania	1 780 406	13 753	2 205	129	93	62	78

Sources: 1/ Annex VIII of Regulation 73/2009 for EU25 and the final (2016) values for Bulgaria and Romania. 2/ Eurostat. 3/ percentage of FADN representation of Eurostat and budget figures. Deviations from 100 caused by imperfect representativeness of FADN. FADN 2007

2.2.2. Effects of a flat rate, modulation and capping on direct payments

At first we analyse the separate effect of implementing an EU-wide flat rate on average premium levels. Because only 90% of the UAA is represented in the EU-FADN database, not all payment claims are activated in the simulations, resulting in a total direct payment of 8% below the EU premium budget. Figure 2.1 shows the consequences on the average level of payments in each Member State.⁴⁶

Figure 2.1. Changes in Member States' average direct payment under a EU wide uniform per hectare flat rate



Source: FADN data. Because of inconsistencies regarding the amount of direct payments, the results are not shown for Malta and Cyprus. Nevertheless, they are included in the calculation of the EU-wide flat rate.

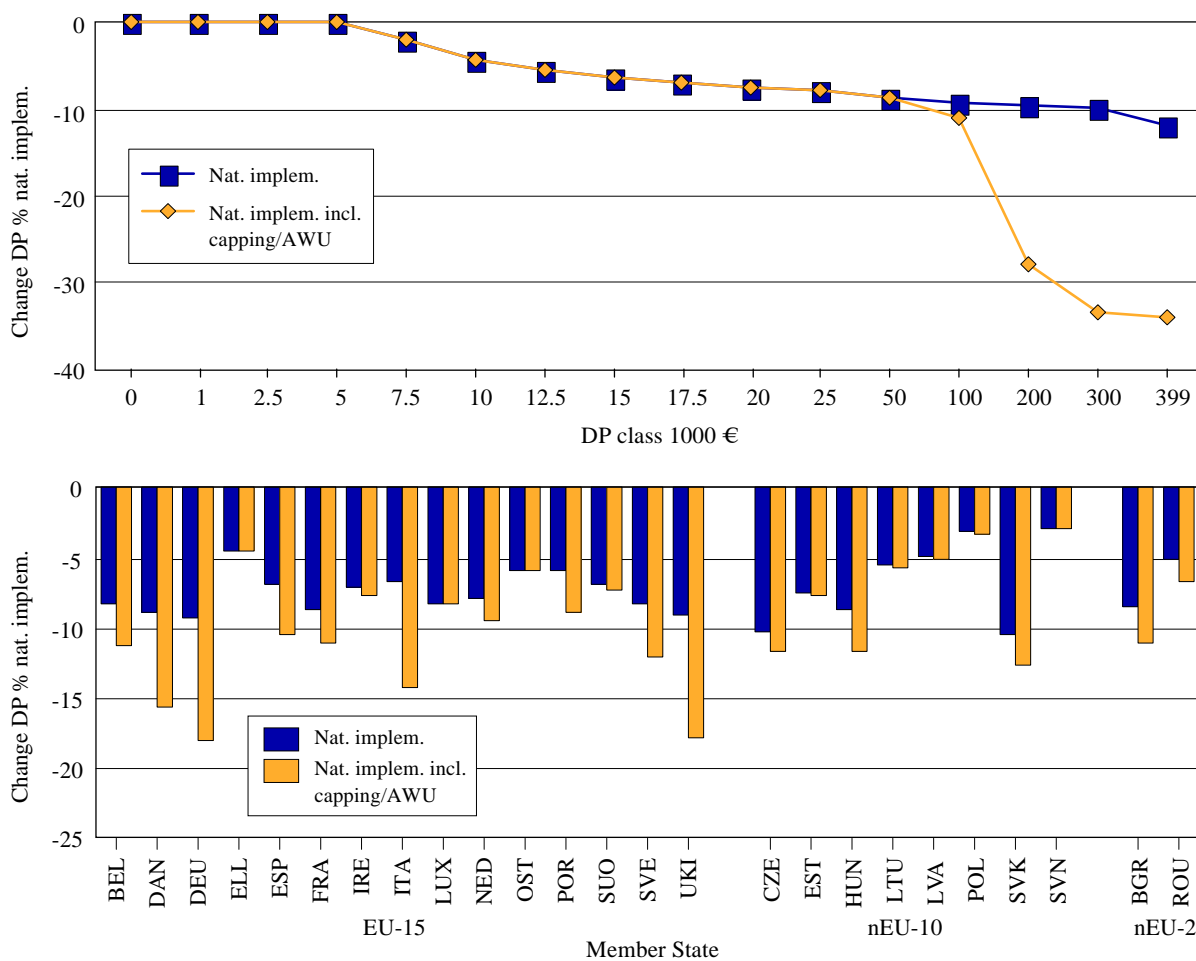
Under an EU-wide flat rate, more than one half of the EU-15 Member States would experience a fall in direct payments between 6% (Luxembourg) and 54% (Greece). Portugal and Spain gain 53% and 29%, respectively. Very significant increases in premium are to be expected in most new Member States, i.e. a premium reallocation occurs in favour of these countries. The strongest increases of the average per hectare payments occur for Estonia and Latvia with 139% and 222%, respectively (Figure 2.1.).

⁴⁶ The so-called 'statistical effects' could be avoided if flat rates were calculated on the basis of FADN data. We have renounced this approach assuming that the calculation of flat rates based on the Regulation and Eurostat data is more transparent. However, when looking at the *changes* in payments through an EU wide flat rate based on FADN calculations compared to FADN based Member State flat rates, statistical effects cancel to a large extent. This is supported by the percentage changes expressed in Figure 2.1 which are very close to the ones that can be calculated based on table 2.1.

The effects of the additional rates of modulation, agreed in 2008, and extrapolated for 2013 as an EU average and for the Member States, is shown in Figure 2.2. For those farms in receipt of over €5,000 direct payments per farm, premium levels are reduced over time up to 10%. For those farms with payments in excess of €300,000, premium levels will be reduced up to 12%. The average reductions by Member State are mainly determined by the share of farms in the class below the €5,000 level. This provides a benchmark to assess the impact of a cap for the payments per unit of labour.

If an additional premium cap of €15,000 per AWU was introduced, reductions in payments from 27% to 33% would arise for farms in receipt of direct payments in excess of €200,000. In Member States such as Denmark, Germany, Italy and France, reductions in payments of 14% to 20% are to be expected. The new Member States are not significantly affected by the capping of payments on a per worker basis (at least at the rate of €15,000 per AWU).

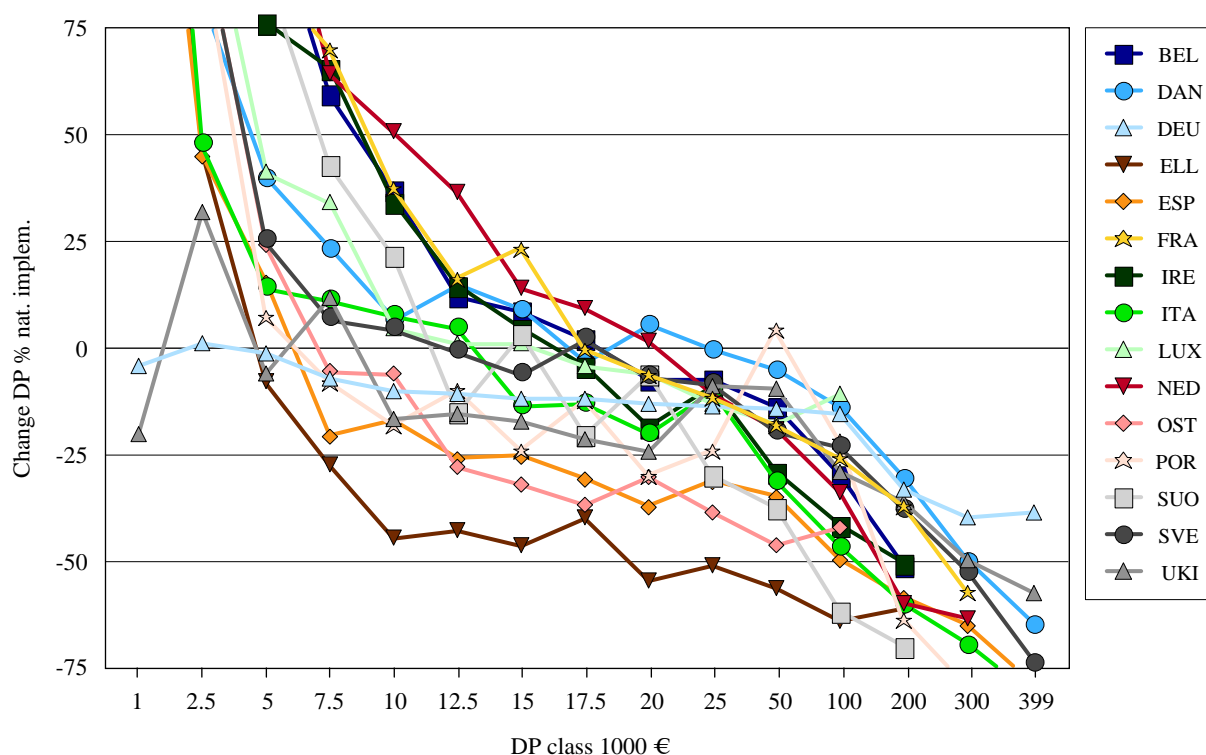
Figure 2.2. Change in direct payments (DP) following modulation and a potential cap of €15,000 per AWU
(% change compared to the 2013 situation)



Source: EU-FADN-DG AGRIL-3.

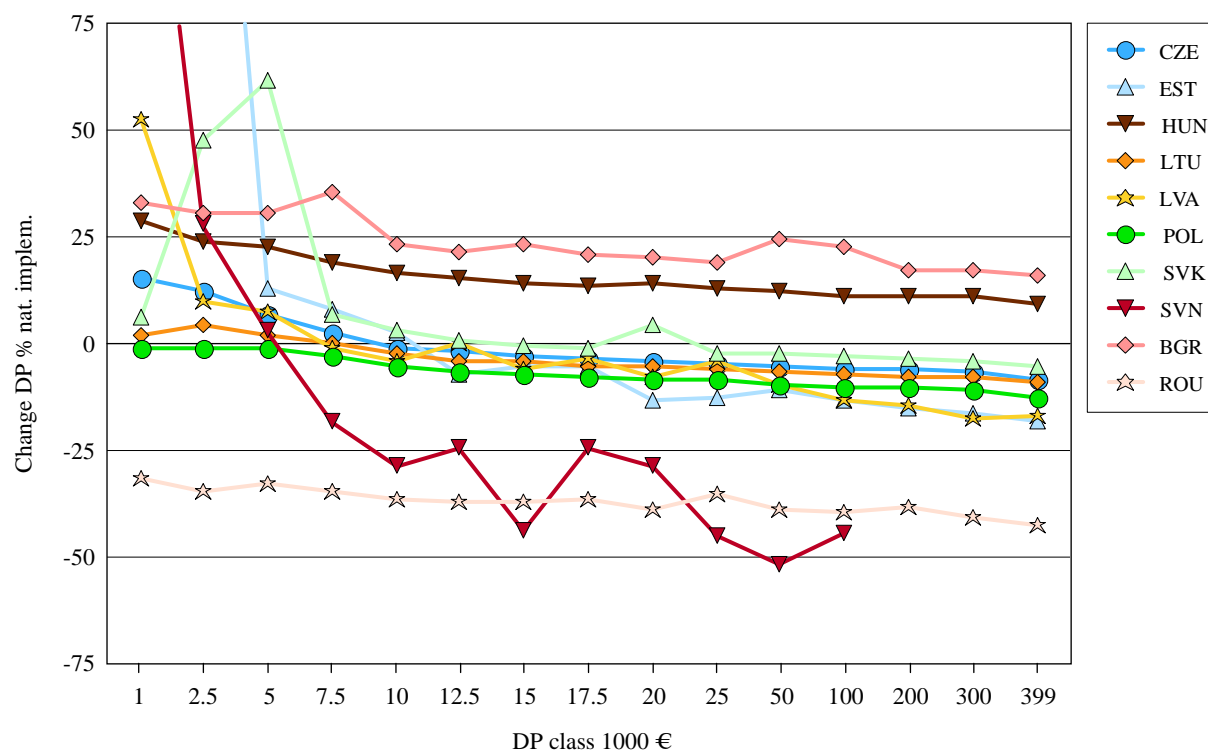
To indicate the combined effects of the flat rate, modulation and premium capping with reference to labour, the changes in the average level of Pillar 1 payment, per direct payment class are shown in Figures 2.3. and 2.4. under the scenario of a flat rate per hectare implemented at the Member State level. Farms in receipt of direct payments of less than €5,000 will experience a significant increase in premiums in the EU-15, except in Germany and the UK (Figure 2.4.). In farms with more than €50,000, the cut in Pillar 1 direct payments would reach -15% to -75%. In Germany and the UK, the redistribution effects are lower because they are already accounted for in the way that the SPS is implemented nationally. The cap per AWU leads to further reductions in direct payments, in particular for farms with direct payments in excess of €100,000. In the new Member States, the impact of capping per worker is also limited, except in Slovenia, where the historical model was used (Figure 2.4.). The increase in the level of payments in Bulgaria and Hungary might be related to the statistical effects mentioned above (overestimation of UAA in FADN).

Figure 2.3. Changes in direct payments (DP) with modulation and capping/AWU under a scenario of a flat rate/ha implemented at the Member State level (EU-15)



Source: EU-FADN-DG AGRI L-3.

Figure 2.4. Changes in direct payments (DP) with modulation and capping/AWU under a scenario of a flat rate/ha implemented at the Member State level (New Member States)



Source: EU-FADN-DG AGRI L-3.

With an EU-wide uniform flat rate (not graphically illustrated), similar effects occur as illustrated in the separate analysis of the flat rate impact above. A further downward shift in the size of direct payments in most EU-15 countries is mirrored by a positive reallocation to new Member States with payment increases of around 75% in Lithuania, or 25% in Slovakia, Poland, Bulgaria and Romania. Strong reallocations within the country take place in Slovenia.

Table 2.2. shows the effect of a flatter per hectare payment by farm type. Two scenarios are presented, one where the flat per hectare payment is implemented at the Member State level, while in the other scenario a EU-wide uniform rate is applied. Unified premium levels per hectare, together with the rates of modulation agreed in 2008, lead to a massive premium reallocation between different farm types (see Table 2.2.). Horticulture, wine and permanent crop farms experience the main gains. Field cropping farms experience a cut in Pillar 1 payments up to 25% in EU-15. The intensive dairy sector is particularly hit, with a cut up to 70%. Beef production, which has been heavily subsidized, will also be most negatively affected, especially where beef production is intensive (Denmark). This would be further reinforced by EU-wide flat rates. In the new Member States, the redistribution of payments is lower because a uniform payment scheme already exists with the SAPS.

Table 2.2. Change in direct payments due to the introduction of a flat rate/ha and additional modulation rates by farm type

		Change of DP (incl. modulation) flatrate/ha MS (%)							Change of DP (incl. modulation) flatrate/ha EU (%)								
		Field-crops	Horti-culture	Wine	Other permanent crops	Milk	Other grazing livestock	Grani-vores	Mixed	Field-crops	Horti-culture	Wine	Other permanent crops	Milk	Other grazing livestock	Grani-vores	Mixed
EU-15	BEL	-11	377		852	-2	-18	37	-14	-46	188		478	-40	-51	-17	-48
	DAN	4	2		225	-29	-40	15	-5	-29	-30		122	-51	-59	-22	-35
	DEU	-15	-8	3	-8	-14	-13	-14	-15	-34	-29	-20	-28	-33	-33	-33	-34
	ELL	-21	52	-47	-26	-56	-53	-40	-17	-63	-29	-75	-66	-79	-78	-72	-61
	ESP	-23	-8	171	23	-64	-35	-20	-25	-2	18	247	58	-54	-17	2	-4
	FRA	-23	-6	128	8	-5	-1	-24	-21	-33	-19	97	-7	-18	-14	-34	-32
	IRE	-20				-10	5	-57	-22	-34				-26	-13	-64	-36
	ITA	-19	271	280	-5	-41	14	-24	-5	-37	189	197	-26	-54	-11	-41	-25
	LUX	13		116		-9	-15	14	-1	6		103		-15	-20	7	-7
	NED	47	714		1229	-19	-3	60	2	-16	369		669	-53	-44	-7	-41
	OST	-31	4	2	75	-10	-24	-23	-34	-23	18	15	98	1	-14	-13	-25
	POR	-37	135	298	139	-66	31	809	10	-5	256	503	261	-49	98	1283	66
	SUO	52	-95		285	-38	-46	-50	-12	62	-95		311	-34	-42	-46	-6
	SVE	-2	46			-29	-18	4	-11	5	57			-23	-11	12	-5
UKI	-28	-27		-25	-30	11	-27	-28	-22	-21		-19	-25	20	-22	-22	
nEU-10	CZE	-7	5	-4	-1	-7	-6	-6	-8	-4	8	-1	2	-4	-3	-3	-5
	EST	-5	16		8	-9	28	3	-10	123	170		151	114	197	143	113
	HUN	13	19	21	17	13	13	15	11	-3	2	3	0	-4	-3	-2	-5
	LTU	-4	0		3	-1	-2	-4	-3	75	84		87	79	79	76	77
	LVA	-6	106		50	1	0	32	3	197	540		364	214	207	320	222
	POL	-6	0		-2	-3	-3	-3	-3	27	35		33	30	30	30	30
	SVK	-4		-4	5	-5	-4	-4	-5	28		27	39	27	28	27	27
	SVN	-20	0	310	73	-25	9	-7	-4	-28	-9	271	56	-32	-1	-16	-14
nEU-2	BGR	31	60	31	58	30	29	167	42	31	59	31	58	30	29	167	41
	ROU	-37	-32	-40	-37	-35	-37	-36	-35	29	39	23	28	33	26	32	33

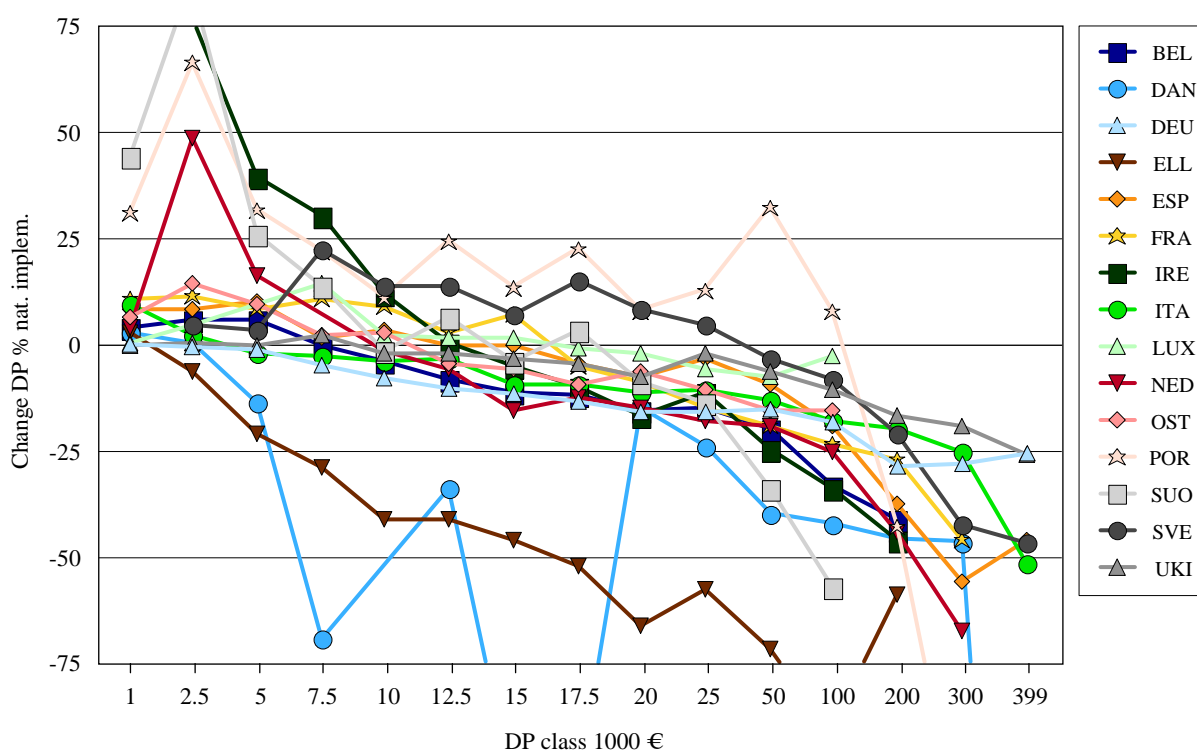
Source: EU-FADN-DG AGRI L-3.

2.2.3. Effects of flat rate, modulation and capping on farm incomes

The income effects are expressed in relation to Family Farm Income (FFI) plus wage expenditure. It is assumed that changes in payments directly affect income. Because the total income estimated this way is larger than the amount of direct payments, scenarios regarding a flatter rate of payments result in smaller percentage changes in incomes. However, there is a significant variation between farms due to variations in type, size and management.

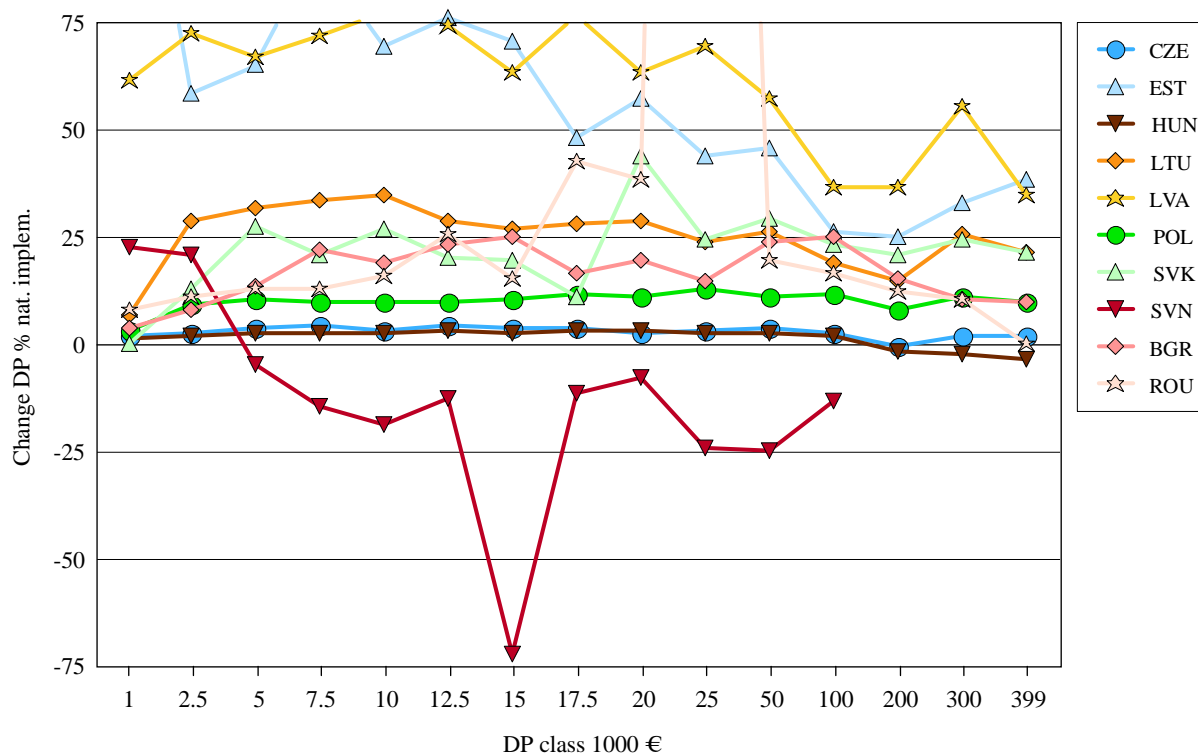
With EU-wide flat rates, large income losses can be expected in Denmark and Greece, while in the new Member States income increases up to 70%. With the additional effect of modulation and capping based on working units, large farms in the EU-15 will be most negatively affected. In the new Member States, however, a more even effect of the different direct payment classes is apparent, whereby higher incomes dominate (see Figures 2.5 and 2.6).

Figure 2.5. Changes in labour returns (FFI and labour costs), modulation included, assuming a cap per AWU. Scenario of an EU wide flat rate per hectare (EU-15)



Source: EU-FADN-DG AGRIL-3.

Figure 2.6. Changes in labour returns (FFI and labour costs), modulation included, assuming a cap per AWU. Scenario of an EU wide flat rate per hectare (New Member States)



Source: EU-FADN-DG AGRI L-3.

2.2.4. Conclusions on the distributional impacts of flat rates, modulation and capping

The move towards a more uniform payment per hectare, defined at the Member State level, would lead to large reallocations of Pillar 1 payments within Member States, especially in the EU-15 countries that have used the historical model. Farms with low level of payments in the base situation, i.e. specialised farms such as fruit and permanent crops would gain. There would nevertheless be a significant decrease in payments for the livestock sector, in particular for intensive beef and dairy farms. The effect on the distribution of payments within the new Member States is smaller given the currently dominant flat rate implementation.

If an EU-wide uniform rate per hectare was applied, there would be in addition large transfers between Member States. New Member states would be the main gainers. A cap in the payments per worker would affect the level of payments unevenly in the different Member States. Clearly, the distribution effect would depend on the threshold. Assuming that payments (on a per hectare basis) are capped at €15000 per AWU, the large farms in the Netherlands, France and other EU-15 Members would see their payments reduced, while the cap would have more limited consequences in New Member States.

The results presented here have to be interpreted as approximations, because of simplifications in the modelling approach, and problems with the representativeness of FADN data with respect to direct payments, UAA and labour input.

2.3. An economic assessment of the various proposals

The simulations of alternative distributions of payments based on the FADN data presented in section 2.2 make it possible to infer some possible consequences of the different proposals presented in section 2.1.2. These proposals range from scrapping the SPS altogether to maintaining an "ambitious" first pillar, with many variations.

A complete dismantling of the SPS

Simply dismantling the SPS would have dramatic consequences in terms of farm income, as shown by figures in section 1.1.5. Overall, Pillar 1 payments account for three quarters of total direct payments, which themselves account for half of farm incomes in a rather "standard" year like 2006, to say nothing about a low income year like 2009. In most cases, abolishing the SFP would only be compensated partially by adjustments in input prices and costs. Claims that payments are capitalized in land values and do not benefit farmers are put forward by CAP opponents (Brady et al 2008, Hofreiter et al 2009). However, this is simply not supported by the existing data, except in some specific New Member States. In addition, as stressed by many farm groups, the current SFP plays a role as a "shock absorber" when prices fluctuate, which means that a large number of farmers would be left rather vulnerable to the large variations observed on world markets, if the SPS were to be abolished. All of this makes it politically difficult to simply dismantle the SPS. It also carries the risk that the measure backfires, should prices remain low during the transition period and emergency payments must be reinstated, as was the case in the US in the early 2000s. If the SPS is to be abolished, one or several of the following conditions would need to be met:

- A long phasing out period which would make it possible for the sector to adjust before fully exposing EU farmers to the test of competitiveness at world prices (Dutch government, 2008; LUPG, 2009).
- Keep some basic lump sum payments (e.g. a flat per hectare or per holding payment) in addition to payments to remunerate the provision of public goods. This is a feature of many of the proposals, even though the level of this "income payment" and the degree of cross-compliance varies dramatically.⁴⁷
- Provide all farmers with the option to enter into contracts for the provision of public goods, regardless whether they are in a highly productive area, or in area of particular ecological or landscape interest (as proposed by ELO or various environmental NGOs).
- Make extensive use of subsidiarity so that governments have the flexibility to adjust the policy according to the political resistance to eliminating the SPS and, possibly, shifting the basis of payments towards the remuneration for public goods. The idea of leaving Member States the possibility of allocating pre-defined national envelopes to either basic (decoupled) payments or the remuneration of services takes the idea of voluntary modulation a step forward (Zahrnt 2008).

⁴⁷ Many stakeholders seem to favour this scenario, but the the proposals by the French and Polish government, the mainstream farmers unions, the OECD on the one hand, and the proposals by Notre Europe, Heißenhuber et al 2008, ELO etc. illustrate the considerable differences amongst those who propose keeping a basic payment.

A flat rate per hectare payment

The possible justification for continuation of a basic hectare payment, as in the SAPS or the regional SFP model, is to be found in the need to provide farmers with some stability of income in a market that is characterized by large price variations. Another argument is that such payments are necessary for "levelling the playing field", assuming that EU society imposes more demanding production conditions on EU farmers, compared to foreign countries (animal welfare, environmental constraints, safety, social issues and the cost of labour, etc).

There is no consensus on the validity of these arguments, however. Many commentators do not see any justification for supporting farmers as a particular category because of their exposure to market risks. The "level playing field" argument is not fully convincing either. Importers face rather similar food safety requirements as EU producers. Some EU standards seem to be met *de facto* in third countries (e.g. animal welfare in countries with extensive production). In addition, one may argue that the EU has other indirect advantages (a large market, good infrastructure, proximity to input suppliers and the food industry, efficient and partly subsidized research programmes, etc.). The most defensible arguments are perhaps that the EU restrictions imposed on GMOs put EU producers at disadvantage (e.g. EU livestock producers had to buy non GM maize in 2008, at a price often 30% higher than that for GM maize available on the world market).

Should a basic SPS be kept, the simple flat rate payment per hectare seems to be favoured by many stakeholders. If a single uniform payment was granted throughout the EU-27 this would lead to a major budget reallocation between Member States as well as producers. Alternative options include some variations according to the purchasing power of the Euro. Transfers between Member States could perhaps be dealt with within a larger package reform that includes structural funds as well as the various rebates. But the idea of predefined national envelopes is an interesting option to explore. Regarding transfers within Member States, there is no obvious solution apart from to increase the degree of flexibility given to Member States to modify the level of payments - already quite significant since the Health Check (see Box 1.2.)

The flat rate nature of the transfer ensures that economic distortions would be limited. However, it only partly addresses the criticism made of the unfairness of the SPS as an income support measure, given that the larger the farm, the larger the payments. If one motivates a payment by the need to support incomes, there is some legitimacy in the idea that an individual should not get more than that which a worker would get from the labour market, hence the idea of cap per worker. Because of the heterogeneous structures in Europe, a ceiling on a per unit of labour (including hired labour) seems preferable to a ceiling per holding.

Moving to countercyclical payment

Several stakeholders stress the importance of the SPS scheme as an instrument of food security, an issue that they rank as a priority. Decoupled payments protect farmers from low prices, but processors, cooperatives and consumer groups have proposed to adjust them downwards if prices are high. This results in replacing the SPS with "countercyclical payments", in a way that is comparable to some measures implemented in the United States (see EP, 2009).

There are several problems with this proposal. The first one is the fact that such a scheme would not be WTO compatible, which is perhaps not a major issue. Indeed, even in the prospect of a Doha agreement, the EU would keep a substantial ceiling of amber box payments (see section 3.6.1.). In addition, the United States seems to have negotiated considerable additional exemptions for their payments, at least if one looks at the December 2008 draft modalities (US countercyclical payments might be eventually notified under the Blue Box due to specific exemptions for the United States). A second problem is that this would be incompatible with the current rigid appropriations in the EU budget that prevent large variations in expenditure. Arguably, this is a rather technical problem, and one could consider the management of a pluri-annual envelope under a particular ceiling. However, a major argument against making the SPS countercyclical is that it would undermine the incentives for cross-compliance. The possibility of making the SPS more countercyclical would be in complete opposition to moving from direct payments to a contract for the provision of public goods. The benefits of having a public authority doing what farmers naturally do from a fixed payment (i.e. save some of in good years for harder times) seem elusive. Finally, from a practical standpoint, it seems difficult to manage a countercyclical payment without going back to product specific payments, which would involve a complete reversal of the current orientation of the CAP.

Moving to a system of remuneration for the provision of public goods and services

This option is proposed by many stakeholders, even though most mainstream and conservative farmers' unions and a several Member States oppose it. Few proposals detail how such payments could be managed. Remunerating the provision of ecological services, the provision of landscape, or water management is solidly legitimized by economic theory. However, this is already largely the goal of most of current Axis 2 Rural Development measures. As explained in section 1.5.4., there are limits to this policy. If one wants to shift larger budgets to such measures, management, inspection and control might prove even more difficult. The terms of reference for the payments might have to go down for farmers willing to participate, at least if there are ample opportunities to receive revenues without conditionality (this would be less the case without the current SPS in place, but if prices go up, interest in conservation schemes, for example, would go down). The few proposals that make precise descriptions of a scheme tend to downplay the actual implementation problems. However, there are many successes in the current Rural Development policy, and many lessons to be drawn for a future scheme. In addition, shifting current SPS budgets to measures that target public goods and services more explicitly would partially preserve some of the current benefits of the SPS, which is to provide farmers with the possibility of accessing a predictable flow of income through contracts for providing public goods. It is clearly something to explore further.

Avoiding the capitalization of payments

Capitalization of payments (land or payment entitlements) is seen as a major source of inefficiency in the current SPS. While some stakeholders see capitalization in a financial asset as a good way to abolish the payments (i.e. the bond scheme), others have proposed schemes designed to mitigate the capitalization problem. One way is to make payments contractual, for a fixed predefined period, and not transferable (Bureau and Mahé 2008, Buckwell 2009a, 2009b). Another way is to link payments more closely to labour, rather than to land or entitlements.

There are nevertheless some possible problems with the proposed solutions. It is unclear whether the proposed schemes could prevent capitalization in any kind of virtual asset. As

soon as there is a rent, the right to benefit from it will have an implicit value.⁴⁸ A closer link between payments and labour might also have unwanted effects, such as providing incentives for farmers to delay retirement, and hampering the transfer to a new generation as well as the consolidation of farm structures.

2.4. Lessons for drawing up a new model of decoupled payments

The survey of the various proposals tabled for a reform of the SPS after 2013 shows a variety of point of views. The position of free market think-tanks, most of the UK, Dutch and Czech NGOs, as well as many academics, who think that Pillar 1 should be scrapped altogether, runs into political economy considerations (with a large negative impact on farm incomes), the risk of leaving the sector exposed to considerable income fluctuations with little safety net remaining. In addition there is the potential risk that EU farmers would have to compete with foreign producers who are exposed to lower standards, even though this latter issue is not fully supported by the evidence.

If policy makers decide to keep a proportion of the current SPS budget for existing purposes, several lessons can be drawn from the various proposals. A rather uniform per hectare decoupled payment would be an imperfect, albeit simple way to maintain a degree of income support. It could be subject to a ceiling per individual, as demanded by many stakeholders, but in such a case, the cap should be per unit of labour including hired workers. The potentially interesting proposals for adjusting payments to market conditions and a move towards countercyclical payments have too many unwanted indirect effects to make them viable options.

Many of the stakeholders consider that a larger share of the current direct payments should be transformed into a contract for the provision of public goods, including conservation and landscape preservation. Even though they tend to underestimate the difficulty in designing efficient ways to remunerate these services, and to overestimate the possibility of moving large budgets to such schemes without relaxing the rules of operation, this option clearly deserves consideration when designing a future scheme.

A compromise might be a two-tier system of payments with a rather basic payment on a per hectare basis for those fulfilling a series of simple environmental criteria, and another level of payments for actions that are subject to much stricter rules of operation. Special provisions could be considered for Less Favoured Areas.

Given the difficulty of finding common ground, the idea of leaving a large degree of subsidiarity to Member States for allocating the payments between different elements within a pre-defined envelope should be considered. Rebalancing the co-financing between measures currently funded by the two pillars is also necessary to remove the disincentives of making use of the Pillar 2 budget. Because of the uneven situation of Member States, different rates of co-financing could perhaps be considered. Caution is nevertheless needed regarding the compatibility with the EU framework and the prerogative of Member States

⁴⁸ DG-Agri, for example, has expressed some scepticism regarding the claims by Bureau and Mahé (2008) that a non-transferable contract for services solved the capitalization issue, in a seminar held in Brussels on November 17 2008. It is noteworthy that even a contract based system, such as the US Conservation Reserve Program, leads to some form of capitalization. An illustration is that a private market has emerged where financial institutions buy future CRP payments, showing that there is a form of capitalization in some virtual asset. See < <http://www.crpquote.com/> > (accessed 17.12.09) which proposes farmers the following: "*We convert your future CRP payments into a lump-sum payment. You or your clients can lump together your remaining CRP payments and receive a present value payment*".

(mandatory co-financing of a pre-defined envelope would run into legal issues, for example).

3. A proposed new model for direct payments

3.1. General principles for a revised SPS

Objectives

Before designing a model for a future SPS scheme, it will be necessary to agree on a set of objectives that the complete system of direct payments (including the current Pillar 2) should target. However, there is apparently no agreement between Member States on a core set of objectives for the CAP, even on the relevance of principles that are still included in the Treaties, such as the need for community preference or what one should understand by the need of "ensuring a fair standard of living" for farmers. Our position regarding the reform of the direct payments is motivated by the economic assessments of the proposals described in section 2 and our experience of the functioning of the past CAP. Our position is as follows:

- The definition of a revised SPS should be consistent with core findings of economic theory, in which public payments are legitimized either for being in line with objectives of redistribution or for addressing a well-identified market failure for the provision of public goods.⁴⁹ In such cases, it is well demonstrated that there is scope for the State to intervene to achieve a socially more optimal outcome. But economic theory also warns that, in such cases, there is no guarantee that an imperfectly informed government or bureaucracy will make things better rather than worse. In particular, the trade-off between fine tuning policies and transaction costs should be kept in mind, especially regarding rural development and targeted support.
- As a general principle, payments should be provided as a reward for services, and in particular the provision of public goods. Agreements on what is a desirable public good should be addressed first. Major progress in this area has been made by EU institutions and other stakeholders. A list of desirable public goods has already emerged from different working groups (see IEEP 2009 for a synthesis). But for some concerns, such as "rural vitality" or "food security", there is still disagreement both on their scope as well as on what the appropriate mechanisms are to address them.

In practice, payments for public goods do not necessarily mean very precise and targeted contracts. Rather flat rate, or lump sum payments (e.g. in particular regions or for particular types of production techniques) should be implemented if they are more efficient with respect to the level of transaction costs. But even in such cases, the underlying framework should be a contract between society and farmers for the provision of public goods or services.

- There is some justification for payments to support incomes, at least in a transition phase, as explained in section 2.3. However, SPS payments can no longer be justified as a compensation for previous policy adjustments. Another

⁴⁹ Market failures include excessive supply of goods with negative externalities, undersupply of public goods, imperfect markets such as credit markets and labour markets, and imperfect information, including uncertainty on prices. The expectations of continuity raised by a long tradition of support to agriculture would also call for gradual changes in the policy orientation, rather than sudden shifts, to keep adjustment costs for quasi-fixed inputs tolerable.

desirable principle is that payments that support income should be provided in a way that does not contribute to increased income inequality.⁵⁰

Some guidelines for future payments

- The future scheme(s) for direct payments should be predictable. Consistency of direction and stability of policy must be a central feature of the new CAP instruments. Assessments of the Rural Development Programmes have revealed transaction costs to be mainly linked to start up costs. This also extends to the administrative principles of Pillar 1 payments. This makes the case for adjusting the current framework of the SPS rather than redesigning a new income payment from first principles. This also means that farmers should have long term guarantees regarding the stability of the payments, especially if they are incentivised to provide public goods.
- Payments must be easy to manage. The attached conditions must not generate an excessive administrative burden. They must not impose constraints that do not bring genuine benefits. One should not ignore the potential conflict with the idea of more targeted payments, which are seen as more effective at generating the provision of a particular service.
- Payments that are designed to address a particular market failure (such as encouraging the provision of public goods) must be proportional to the services provided by farmers and to the value accrued to society as a whole. There are cases where social benefits might motivate some limitation of payments (e.g. maintaining diversity in management practices might require maintaining differentiated holdings). But as a general rule there is little rationale for capping those payments that really remunerate the provision of a public good. If the service provided is large, large payments should be granted.
- The design of a direct payment scheme should be based on a pragmatic approach. Economic theory suggests that decoupled payments are associated with less deadweight losses for society, and should therefore be favoured. However, where agriculture is recognized as necessary for the provision of public goods (e.g. joint production of amenities and agricultural products) payments could be coupled to production. A condition should be that they must be related to genuine jointness between agricultural production and the provision of a public good.
- The future scheme should not leave itself open to legal challenge or be incompatible with other EU policies, which would require a further reform. In particular, it should be consistent with EU principles, avoid distortions of competition between Member States, and be consistent with current and prospective WTO agreements, in particular as far as coupled payments are concerned.

⁵⁰ There are obviously many ways to define inequality. More precisely, a redistributive policy should aim at modifying the distribution of income in a way that makes Lorenz curves – i.e. the curve that corresponds to a cumulative distribution of incomes – closer, or at least not further away, to a 45° line (Boadway and Bruce, 1984). Atkinson (1970) and further developments show that this is a simple criterion for collective welfare to be improved by redistribution, at least under a set of reasonable assumptions.

On subsidiarity and co-financing

- Even though caution is needed in order to avoid distortions of in competition between Member States, a large degree of subsidiarity in the management of payments is desirable. EU farm structures are no longer the rather homogenous family farm of the six founding members of the EU in the late 1950s, but are becoming increasingly polarized. The farm income issue is not the same in all Member states. Member States should be allowed to define caps, levels and zoning of various types of payments. However, it is necessary to maintain a consistent set of guidelines at the EU level for the CAP to retain the capacity to address transnational objectives. This is the case for potential income support payments (e.g. designing a particular model, such as a per hectare or per worker payment, even though the definition of provisions are left to Member States). This is even more necessary for payments that provide public goods. In particular, it is necessary that the obligations that constitute the reference level (e.g. the obligation of maintaining hedges or permanent pastures at a pre-existing level) and what is eligible to for an EU payment (e.g. going beyond the reference) remain consistent across countries.⁵¹
- There is a strong case for generalizing co-financing to both income support and public goods payments (e.g. to measures that are currently under Pillar 1 as well as Pillar 2). Regarding payments for public goods, some co-financing by national or local budgets is often useful in order to ensure that authorities impose sound rules and implement reliable inspection procedures. But it is also essential to overcome the current bias against public goods and rural development. This bias comes from the fact that Member States prefer policies that do not require national co-financing (in addition to the more difficult implementation and monitoring of current Pillar 2 payments). The fact that certain Member States have made little use of Rural Development provisions (especially Axis 2) can be seen as a failure of the past CAP to protect transnational public goods and the European heritage.

3.2. Description of a proposed model

A proposed SPS for the CAP after 2013 could include a revised system of direct payments, including two components.

The first component would be a payment to provide continuous income support during a transition phase, which would lead to a gradual shift in the budget devoted to this scheme towards "public goods" oriented policies. During this phase, the income support component would be largely based on the continuation of the current system of direct payments, although with a reformed basis of calculation that makes it more evenly distributed. A schedule in view of phasing out of the current SPS payments should be set out. After 2020, the future schedule will be made in the context of the next financial framework taking into account what has happened in the meantime. But in order to provide long term guidance to the farming sector, signals that this refocusing of the CAP will continue after 2020 are useful.

⁵¹ Note that differences in property rights imply that this reference cannot be fully harmonized. See Cooper et al (2010).

The second component would be based on contracts for services. It could include a system of rather flat rate payments in order to fulfil some basic natural husbandry functions, with some differentiation in regional terms, including in particular provisions for LFAs or HNV farmland. In addition there would be contracts tailored to particular efforts needed locally, based on the experience of successes (and failures) of the current programmes under Axis 2 of Rural Development policy. Over time, the contract for services component should become the basis for all future direct payments.

Both components should be co-financed by Member States so as to avoid the current incentives against schemes that aim to support the provision of public goods. This does not mean that the two pillars would be explicitly merged, given the very different management and programming procedures, which are designed to fit particular types of instruments.⁵² Co-financing of all payments could lead to some countries providing only limited income support to their farmers. Flexibility within predefined national envelopes, as well as different rates of co-financing between programmes and Member States are advisable, with higher EU co-financing for public goods of European interest and for poorer Member States, to counteract these risks. National envelopes and co-financing would clearly raise complex institutional issues which deserve further examination, but it is an important step towards removing the current policy bias generated by differences in co-financing between the two pillars.

3.2.1. Provision 1: a transitory income support component

One may argue that there is little justification for supporting farmers' incomes *per se*. Furthermore social policy is not something that is best addressed by the CAP, but by fiscal and welfare policies and it should apply to all segments of the population. However, removing the SPS altogether would generate a considerable decrease in revenue, only partially matched by adjustment in the cost of primary inputs (e.g. land prices). Economic shocks, with repercussions also for the non-farm sectors of rural regions should be mitigated. Political acceptance may also be a critical issue, especially in the New Member States, where farmers would see payments increase progressively before disappearing all of a sudden, if there were no transitional income support arrangements.

Several arguments propose an income support component based on the current SPS with scaled down budgets. The proposed income support scheme is a flatter, simplified version of the regional model for SFPs. The corresponding payments should have the following characteristics:

- **Transitory.** If political economy and adjustment arguments call for maintaining some income support, it must nevertheless not prevent the shift of a large section of the current Pillar 1 budget to remunerate the provision of public goods, which is a more defensible objective in the long run. A scheduled phasing out of the payments would be a way to ensure their transitory nature and to induce expectations that will speed up adjustments in the price of primary factors and capitalized rents.
- **Simple.** Even though this is a controversial issue, with arguments on both sides, the proposal that is made here is that these payments should be specified on a per hectare basis, without any countercyclical component.

⁵² Pillar 2 payments are disbursed on a programming basis after review programs and with multi year commitment periods, i.e. very different from Pillar 1.

Overall, the preferred approach would be a transitory "flat rate" payment per hectare. The term "flat rate" should not be misleading, though. An EU wide uniform amount is questionable from a fairness point of view, for example, due to the variations in purchasing power of the amount of Euros across Member States. The level of per hectare payment could vary between Member States, on the basis of some objective criteria, which deserve more investigation and simulations. In addition, it should not necessarily be equal within a Member State, which should also be free to use objective criteria for differentiating this income support between geographical areas or broad area categories (say arable and grassland as it is already the case under Regulation 73/2009).

- ***Capped on a per labour basis.*** Payments per farm would be subject to a system of capping. Given the heterogeneous structures across the EU, a labour based modulation or ceiling seems more in line with the idea of supporting incomes than a simple cap on the total payment per farm. Simulations carried out for this report show that the alternative approach to define individual payments on a per worker basis would have some unwanted effects (Box 3.1.).

A preferred alternative is thus a per hectare flat rate payment capped by a ceiling based on the total labour employed on the farm. Minimizing fraud (from misreporting the number of work units in part time family farms, or in societal farms where shareholders supply mostly capital) will be a problem. The setting of a predefined national envelope should limit the budgetary consequences. EU guidelines and templates should be provided regarding the labour cap, but Member States should be encouraged to tailor the ceiling based on individual fiscal income or *ad hoc* proxy variables. Means testing would make the transition between a regime designed to support farmers' incomes and the regular safety net schemes that exist in many Member States. In line with subsidiarity, the ceiling per worker (either based on the number of units of labour or on the household's income) could vary across Member States. In such a case, Member States that implement a stricter cap than the EU standard should not lose the corresponding amounts, but should be able to use it in other components of the proposed scheme, in particular under the public goods scheme.

- ***Subject to limited cross-compliance at the EU level.*** The income support scheme should be simple and match criteria that can be imposed throughout the EU. The implementation of a common set of SMRs throughout the EU should be maintained but a regular reconsideration of their appropriateness is recommended. Regarding further cross-compliance, such as GAECs, a set of guidelines and basic criteria should be imposed at the EU level, but the exact provisions should be left to Member States. One challenge is to give Member States the flexibility to tailor the conditions that are best adapted to local situations, but without encouraging too much variation across Member States regarding the "standard" legislative baseline that farmers need to adhere to at their own cost.
- ***Decentralized to Member States.*** National or regional governments should have the possibility to move funds from the income support component of the new direct payments during the transition period into a national envelope and to reallocate some of it to the measures for the provision of public goods described in section 3.2.2. They should also be able to adjust the level of payment

according to objective criteria as mentioned above, for example, to differentiate the level of payments between regions.

- **Co-financed** by Member States. The fact that the current Pillar 1 is exclusively funded by the EU taxpayer whereas Pillar 2 requires some co-financing is a source of political distortions. Extending co-financing to income support (i.e. what is currently under Pillar 1) is useful to break the habit of calling for income support because this is (largely) paid by taxpayers in other Member States. Obviously, the idea of co-financing all payments as well as the degree of co-financing are politically sensitive issues. Nevertheless, the current bias against public goods oriented policies would disappear if income support payments could only be drawn by Member States provided they provide co-financing with their national budget.

Co-financing of income support payments (i.e. current Pillar 1) could be phased in gradually, starting in 2013, so as to adjust the overall budget and to prevent the income support budget doubling, or being reduced to zero, if Member States cannot provide co-financing. The way to do so could rely on the idea of predefined path for national envelopes and co-financing rates that differ between Member States.

The proposal for the income support scheme in brief

For the next financial perspective, to maintain a share of the SPS as income support. This system of basic income support should be progressively phased out and replaced by contracts proposed to farmers for providing public goods (see 3.2.2). The progressive decline in the size of payments should start with the next financial framework, making sure that New Member States do not get involved in a system of payments that is about to be reformed. Co-financing of this income support would simultaneously be phased in. A possibility is to manage the entire budget during this transition period through predefined national envelopes, perhaps based on criteria like the agricultural area and active farm population as well as other criteria (see section 3.3.1.).

Some guidelines would be needed to maintain a common EU-wide framework for the allocation of payments, even though a large degree of subsidiarity would be left to Member States for defining thresholds and payment levels. The general framework would be that the income support payments would be on a per hectare basis, with a possible cap, based on labour units. Member States would nevertheless have the freedom to define regional payment levels, and to replace the cap per unit of labour by other forms of means testing, such as ceilings based on household income. Cross compliance would involve respecting a set of SMRs and a general framework for GAECs, with a clear indication of "reference" practices that farmers should implement without receiving EU payments.

Income support payments should eventually be co-financed by national budgets at a rate that is at least equal to the rate for public good payments in order to encourage Member States to move towards the public goods schemes. The degree of co-financing could vary as a function of the GDP per capita of the Member State or other objective criteria. Those Member States that are inclined to do so should be allowed to use the income support envelope for encouraging the provision of public goods, and thus to speed up the transition in this direction. Because income support payments would become increasingly lower than the current SPS, and decoupled from production, distortions in competition between Member States should be limited.

Box 3.1. Payment per hectare or payment per worker?

When designing "income support", it makes sense to consider a payment per worker rather than per hectare. Indeed, a per hectare payment removes some of the uneven component of the current distribution, which is an inheritance of unevenly supported sectors and regions, but maintains large payments for the largest producers who farm, and often own, the largest areas of land. A payment per unit of worker would nevertheless raise considerable implementation problems. In the EU-27, the traditional family farm is no longer the rule and many other forms coexist. That means that a payment per worker should be based also on hired labour. Part time farming has become widespread in family agriculture in some countries. In such cases, there is both a problem in defining a basis for payment and scope for circumventing payment limits. In addition, the distribution effects of a payment per worker are questionable, as illustrated below.

Using the FADN data, simulations were made keeping the current level of Pillar 1 payment constant within each administrative region, but allocating the current payments per hectare. The results are then compared to a situation where, within the same region, the payments are provided on a per unit of labour basis (the budget in that case is not constant but we assume no transfer of payments between regions).

If SPS payments were provided as a flat rate per hectare. On average in the EU, dairy farms would experience large losses compared to the current situation, while arable crop growers experience a limited gain. The loss for dairy farmers is particularly large in regions where there is some intensive dairy production (Netherlands, Denmark, Italy). The reason is that, historically, the level of dairy production per hectare was high and in past reforms, direct payments were proportional to the level of quota. In regions where dairy production was more land intensive (Austria, France) dairy farmers tend to gain. In regions where there is a high level of direct payments per hectare for arable crop farms (e.g. France, where payments per hectare are high in cereal production areas), arable crop farmers lose with a flatter rate per hectare. The net situation of suckler cow producers is such that they gain in those regions where extensive grazing dominates (France, UK), and lose in others (Belgium, Germany). At the EU level, these types of producers gain. Producers of fruits, vegetable and wine experience positive net transfers, but olive oil producers in Greece and Italy experience large negative transfers. This shows that a flatter per hectare payment would involve large transfers between producers even without reallocation of payments between regions.

It is noteworthy, though that a shift from the current situation to a flat rate per hectare payment within each region does not reduce overall inequality if we focus on farm incomes. The Gini coefficient for annual farm incomes for the whole EU remains unchanged. Even in Member States currently using the historical model, what is observed is a reallocation of payments between individuals, but the distribution of incomes does not get much flatter. The transfers, once expressed on a per unit of labour basis, are sometimes very large, reaching several thousand Euros. On average in the EU, dairy farmers would lose some €700 per AWU, while wine producers would gain €1000 per AWU for example. But these average figures hide very contrasting situations between individuals.

If SPS payments were allocated on a per worker basis (still without any transfer between regions, and on the basis of AWUs including hired labour). Arable crop producers who often have the lowest per ratio of workers per hectare would be the big losers. In France, on average, such a scheme would involve a net transfer of minus €6700 per AWU in the arable crop sector, assuming that all current direct payments are allocated on a per worker basis within an administrative region. The beef (suckler cow) sector would also be

affected, losing an average of €2100 per AWU in the EU-25. Individual or regional situations also involve much more dramatic transfers than those suggested by these average figures. Horticulture and wine would be the major beneficiaries of the reallocation of payments. When looking at the distribution of payments/AWU, a significant decrease in the Gini coefficient can be observed when moving to a flat payment per AWU. However, if one considers the change in the distribution of income, the Gini coefficient (based on income per AWU) remains exactly the same as in the current situation. This suggests that the large transfers between producers are not necessarily related to an overall decrease in income inequality. A per worker allocation might involve large transfers but not necessarily a reduction in the overall inequality. The collapse of incomes in some intermediate regions where farmers combine cereals and beef production, and the increase in incomes of quality wine producers explain that an allocation of payments on a per worker basis maintains a rather uneven distribution of incomes.

Source: data from FADN 2006 (calculations by J.P. Butault and N. Delame)

3.2.2. Provision 2: payments as contracts for public goods

Parallel to the decreasing budget for income support, it is desirable to shift a significant amount of the current Pillar 1 budget to those payments that remunerate the provision of public goods. This does not necessarily mean that all "public goods" payments should formally be under Pillar 2. Indeed, Pillar 2 administrative and financial provisions are currently quite different from Pillar 1's budgetary procedures. It is conceivable that some of the "public goods payments" be allocated using Pillar 1 instruments. But in such a case, the distinction between the two pillars would mostly relate to managerial and administrative aspects.

A well-agreed definition of the public goods that should be targeted is necessary. This is an area where there is a need for consistency for the CAP to be able to address transnational issues. The list of public goods could draw on existing work done by the European Network for Rural Development (e.g. agricultural landscapes, farmland biodiversity, water, soil and air quality, climate stability, resilience to fire and flooding, etc; see also Cooper et al, 2010). Equally important is the need to define what the "baseline" is, i.e. what farmers must not do, and the threshold from which their effort is considered as eligible for a payment, as codified in the concept of the reference level. Many aspects of this reference level, e.g. maintaining existing wetlands, permanent crops, hedges, not polluting groundwater, avoid erosion, etc. are already partly covered by statutory requirements. In practice, there are significant differences between Member States. These differences are sometimes motivated by national legal systems and property rights, but keeping these statutory requirements consistent within the EU is desirable.

The design of payments for public goods includes two possible orientations, which share the same philosophy: a contract covering the costs of services that is voluntary on the land manager and for a well-defined period.

- At one end of the spectrum is the possibility that all farms meeting specified eligibility criteria in a particular region (less-favoured, mountainous, of high natural value, water catchment area, etc.) receive a particular form of support. Indirectly this may also provide support to production to ensure the continuation of particular farming practices, or the provision of particular services that are dependent on the maintenance of agricultural activity. Because of the potential

windfall gains generated by such broad schemes, payments need to be tailored to specified additional requirements (on top of SMRs and GAECs) and regions.

- At the other end of the spectrum is the notion of a contract targeted at the provision of specific public goods and services. Such a contract may be for specific environmental, water protection, landscape or other services provided by farmers. While such payments are potentially highly effective, they necessitate a robust monitoring and evaluation framework and could carry considerable transaction and administration costs. Targeted schemes could be applied if both the value and the costs of these services are high. These measures are not fundamentally different from the current AES. The issue, here, is more to draw from the AES experience to assist the design of cost effective and efficient contracts, and to assist implementation through the provision of advice and training.

Public good payments should have the following characteristics.

- ***The instruments to be used.*** *Broad schemes* could be offered across the whole EU territory with regional differentiation left to the MS, as there are some merits to improving the state of the environment throughout the whole EU, although some regions will be clearly of particular interest. Such areas are mountain areas or other areas in danger of agricultural abandonment; areas affected by specific handicaps where farming should be continued in order to conserve or improve the environment, maintain the countryside and preserve the recreational potential of the area; areas subject to environmental restrictions on agricultural use based on Community environmental protection rules, in particular the Birds () and Habitats Directives and the Water Framework Directive. In some cases, payments on a per worker basis may be considered in order to promote those public goods that require the presence of farmers (in particular in far Northern regions or mountainous regions).

Existing LFA payments also could be incorporated into these broad schemes, but the mere fact of being in a less favoured area should not be sufficient basis for a payment. Eligibility criteria within LFAs should be revised to support the provision of public goods (e.g. stocking rates could be specified more precisely than under SMRs). While the LFA model is helpful for the specification of extended broad schemes there should also be the option for Member States to siphon some funds to those Article 68 type measures that also fall into the broad schemes category.

More *targeted schemes* should provide payments on an individual basis, for well-defined services, broadly following the model of existing AES. Typically, major challenges are to keep transaction costs low and make the scheme multi-annual and predictable without funds being capitalised and thus lost in assets such as land. In order to do so, several schemes have been proposed that deserve attention. Payments should be based on contracts entered into with farmers (and possibly other landowners) concerning the delivery of services that go beyond the legislative baseline. Flexibility should be left to Member States to design the schemes, such as under the current AES. However, evaluation of current agri-environment contracts suggest that systems based on points for blue or green services (water or environment) and systems based on the benefits of the services, with payments potentially auctioned, are sometimes a good compromise between targeting and excessive control costs and information rents. In other cases, measures with very specific requirements are sometimes better vehicles

for the delivery of services. Clearly, like in the current AES, the conditions differ significantly between Member States, and targeting is not possible to the same extent everywhere.

- ***On the issue of capping.*** The targeted payments - those based on an individual contract for services - should be proportional to the services provided. These payments might include a fixed component, for example, when changing practices requires an investment in fixed assets or one-off costs. There is evidence that the provision of public goods is mostly unrelated to farm size, but conservation efforts, for example, are sometimes more effective across large areas. There are therefore no convincing reasons to cap payments that are directly linked to an environmental contract.⁵³
- ***On the adjustment to market conditions.*** While this is debatable for income support payments, making payments which remunerate the provision of public goods countercyclical is clearly inappropriate. Such a provision would make the incentives to supply public goods a function of market situations, while in many cases, the weakness of current agri-environment schemes is their lack of longer term predictability. As farmers tend to decrease participation in agri-environment schemes and voluntary set-aside when agricultural commodity prices are high, this should not be encouraged by reducing the environmental payments in these periods. High prices could lead to more conversion of grassland to arable without substantial incentives to counteract this (there is historical evidence that the major losses in biodiversity are correlated with periods of high agricultural prices, see Hanley et al 2009). One may even consider that, in order to keep the provision of environmental services attractive when high market prices provide incentives to opt out of environmental and conservation schemes, payments must be made procyclical rather than countercyclical.
- ***On the issue of decoupling.*** In cases where certain types of agricultural production directly lead to the provision of public goods, payments for the latter would also support the former. It is thus contradictory that these payments should help to maintain farmers in activity, while being minimally 'distorting'. The reconciliation needs to be through the design of payments that focus on the provision of public good rather than on the methods to obtain it. When there is the need to maintain landscapes dependent on grazing, in particular in LFAs, some coupling to livestock production may be a simple, yet targeted measure.
- ***On the issue of co-financing.*** Co-financing should be the standard rule for all public goods payments, in order to limit any budgetary incentive to accept lenient rules and to expand the definition of service provision beyond their actual interest for EU citizens. However, because national co-financing has acted as a strong disincentive for cash strapped countries in implementing agri-environment schemes, this could also result in a low level of provision of European public goods by a Member State, if the required rate of co-financing has been set too high.

The rate of co-financing for public good payments should not be higher than for income support payments. The degree of co-financing could nevertheless differ according to whether the public goods are local or whether they are truly of

⁵³ Unless there is a clear indication that the level of services has decreasing returns. While this is possible that, beyond a certain level, the marginal level of the service provided becomes very small, it is often the opposite in problems such as biodiversity protection, environmental services or landscape related issues.

importance for Europeans as a whole (migrating birds, climate, landscape with European importance, biodiversity under Natura 2000, non eutrophized Baltic or Northern sea, etc.). The rate of co-financing might be adjusted between Member States or between the type of farming/landscape protection involved, based on some objective criteria.

The proposal for public goods and services in brief

This proposal includes a progressive reallocation of income support into a contract for services designed to support the provision of public goods by farmers. This amounts to a shift of the CAP budget to the type of services that are currently covered by agri-environment and some other rural development measures, as well as some currently funded under Article 68, with several administrative options being open. A more limited budget for income support than the current Pillar 1 measures should make it possible to carry out more ambitious and more effective policies on issues that are not currently well addressed, in particular issues related water protection, biodiversity and landscape management. After 2020, payments for providing public goods administered via a contract should be the dominant source of direct payments proposed to farmers.

As a general orientation, future direct payments should be based on contracts. Payments should reward farmers and potentially other land managers for the provision of public goods, and should be attached to these services. Contracts should be targeted, predictable, covering an annual to 15 year period depending on the content. Results need to be verifiable, i.e. with rules that can be monitored (e.g. stocking densities for livestock). Payment entitlements should be neither transferable nor inheritable. Contracting should be on a voluntary basis, but in particular circumstances (such as water catchment areas or Natura 2000 sites) where prescriptions are made compulsory, similar payments should be provided. A precise identification of the public goods eligible for EU level payments could rely on the work already carried out.⁵⁴ They cover a variety of issues such as landscape, farmland biodiversity, conservation of agricultural genetic resources, water and watershed functionality, soil and air quality, resilience to wildfire and flooding, carbon storage and, if direct payments to farmers are the most efficient measure for this goal, to maintain rural vitality. Member States would be left to define the precise terms of reference of what is proposed to farmers according to local priorities.

Contract payments may be granted both in narrowly targeted and in broad schemes. Targeted schemes would include individual contracts where farmers commit to use certain production techniques or commit to particular environmental services. These contracts are in the line of the current AES, but lessons should be drawn to avoid excessive transaction costs. A system of credit points associated with a number of commitments could allow modularity with limited management costs, as well as other approaches including auctioning, discretionary approaches, outcome based approaches and payment by results that have proven to be cost effective in the current schemes that have provided the framework for various experiments since 1993.⁵⁵

Broad schemes could also rely on contracts, but with lower, flatter rates and simplified service definition, often targeted to a particular area. Payments should be conditional on

⁵⁴ These issues have been investigated by the European Rural Development Network as well as several NGOs, and by studies commissioned by DG Agriculture (see Cooper et al 2010).

⁵⁵ Over the recent years, many evaluations have been made of various AES in Europe, and have suggested some ways for improvement. See for example the series of evaluations of the MEKA programme in Baden-Wuerttemberg, Germany.

adherence to simple but strict terms of references. Because it is a well-codified, comprehensive and enforceable terms of reference, organic farming deserves specific incentives. It may also be one option to meet the enhanced needs of fragile areas, water catchments and other areas where non-point source pollution is a significant problem.

There is little motivation for capping or modulating such payments for a particular individual but flexibility would be left to Member States. These payments should be co-financed by national budgets with co-financing rates at most as high as for transitory income support. The rates may differ according to the valuation of the services by Europeans and according to the financing capabilities of the Member States concerned.

3.3. Budgetary and institutional issues

3.3.1. Funding the proposed reformed SPS

Defining global "envelopes"

The future distribution of direct payments could be embedded in two mechanisms. One is national envelopes which Member States could spend according to their preferences within certain limits. This has *de facto* become the current practice with regard to the SFP since the Health Check. The alternative is to create envelopes for each instrument at European level and to let Member States "compete" for this funding. For example, a certain amount of money can be dedicated to Natura 2000, organic farming or LFAs. National entitlements would then correspond to their share in the specific area.

Among the advantages of the latter "instrument envelopes" would be greater flexibility in the allocation across Member States.⁵⁶ It would also set incentives for Member States to create entitlements, for instance by expanding say Natura 2000 sites. A disadvantage could be that distributional competition prevents optimal allocation across instruments as Member States would privilege those instrument envelopes from which they stand to receive a relatively high share. Another inconvenience would be less certainty for farmers, given that payment levels for a given instrument would fluctuate over the years as a function of overall EU uptake by farmers.

These two mechanisms could also be combined. For instance, some instruments could be financed from a national envelope – say, income support and payments for certain farming practices – while payments more closely connected to areas could be financed through EU-level instrument envelopes. Another way to combine these mechanisms would be to guarantee a certain amount through national envelopes and to distribute the rest through instrument envelopes.

In the following, it will be assumed that payments are channelled through national envelopes. One issue of importance is that co-financing (that we propose for both the "income support" component and the "public goods" component of the proposed scheme) is somewhat at odds with the idea of fixed national envelopes, in the sense that imposing a particular Member State to co-finance a predefined envelope would interfere with the Member States prerogatives in terms of budget. Rather, envelopes should be maximum envelopes which Member States could use provided that they provide some co-financing.

⁵⁶ This would be significant especially for eastern European countries that are likely to see substantial changes that would enhance their entitlements, such as an expansion of organic farming.

There is a risk that some Member States simply do not fund agricultural policy while others, more able or more willing to fund agriculture see their spending propensity boosted by extra budgetary returns. However, national envelopes would set a limit to this latter behaviour. While a differentiation in the co-financing rates would help preventing the former.

The allocation criteria for fixing the national envelopes will have to be easily applicable, resistant to abusive claims, and compatible with the Treaties. Here, we provide an illustration of the possible consequences of potential criteria, rather than a recommendation.⁵⁷

Criteria reflecting provision # 1: income support

- *Agricultural area.* The argument that agricultural area should be rewarded similarly across the EU appeals to basic ideas of equality and the spirit of European integration. In addition, agricultural area is loosely related to the need for funds to provide European public goods. This relationship is most straightforward when it comes to enhancing the amenity value of landscapes, but is also reasonably close for climate protection, biodiversity preservation, and water management measures. Agricultural area can similarly serve as a proxy for the funds needed to ensure food safety and animal welfare. It appears reasonable to differentiate between different types of agricultural area.
- *Agricultural labour.* When payments are tied to agricultural labour, a larger share is likely to reach farmers, and especially poor farm households, than in the case of area-based payments. If one intends to introduce income support based on agricultural labour, inclusion of this criterion in the EU-level distribution of payments is an intuitive choice. However, such a per-labour payment would cause excessive distortions. Alternatively, labour may come into play indirectly in the context of income support, for instance if payments are capped per AWU active on a farm. One could also argue that other kinds of expenses, such as for training, diversification and early retirement, are related to the amount of agricultural labour. An obstacle arises over measurement issues of the AWU, which is particularly cumbersome given the heterogeneous importance of part time farming across Member States.
- *GDP per capita.* In richer Member States, wages in non-agricultural jobs that are comparable to agricultural employment are higher. So a higher level of income support is needed to ascertain a fair standard of living for farmers and prevent land abandonment. Higher payments are also necessary to establish sufficient incentives for agri-environmental schemes. Furthermore, flattening income support across the EU without taking account of differences in GDP per capita could lead to excessively high support in poor Member States and thus to possible distortions in the economy. Co-financing problems in poor Member States can be alleviated through differentiated co-financing rates.
- *Purchasing power.* One could argue that it is fair if the EU pays farmers an amount equal in purchasing power across Member States. Also, the cost of providing public goods is likely to be greater in Member States where the purchasing power of one Euro is low. So both from an income-support, and a

⁵⁷ See also Zahrnt (2009) and, for partly different criteria, Mantino (2003).

public-goods perspective, Member States with higher price levels should receive more CAP payments.

Criteria reflecting provision # 2: public goods

(a) Targeted services

- *Organic farming area.* Organic farming provides a bundle of environmental public goods (biodiversity, amenity value, flood control, etc.). It also ensures higher animal welfare than traditional farming and possibly produces healthier food. There is also a long history of well functioning certification, and it is reasonably well enforced through the control of fertilizers or pesticides residues.

(b) Regional payment

- *Less favoured areas.* Supporting farmers in less-advantaged areas helps to maintain decentralized settlement structures. It can also promote public goods, notably with regard to the amenity value of landscapes and biodiversity. However, the size of less advantaged areas is only a very crude indicator for appropriate payment allocation. The circumstance that an area is less suitable for farming does not imply that farming on this area is socially desirable.
- *Natura 2000 area.* The size of Natura 2000 sites is a suitable criterion for four reasons. First, they fulfil a clear cross-border function by protecting biodiversity. Second, they are clearly designated and registered. Third, Member States that designate Natura 2000 sites pay a price as they have to fulfil strict EU requirements that limit land use. It is thus fair to reward such efforts. Fourth, if the impact of Natura 2000 sites on CAP allocation disposes Member States to extend their Natura 2000 sites, this would be a desirable development.
- *Forest area.* The importance of responsible forest stewardship is increasingly being recognized. Member States with significant forest areas can make a strong case for obtaining payments to enhance the environmental value of their forests. Furthermore, excessively penalizing forest area compared to agricultural area, given the contribution of forests to fighting climate change, should be avoided.

Appendix III shows how Member States are likely to fare according to each allocation criterion and it considers four allocation scenarios. One result is that the distribution of payments between the EU-15 and the EU-12 will remain quite stable after 2013 compared to 2013 levels, regardless of the criteria that are used. The share of the EU-15 will decrease slightly in the agricultural labour scenario, compared to 2013 levels, but slightly increase in the three other cases. The sustainable farming and sustainable land use scenarios are the most favourable for the EU-15.

Another result is that the distribution across individual Member States varies strongly from one scenario to another. The payment differences are extreme for Sweden (and Finland), which would get 1.9% (1.5%) under the agricultural labour scenario but 5.8% (4.4%) under the sustainable land use scenario. In both countries, employment in agriculture is low, whereas forests and Natura 2000 sites are considerable.

A large group of Member States will win in some scenarios and lose in others. The only Member States that would win in all scenarios are Luxembourg, Spain, Sweden, Estonia,

Latvia and Lithuania. The persistent losers would be Belgium, Denmark, Germany, Greece, Ireland, Italy, the Netherlands, Bulgaria, the Czech Republic, Hungary, Slovakia and Malta. It is worth noting that national interests, even from a purely financial perspective, are broader than the CAP payments considered (depending also on their budget contributions and their shares in alternative spending items).

3.3.2. Subsidiarity and co-financing in the proposed model

Under the TFEU national parliaments should check whether the European Competence is incorrectly extended beyond the foreseen scope in the Treaty (Article 12 of the TFEU). This provides a way to gauge whether the degree of subsidiarity of a future SPS is appropriate.

Subsidiarity

The proposed model implies a significant degree of decentralization, driven by the idea that the recent EU enlargements have introduced too much heterogeneity in structures and geographical as well as social conditions to continue with a CAP that was largely designed for six original members, with an agriculture based on rather comparable family farms.

Subsidiarity should be left to Member States regarding several features of the income support component. This is particularly the case of the zoning for the regionalization of payments, and the setting of relative payments levels which involve large redistribution between farmers. This should also be the case of the thresholds for capping payments. Regarding the public goods support scheme, the degree of subsidiarity is already considerable in the current Pillar 2. However, it is important to maintain a standardized baseline in defining what farmers are required to do as a standard practice, and beyond which they are eligible for payments, for the reasons mentioned in section 3.2. This will even be more necessary with the shift to a greater budget for public goods provisions. EU wide regulations (such as the Nitrates Directive 91/676/EEC) remain essential, and control of negative externalities through taxation and regulation is useful. The GAECs should be decentralized but with a common set of rules so as to avoid, for example that a farmer is paid for not destroying wetlands, while it is asked to do so as a minimal reference in another Member State.

A high degree of decentralization in allocating payments raises concerns when it comes to fair competition and external effects. The potential negative effects of decentralization on competition are mitigated by the move to payments for public goods. These payments do not aim to stimulate production except in well-defined and limited circumstances. Instead, most of them are designed to compensate farmers for non-productive activities and investments as well as for productivity-reducing farming practices. Decentralized use of such instruments will create less distortion than the current (and even more so the pre-Health Check CAP). Some distortions are nevertheless to be feared and some guidelines should be enforced by the Commission (see section 4.4.).

Co-financing

The generalization of co-financing to all CAP direct payments is desirable to avoid the current bias against public goods oriented policies. This nevertheless raises difficulties. Financial contribution creates an incentive for the implementing Member States to use EU funds responsibly to fulfil genuine needs. Member States can be expected to administer public funds more efficiently, attaining a greater impact for a given amount of money, if they share the burden of costs. Co-financing provides the EU with higher leverage for its

limited funds, so that it can more comprehensively shape policies in line with a European agenda. Finally, there are few public goods that are fully "European", most of them have a higher value for local citizens, so it makes sense that local stakeholders contribute to the costs, in addition to EU taxpayers. The main problem with the generalization of co-financing, however, are that it goes against cohesion principles and the fact that co-financing is an obstacle for the implementation of policies – even those that are desirable from an EU wide point of view - in cash strapped Member States.⁵⁸

Ideally, the differentiation of co-financing rates should be developed further in order to maximize the leverage effect of the EU budget. One aspect of differentiation concerns the nature of the supported programme. EU contributions in favour of public goods with strong cross-border effects should be higher than those for public goods where most benefits remain within the subsidizing country. Furthermore, it is reasonable to presume that relatively poor regions are less likely to provide the optimal level of European public goods in agriculture and should therefore receive higher EU contributions. However, the current distinction between convergence and non-convergence regions is overly blunt. It does not sufficiently account for differentials in regional wealth. Furthermore, it ignores that the costs of co-financed programmes that are not borne by the EU are generally shared between the regional and the national level. Accordingly, programmes implemented in poorer Member States should receive a greater percentage of EU co-financing (even though the level of payments might be lower depending on the purchasing power of the Euro). It would therefore be preferable to have a more nuanced set of, or formula for, co-financing rates that is responsive to regions' and Member States' GDP per capita.

Differentiated co-financing may also bring about political advantages. Having one rigid co-financing rate would require possibly arbitrary decisions about which objectives and instruments receive support and which do not. By contrast, negotiations about which of say five co-financing rates apply to a given objective or instrument would be easier to conduct. A reasoned debate should permit the identification of two rates that could possibly be applied to a given programme type, so that the negotiable stakes would be minor (not 0% vs. 50% EU co-financing but 20% vs. 30% or 50% vs. 60%). Measures that are likely to deliver high value should receive enhanced EU support.

3.4. Comparison with policies in other OECD countries

Other OECD members have taken different routes regarding their farm support, even though most of them have moved from a market support system towards direct payments. The model proposed in section 3.2. has some similarities with the systems implemented in Switzerland and with some of the US programs.

Comparison with Swiss policy

In Switzerland, direct payments primarily intend to remunerate farmers for the provision of public goods. These public goods are nevertheless defined in a rather broad sense, since the list includes "supplying food to the Swiss population", "ensuring a decentralized

⁵⁸ Note that co-financing has sometimes resulted in under utilization of the possible budgets also at the national level. In Germany, a special financing mechanism for some rural development measures ("Gemeinschaftsaufgabe Agrar- und Küstenschutz") requires joint financing by the federal and the federal state (Bundesländer) level. Hereby a required co-financing part for rural development is again shared. In the past that has led to enormous resistance on the part of the federal states to support any new measures. Thereby in some Länder not all EU budget available for Rural Development had been used.

occupation of the territory", or maintaining biodiversity. In practice, direct payments also ensure a significant level of support to farm incomes.

The Swiss system of direct payments includes "general direct payments" and "ecological payments". The objective of "general direct payments" is to support income but these payments are subject to strict cross-compliance conditions. They include per hectare payments, payments to grazing livestock, payments for steep sloped areas, and payments for animal husbandry in difficult regions. The budget was CHF1.9 billion, i.e. €1.3 billion in 2008. "Ecological payments" include payments to organic agriculture, extensive grain production as well as ecological compensation (the budget, CHF539 million or €361 million in 2008). A third scheme of "ethological payments" includes particularly animal friendly free range animal rearing.

In order to receive payments, farmers must meet certain conditions. Farmers must devote at least 7% of their agricultural land as an "ecological compensation area", i.e. reserves of biodiversity, ensure protection of rivers and groundwater (through buffer strips in particular), crop rotations, soil protection and thresholds regarding pesticide application. In addition, there is a maximum amount of payment allocated per unit of "standard labour", and degressive payments on the basis of the farm acreage and the number of animals. For example, the "general" direct payment of CHF1080 (€724) per ha is granted up to 30 hectares, then becomes degressive and is capped at 90 ha. Livestock payments are provided on the basis of hectares of pasture with a maximum stocking density (0.9 bovine unit equivalent in mountain areas, to 2 units in lowland areas). The natural handicap payments are provided on a per unit of livestock basis, but with a cap at 20 bovine equivalent units per farm.

In May 2009, the Swiss Federal Council released some proposals for the future of direct payments, in particular for a better targeting to a set of services. The orientations were largely endorsed by the Swiss assembly in the autumn of 2009. Five instruments were proposed: (i) Contribution to the maintenance of cultivated landscape, with some modulation of the level of payments according to natural handicaps; (ii) Contribution to food security by guaranteeing that production capacity is maintained (maintenance of open fields for potential agricultural production, targeting on strategic crops); (iii) Contribution to biodiversity, with an emphasis on ecological compensation areas; (iv) Contribution to landscape quality; (iv) Contribution to animal welfare. The proposal also includes a series of transition payments in order to help adjustment to the new system. The proposals result in a simpler scheme more oriented towards payment on a per hectare basis rather than a per animal basis, and less support to organic farming than in the past.

The Swiss policy shares many of the objectives and methods of the model for a future SPS proposed here. In Switzerland, direct payments are not "indemnities" but genuine "financial incentives for the provision of public interest services" according to Huber (2003). Evaluations of the policy since 1999 show significant improvement in the provision of such services (Lantz et al 2010). One must however emphasize the cost of the Swiss direct payment programs (the average payment is some CHF46600, i.e. €31000 per holding).

Clearly, there are similarities between the Swiss scheme and the "broad ranged" as well as "targeted" systems of direct payments proposed in section 3.2.2. The main differences are perhaps in the high level of the Swiss payments, and the fact that the Swiss scheme includes many forms of capping, which we do not propose here. The scheme has received support from a large majority of the Swiss population, but Switzerland is a wealthy country

where food represents the smallest share of household's budget worldwide, much below the EU average. The situation is therefore not fully transferable to the EU case.

Comparison with US policy

The proposed model would show major differences with the US system of direct payments. However, it would share some common features with some US programs, namely US conservation programs, in the design of incentives.

Payments under the 2008 US farm legislation are more largely designed to support farm incomes than the EU SPS (see EP, 2009). There are three levels of payments. The "Direct payments" include transfers that are largely independent from price variations and to a large extent decoupled from production. They are function of a base acre, i.e. an individual reference, rather comparable to those EU Member States that opted for the historical model of the SPS. However, these payments are topped by countercyclical payments that are triggered whenever the market price ("season-average" price) is less than a target price. They are also topped by the rather ancient program of marketing loans which guarantee farmers a minimum price for all production.⁵⁹ The 2008 Farm legislation expanded insurance programs and provided the possibility to opt for revenue insurance instead of the countercyclical payments, through the ACRE (Average Crop Revenue Election) program.

Currently, there are more cross-compliance conditions in the SPS than in the US scheme, under which there is only a constraint that land should be kept in "good agricultural condition". If we consider the whole set of payments in the United States, a major difference with the proposed model for EU SPS is that the US one multiplies the countercyclical and safety nets instruments for farmers. With new programs such as ACRE and Supplemental Revenue Assistance programs, the US system focuses even more on guaranteeing producers a desired price and income level under any circumstances. As a result, budgets show dramatic changes from one year to another (budgets of the commodity credit corporation were US\$23 billion in 2007 and \$13 billion in 2008, and insurance and the large payments under disaster and insurance schemes show very large variations as well). This situation, which requires frequent "exceptional" budget extensions granted by the Congress, is not transferable to the EU where the budget framework is much more rigid.

The "public goods" component of the proposed SPS model show some similarity with the payments for "working land conservation programs" such as the Environmental Quality Incentives Program (EQIP), even though the EQIP budget is much smaller than the current EU SPS budget.⁶⁰ The principal objective of EQIP is to provide producers with incentives to promote both production and environmental quality as compatible goals, optimizes environmental benefits, and help farmers meet regulatory requirements. Incentive payments are made to encourage a producer to perform land management practices,

⁵⁹ "Loan rates" are administratively set prices for each program crop, which guarantee that unit returns for farmers will be at least as high as the corresponding loan rate. Farmers use the loans to finance their upcoming crops, with those crops used as collateral. If the market price for the crop is above the loan rate, the producer can repay the loan and keep the balance. If the market price falls below the loan rate, there are four options for farmers to obtain the loan rate rather than the lower market price as the effective producer price. See details in EP (2009).

⁶⁰ The main US conservation programs include the Conservation Reserve Program, the Conservation Reserve Enhancement Program, the Wetlands Reserve Program, the Grasslands Reserve Program, and the Farmland Protection Program. While these programs tend to remove land from production, there are also some "working lands" programs such as the Environmental Quality Incentives Program, the Conservation Stewardship Program, the Agricultural Management Assistance program, and the Wildlife Habitat Incentives Program. See EP (2009) for details.

manure management, integrated pest management, irrigation water management, prescribed grazing, and wildlife habitat management. Contracts are provided for 3 to 10 years. A cap for the payments is such that individuals and entities whose average gross income exceeds a particular threshold are not eligible. EQIP funds a great diversity of practices and systems that fall into two categories. Engineered and constructed structures such as terraces, grassed waterways, and manure handling facilities are funded by cost-share payments. Management-intensive, ongoing annual activities such as nutrient, pest, grazing, tillage, and irrigation water management are funded by incentive payments. Incentive payments are flat-rate per-acre payments tied to an estimate of the payment level needed to encourage adoption of a practice in a specific geographic area. Most EQIP contracts are from two to five years in length and producers sign for two to five practices in most cases. Applicants to the contracts are selected after ranking cost effectiveness through a system of points. It is noteworthy, however, that some assessments are rather critical of the way in which the various US States have allocated the contracts (SWCED, 2007).

Other OECD countries

In most OECD countries, regulatory measures are preferred to financial incentives for farmers to provide agri-environmental services. Several countries have nevertheless implemented payments for farmers to provide a variety of public goods. Norway has developed ambitious programmes of payments for conversion to organic farming and for the preservation of landscapes. In the latter case, it is a fixed per hectare payment provided that the farmer complies with a set of requirements and beneficial practices. In Canada, payments are provided under the Farm Stewardship Program, provided that farmers comply with a set of measures that ensure public services, beyond what is normally expected under standard regulations. Specific areas are targeted by the Green Cover Canada program that provide assistance to farmers for maintaining different forms of environmental protection in critical areas and by the National Water Supply Expansion Program, which helps farmers to enhance and protect long term agricultural water supply. While still modest (less than C\$100 million) the budget of these programs has expanded dramatically in a few years. Australia, a country that is well-known for the damage done to soil and water resources by agriculture, has launched several programs for protecting ecosystems, wetlands, coastal catchments, reverse land degradation and promote sustainable agriculture in recent years.

3.5. Comparison with the current model

Major changes

While the two components of the proposed model (i.e. income support and contract for services and public goods) are in the line of the current Pillar 1 and Pillar 2 components of the current CAP, several fundamental adjustments are proposed.

The proposed income support component departs from the current system of SFPs and SAPs. It is suggested that this component follows a schedule in which the income support it progressively decreased while the "public goods" component is phased in. A flatter rate system, with the definition of national envelopes on the basis of objective criteria is proposed. It is also proposed that income support is co-financed in similar proportions to public good payments, even though the rate of co-financing could vary between Member States.

The public good component is clearly in the line of the current Pillar 2. The proposed model would combine targeted payments under a contract for services, i.e. rather similar in spirit to the existing AES, and a more standardized payment for particular production techniques or geographical areas. LFA payments, would be in the "broad scheme" for public goods, but they could be reformed so as to cover more restricted areas where agricultural production is both essential to the rural fabric and provides actual services (alternatively, LFA payments could become a regionally modulated form of the "income support" component, but this would require changes in programming and control so as to comply with procedures under the current Pillar 1).

The proposed criteria for allocating budgets between Member States (i.e. national envelopes based on objective criteria) and between farmers (a per hectare basis, with a cap per labour units for the income support component, and a contract for services with no cap for the public goods component) would generate some significant redistribution of the current budgets (see Appendix III). These redistributions go in the direction that has been adopted by those countries that opted for the dynamic regionalization of the SFP.

Economic consequences

Almost all current payments are already decoupled from production or will soon be. The proposed shift of the budget towards payments for public goods, is unlikely to have a large impact on production and external trade. There is still some controversy regarding indirect production impacts of decoupled payments via wealth effects as well as credit reduction constraints and changes in producers' perceptions of risk. So far the available econometric evidence suggests that the impact of the current (decoupled) SPS on output is minimal (see Rude, 2008; Bureau and Gohin 2009, Skully 2009 for recent analyses). One must, however, acknowledge that because of the recent implementation of decoupling, empirical studies are limited and that some authors claim that such an impact has long been underestimated (Melendez-Ortiz et al eds, 2009). A consequence of this scientific uncertainty is that assessments of reductions in the level of SPS still differ between studies.⁶¹

The shift of the budget towards contracts for public goods and services should also reduce the capitalization in primary factors, and therefore contribute to a decrease in land prices. Since 2006, however, there is already a rather separate market for entitlements and land, in those countries that have adopted the SFP (SAPS do not offer the possibility of trading entitlement without land). Given that it will be difficult to avoid some degree of capitalization in land values of the growing public goods payments, the outcome is uncertain. Land values are more affected by external factors such as non agricultural demand and output prices.

The estimates by Gohin (2009) on the EU-15 of a reduction of the level of SFPs, provides a benchmark regarding the possible consequences of phasing out the income support component of the proposed scheme. The study shows some reduction mostly in the production of wheat (-6%) and beef (-4%), following a complete dismantling of the SFPs, after the macroeconomics effects and the impact on primary factor values is taken into account. A reallocation of the SPS budget towards the provision of public goods would have less impact on output than a decrease in the CAP budget that would lead to cut the direct payment budgets. In particular, because Gohin's findings indicate a sharp drop in farm

⁶¹ In particular, Gohin (2009) results are not fully in line with those of the SCENAR 2020 Commission's simulation regarding the removal of direct payments, see Nowicki et al (2006).

income even after accounting for macroeconomic closure and adjustment in input prices, the overall impact of the proposed model is perhaps more dependent on the level of payment than the actual allocation of payments between income support and public good provision.

Distributional consequences

The proposed model leaves large degrees of freedom for adjusting the degree of redistribution. Indeed, the criteria for defining national envelopes are left to negotiation. So is the level of the standard (average) per hectare payment, which depends on the budget the Council and the European Parliament will want to allocate to the income support scheme. Member States which opted for the historical model would also have large degrees of freedom for the regionalization of the payments. As a result, it is difficult to make exact predictions on the distributional consequences of the proposed model. However, some general benchmarks can be estimated using the FADN data.

Table 2.2. provides some information regarding the effect of a flatter per hectare payment. However, in practice, in the proposed scheme, Member States would be able to allocate a pre-defined envelope of payments, provided that they supply national cofinancing, but also define the various thresholds, ceiling and allocation criteria. Box 3.2. shows that by choosing particular forms of regionalization and means testing, Member States would have a large degree of freedom to influence the eventual distribution of payments and incomes.

The shift from the current Pillar 1 payments towards a more even payment per hectare result, globally, in moving income support towards the more extensive (i.e. land intensive) sectors and regions in those Member States that are using the historical model. The introduction of a cap per worker generates potentially large budget savings, but also some complex redistribution and potential conflicts with some other objectives (Box 3.2.). This pleads for more detailed analysis, and for leaving Member States with a large degree of flexibility in this area.

Box 3.2. Regionalization, means testing and the distribution of payments

In order to refine the conclusions drawn in section 2.2.2. regarding the consequences of a flatter payment per hectare at the EU or Member State level, here we assess what could be the consequences of subsidiarity in regionalization and in setting a ceiling on payments per worker.

Assume that the income support scheme is based on the current Pillar 1 budgets, but that Member States maintain the current regional envelopes (i.e. based on administrative regions).⁶² Simulations show that a uniform payment rate per hectare in each region (i.e. at a different level between regions) would still be mostly detrimental to intensive (i.e. capital intensive) dairy producers and they would benefit mostly to extensive (i.e. land intensive) field crops as well as wine producers. More precisely, dairy producers in Germany, Italy, the Netherlands, Denmark and the UK would be net losers compared to the current situation. Arable crop producers in those countries that implemented the historical model (for example, producers in "field crops" sector would experience a net loss equivalent to more than €1100 per AWU in France). In Greece, if a flat per hectare payment was implemented even without any transfer between administrative regions, olive oil producers

⁶² We do not know how Member States would define their zoning for possible adjustment of the per hectare payment. Besides, administrative entities are the only geographical criterion available in the FADN.

would lose a significant income. In brief, regionalization would limit the transfers compared to a single national payment per hectare, and even more compared to an EU-wide payment per hectare, but there would still be a considerable reallocation of payments.

Now assume that Member States introduce in addition a very strict cap per worker and that income support payments are capped to the average wage rate for hired farm labour in the Member State, per AWU (hired as well as self employed). In such an extreme scenario, where income support would be limited to roughly the minimal income per worker, the current Pillar 1 budget would be reduced by more than €12 billion for the EU-25 (compared to 2006 figures). While this would mean "only" an average cut of €86 per hectare, it would mean that on average in the EU-27, the net income per AWU would decrease by €1800. With such a ceiling per worker, in France, for example the current Pillar 1 payments would decrease by €2.7 billion.

Compared to a standard reallocation of payments per hectare, such a cap would increase the net loss resulting from a per hectare allocation for arable crop producers in France, Germany, Greece, Spain, Finland and the UK. It would also lead beef producers to shift from a net beneficiary of a per hectare reallocation of payments to net losers, in particular in Sweden, France and Austria. Dairy producers in Finland and Sweden would also have their payments reduced dramatically. Compared to the 2006 situation, the fall in income would for example exceed €8000 per AWU for French arable crop as well as French beef producers, due to this cap, which is, admittedly quite extreme. The cap would hit even more the beef and sheep producers in Germany, Sweden and Finland.

Source: FADN data 2006

3.6. Implementation

3.6.1. Compatibility with the multilateral framework

The proposed revision of the SPS would only impact the domestic support constraint under the WTO. The export competition and the market access provisions are somewhat unrelated. Under the domestic support provisions, several variables must be accounted for: the Aggregate Measure of Support (AMS), the product specific AMS ceilings, the Blue Box ceiling and the Overall Trade Distorting Support (OTDS) ceiling. It is noteworthy that the EU could also use the *de minimis* provisions in order to exempt counting some of the payments under distorting support, provided that they represent a small share of the value of production. This could be an important element degree of freedom for possible coupled payments, when there is a need to support particular productions associated with public goods provisions.

Ceilings

The existing limit to the EU AMs under the WTO is €67.17 billion. In the most recent notifications (G/AG/N/EEC/64) to the WTO, the EU indicated that the new ceiling was €72.2 billion after including Bulgaria's AMS commitments to establish the EU-27 level. However, the EU enlargement also mathematically increased the EU AMS due to the extra production that is counted as benefiting from market price support. Other relevant ceilings include the OTDS and product specific AMS ceilings, including for wheat (see Josling and Swinbank 2008 for detailed explanations).

Given the uncertainties regarding the actual provisions of a Doha agreement, it is difficult to assess what the EU commitments would be. As a benchmark, one can use the December 2008 draft modalities to assess plausible ceilings for the EU domestic support. A Doha agreement, which would most likely involve (i) a reduction in the Final Bound AMS; (ii) a reduction in *de minimis* allowances; (iii) a cap on Blue Box support; (iv) a cap and reduction in the OTDS; (v) product-specific AMS and Blue Box caps. Simulations using a spreadsheet model provided by Tim Josling, which rely on particular assumptions regarding future prices and the classification of the payments, suggest that in such a case the EU AMS might be bound to €21.6 billion, the OTDS might be limited to a bit more of €23 billion and €27 billion depending on the basis taken for the value of reference production and the Blue Box to €5.5 billion (note that these figures are given as indicative benchmarks and that the potential adopted formula are still surrounded by a considerable uncertainty). Under a potential Doha agreement, some product specific limits would also be potentially constraining.

The most recent notifications of the EU Domestic support (for year 2006/2007, as notified to the WTO in March 2009) amounted to €26.6 billion, well below the current ceiling (Table 3.1). Since this campaign year there have been considerable changes to the CAP. Sectoral reforms as well as the Health Check were implemented, which should in the future lead to a reduction in the price support related AMS (with the dismantling of the intervention price for barley, corn, etc.). The changes in the dairy regime should lead to a significantly lower AMS. As a result, without a Doha Agreement, it is hard to imagine that a revised SPS would cause some WTO compatibility issues. Even if the current SPS budgets were turned into some kind of countercyclical payment that would have to be notified under the amber box.

In case of a Doha agreement, things would nevertheless be different. Taking into account the Health Check provisions (without taking into account the future use of the "coupled" payments under Article 68 by Member States), our estimate is that the actual level of support that the EU could notify under AMS would be around €18.8 in 2013; that the support that the EU should notify under the Blue Box would reach €2.4 billion and that the overall OTDS would reach €22.8 billion if the *de minimis* provisions are fully used.⁶³

The precise impact of the Health Check is nevertheless unknown, given that it is not yet clear how much specific sector payments will be provided under Article 68, and how these payments will be classified. However, support that is unlikely to be eligible as Green Box is limited to 3.5% of national ceilings in the EU (Regulation 73/2009). Assuming as an upper bound that all Member States use as much sector specific payments as they could, this would result in €1.6 billion of Article 68 support that could not be eligible to the Green Box after 2016. This would therefore bring the level of the Blue Box to a maximum of €4.2 billion and the level of the OTDS to €24.5 billion (see Table 3.1). Note that the preliminary and figures that we obtained from the media regarding the use of Article 68 provisions of coupled support suggest that this €1.6 billion is above reality, since most of the payments under Article 68 seem to be for environment or quality improvement issues and therefore eligible to the Green Box (see section 1.3). The *de minimis* exemptions based on actual

⁶³ These projections were obtained using the WTO simulator constructed by Tim Josling, July 2008 version, under assumptions regarding the continuation of administrative prices, market prices for fruits and vegetables, and the classification of the various payments given the scheduled changes in their definition. We amended the simulator in order to account for the Health Check changes, namely the end of intervention for coarse grains, the future integration of a variety of payments in the SFP and therefore outside the Non Exempt Direct Payments. There is however a strong uncertainty on the eligibility of some payments to the product specific *de minimis* and the actual level of the coupled support under Article 68. These figures should be considered as approximative and taken with caution. We thank Tim Josling for his helpful collaboration but possible errors are ours.

policies have been included in this calculation but changes in the policy instruments after 2013 might lead to greater degrees of freedom by making it possible to exploit all the possible *de minimis* product specific exemptions.

Overall, with an AMS projected to be slightly less than €19 billion, the constraint on the AMS could still be significant if the AMS ceiling were to be cut by 70% or more in case of a Doha scenario. In addition, the OTDS constraint could be even more binding if the OTDS ceiling were to be cut by 80%. The latter constraint would perhaps be more a problem than potential blue box ceilings.

A major consequence is that an agreement would leave little room for making the "income support" component of our proposed SPS countercyclical. If such a component were designed so as to adjust to market conditions, this would certainly have to be notified under the AMS (US countercyclical payments which are directly linked to market prices even though they are based on fixed areas and yields are notified as part of the AMS). In any case, it would have to fit under the OTDS constraint.

In order to make such a potential set of countercyclical direct payments compatible with an equally potential WTO agreement, the EU would have to make an equivalent in the remaining AMS in the sectors where it still exist. This would require making significant reforms in the fruit and vegetable institutional price system (fruit and vegetables are likely to account for more of €8 billion of AMS in 2013) and/or in the sugar and the butter administration system (each of these sectors are likely to account for more than €3 billion of AMS).

The current modalities for constructing the AMS have become out of touch with market realities. Indeed, because of the methodology used, the mere existence of an administrative price might generate some AMS even though this price is permanently below market prices for example. Some degree of freedom could therefore be obtained by administrative changes in the fruit and vegetable or in the dairy sector (the new US Farm Bill recently used one of these "tricks" in the dairy sector, see EP, 2009). However, any attempt to vary some direct payments with market conditions would require exposing either the sugar, dairy, or fruit and vegetable sectors to potentially adverse market conditions.

By contrast, the proposed model relying on a fixed income support would be more compatible with international commitments, even though the assumption of an AMS reduction constraint of 70% and an OTDS reduction constraint of 80% are likely to be binding in any case. A more precise assessment would nevertheless be required, using information on how Health Check provisions are eventually implemented by Member States.

Table 3.1. Current and forecast WTO Domestic Support measures, (limits without a Doha agreement), million euros

Indicator		2006/07 Notified	2009/10 Calculated	2013/14 Forecast
Total AMS		26 632	21 073	18 830
Including	Price support	22 237	17 919	15 774
AMS limit		72 244	72 244	72 244
Blue Box		5 697	4 306	<4 200
Potential de minimis		1 407	1 277	1 290
OTDS		33 736	26 656	24 500
Composition of product specific AMS (before de minimis)				
Cereals	Market price support	4 536	4 132	2 019
Sugar	Market price support	6 767	3 479	3 289
Milkpowder	Market price support	908	951	940
Butter	Market price support	3 581	3 181	3 054
Milk	Direct payments	173	173	0
Dried fodder	Direct payments	159	159	0
Tobacco	Direct payments	416	416	416
Bananas	Direct payments	123	0	0
Apples	Market price support	2 652	2 625	2 625
Tomatoes	Market price support	2 149	2 150	2 387
Other fruits and vegetables	Market price support	4 169	3 549	3 520
Wine	Direct payments	875	0	0
Other	various	460	257	257

Source: EU WTO notification (G/AG/N/EEC/64) for 2006/2007. Estimation of shadow notification for 2009/10 and forecasts for 2013/2014 using EU simulator and data kindly provided by Tim Josling, Stanford University. All errors in amending the simulator and using it are ours.

3.6.2. Compatibility with the EU institutional framework

Institutional issues

Changes introduced by the TFEU are significant for the CAP decision making process (see Box 3.3). More generally, the new institutional arrangements will require a broader perspective on agricultural issues with an external dimension (like development and trade) as part of an overall coherent set of external policies. In this context, a more transparent CAP based on clear criteria to provide public goods may facilitate a cooperative approach.

A change of first pillar spending, e.g. by introducing national co-financing would have an impact on the financial management procedures and involved authorities. The specific design of the financial management so far differs between EAGGF (first pillar) and EAFRD (second pillar) spending as regards a set of required accredited national authorities and the management mechanism. For spending under the EAFRD, in particular, a more complex system is established - starting from the programming phase and including extensive monitoring (national strategies based on overall Council's strategies have to be specified by national multi-annual rural development programmes which are to be approved by the Commission for the whole phase of a financial perspective). Under the approach proposed here the EAFRD model would be retained for continuing Pillar 2 measures but aspects of programming and monitoring would be required for the public goods component of the direct payments, although the rules and procedures could be lighter than under the present EAFRD model. The distinction between Pillar 1 and Pillar 2 would be less fundamental, with a higher level of targeting throughout the CAP.

The new objectives and criteria would be used to draw up national CAP envelopes for the budget period beyond 2013, within which transfers between measures would take place without the need for modulation as at present. A more objective basis for the allocation of former Pillar 2 budgets within the EU-15 would be required. National envelopes could be made subject to a mid-term review by the EU institutions to strengthen accountability.

Subsidiarity

Subsidiarity has been a major pillar of the EU construction since the Maastricht Treaty, as well as increasingly important in the CAP development, in particular since the emergence of the second Pillar in the late 1990s. The proposed model relies on a considerable degree of subsidiarity in the management and implementation of the future SPS.

The EU-level centralization of market intervention was an inevitable feature of the CAP because national action would have been neither effective nor tolerable with regard to the internal market and the customs union. The direct payments for production or cultivated area that came to increasingly replace price support after 1992 were still highly distorting, so that national discretion in setting payment levels was again not acceptable. The introduction of direct income support decoupled from production changed this situation. First, the SPS poses significantly weaker threats to fair competition. Indeed, Member States tolerated extreme differences in payment levels across Member States and among farmers within one Member State. Centralization no longer served to create a level playing field. Second, cross-compliance established a stronger and more explicit link between the first pillar and the provision of public goods. European standardization of cross-compliance is impractical because local adaptation is essential.

However, for the CAP to be able to maintain transnational objectives, flexibility should be allowed within common guidelines. This is particularly important if larger budgets go to the provision of public goods. The definition of the terms of reference, as well as inspection and enforcement, are best left to local authorities which have more information than a centralized body. However, if there is no common framework and a harmonized baseline defining the practices that are statutory requirements and those that deserve support because they go beyond standard practices, distortions will make the whole EU public goods policy will be endangered. Already, differences in national standards (regarding, for example, animal welfare requirements, the list of authorized pesticides, water protection etc.) are such that farmers are not always treated evenly and that what is considered as the provision of an amenity in one country is considered as a standard practice in another.

Box 3.3. The TFEU and the new CAP institutional framework

The TFEU modifies the role of the European Parliament in the CAP decision making process. A maximum of 26 month may be required for adopting final acts, if conciliation is needed as final step to find a consensus between the Parliament and the Council. This means for any agricultural reform beyond 2013 that Commission's legal proposals have to be initiated by summer 2011 to ensure an adoption by end 2013.

The Parliament role's is strengthened within the annual procedure as the former distinction between obligatory and non-obligatory expenditures, like agricultural expenditures, becomes obsolete (Art. 315 and 316 TFEU).

The increase in the European Parliament's power is accompanied by the coincidental extension of those Councils' decision procedures that do not involve the EP. The former exceptions for such decisions to define aids compensating for exceptional natural or economic disadvantages have been transferred to the Treaty (Art. 42.2 TFEU). But a new exception for setting prices, levies, aid and quantitative limitations has been added (Art. 43.3 TFEU). Here an Interinstitutional Agreement is likely to be needed to clarify whether such decisions are restricted to technical adjustments only.

Another new procedural issue to be clarified before adopting any new legal acts on CAP refers to implementation acts. Such acts always played an important role under the comitology procedure for CAP (e.g. technical issues like triggering intervention, approval of GMOs). The TFEU now distinguishes between two principal procedures. So far it is not clear how or whether the old procedures fit within this new frame and how and for what case the European Parliaments may gain or lose influence.

The prior and more important step for any CAP reform, i.e. defining the multiannual financial framework and allocating the budget to different expenditure headings, has become more formalized now compared to the prior procedure (Art. 312.2 TFEU). Instead of the former Interinstitutional Agreement between Commission, Parliament and Council now a specific legislative procedure has to be applied for adopting a formal Regulation. Hereby the Commission gains power by the initiative right. The Parliament only has the right for approval (Art. 312.2 TFEU). The first Commission legislative proposal under this new procedure is expected for the first half 2011 and by that will start in parallel with any proposal for a CAP reform.

3.6.3. Political difficulties and suggestions for phasing in

The new policy orientation proposed here is likely to face political difficulties at a number of levels. Overall, much will depend on the budget that the Council and the Parliament will devote to the future CAP. However, a progressive phasing out of income support is likely to be opposed by a number of Member States and by many farmers' organizations, even if it went with a larger budget for public goods. There is a risk that farmers who do not contract for these public goods and services will be more exposed to market conditions. While it is possible that steady, or even firmer agricultural prices could improve these conditions in the future, this is not assured.

Budgetary envelopes for Member States defined on objective criteria (unlike the present Pillar 2 budget for EU-15 members) would lead to a significant redistribution of the budget between Member States. National adjustment of the various coefficients and thresholds, in particular in order to take into account the purchasing power of the euro, would limit these

transfers to some degree but they would still be substantial. The redistribution could be tapered in over time to ease the process of adjustment but there would still be significant winners and losers. This underlines the point that a significant reform of the CAP would not and should not be proposed in isolation and would need to be part of a larger package of EU budgetary adjustments, involving negotiations on the structural funds, other spending categories and national rebates.

The fact that income support payments would be attributed on a per hectare basis with a cap per unit of labour would also involve a significant redistribution between farmers. Section 3.5. on distributional consequences illustrates that any redesigning of the SPS scheme results in complex, and sometimes counterintuitive transfers between categories of producers and regions. A significant degree of flexibility should be left to Member States to adjust the schemes so as to make these changes politically possible without undermining the coherence of the underlying objectives or resulting in serious distortions to the market.

There will also be opposition to the change in the political rationale of the CAP away from the compensation culture inherent in the current direct payments, towards the principle of payment for services provided. This involves a transition from seeing payments as a right to a new understanding of a social contract between the society and farmers. While this is not easy to accept, it will be important to address the questions it raises and seek buy-in from the farming community as well as other stakeholders with less to lose. Some sections of the farming community in Europe will gain from the new approach. For example, many with grazing livestock who will normally be eligible for public goods payments. For others, there will be losses. However, inside and outside the farming community there is a growing appreciation that the only basis for the long term legitimacy of the CAP in Europe seems to lie in its ability to support the provision of public goods. Whereas this involves adjustments, it opens the prospect of a much more durable formulation for agriculture policy in Europe and longer term stability in payments. Several farmers' organisations are evolving their positions on the future of the CAP in awareness of this shift in social attitudes.

A source of worry is that remuneration of public goods and services is a more complex issue than a flat rate lump sum payments. One major challenge will be to keep the public good support scheme simple and avoid the risk of bureaucracy. There is clearly a trade-off between targeted and well-enforced measures and administration costs. Management could be a major problem in some of the New Member States with a large population of small farmers. In addition, in the new Member States, there will be a particular communication challenge. The present targeting is one of rising direct payments in the period to 2013 and considerable efforts have been made to alter the basis of direct payments from the relatively simple SAPS model to a form of the SFP. A further change towards a new system, simple in some respects but also requiring new obligations to receive targeted payments, will be met with some puzzlement, if not incomprehension. However, some of the sunk costs arising on farms in the EU-15 will not be mirrored fully in the new Member States which have a relatively short history of direct payments and there is considerable potential for the deployment of public goods payments in these countries.

Given the scale of the changes proposed, considerable thought would need to be devoted to the process of transition and adjustment and the policies required to make this orderly and politically acceptable whilst avoiding economic shocks to agriculture and the linked industries upstream and downstream. The costs of reform can be increased unnecessarily if reforms are introduced too suddenly and without preparation; especially given the sunk costs and fixed investments in agriculture. There will be impacts that are unavoidable, for example, on land prices in areas where these are driven by returns from agriculture and it

would be important to ensure that any fall in prices is not too sudden, undermining the value of land as a collateral for loans.

A transition programme would need to be developed in advance as part of a new model of the CAP. Such a programme would be subject to scrutiny and amendment in the European institutions including the Parliament but a number of elements can be anticipated. These include:

- A clear timescale for adoption and implementation, e.g. for the period 2013-20 and beyond.
- A procedure designed to avoid too much delay in the adoption and implementation phase.
- Clear analysis of potential impacts at different levels through a serious ex-ante impact assessment.
- A solid understanding of impacts in Member States that have changed their implementation of the SFP / SAPS in recent years.
- A timetable and set of mechanisms⁶⁴ for tapering in / tapering out certain payments over the period to smooth the adjustment process.
- Consideration of any specific compensatory measures that might be required in order to reduce the impacts on those with the most serious net losses or address specific sectoral or geographic issues.
- Considerations of special measures that might be required in respect of circumstances where the new approach might be challenging, so for example in regions with very small farm structures.
- Investment in national and regional institutional capacity to target measures in new ways and monitor their impact. Monitoring and evaluation are necessary to ensure that measures intended to support public good provision do so in practice.
- An extensive programme of communication and training at the relevant levels so as to maximise understanding of the objectives as well as improve the delivery of the policy and the engagement of farmers.
- A programme of active engagement with the farming community and other stakeholders.

Some legal issues may arise and need to be addressed, in particular because of the consequences of changes in asset values. Member States' legislation, however, has largely addressed these issues as a result of recent policy changes and a jurisprudence has been established, in particular regarding the sharing of the benefits and losses between the landowner and the farmer where these are different.

⁶⁴ Modulation has been a useful mechanism for reallocations between Pillars 1 and 2 within a given financial framework. At the outset of a new financial framework it appears that this rather complex mechanism can be avoided by directly specifying a declining schedule for budgetary expenditure for income support on the one hand, and increasing budgetary expenditure for public goods remuneration. Modulation might still be an option to modify the decision on the financial perspective of 2013-2020, for example at the opportunity of a mid term review. But for all planned changes and flexibilities it should be possible to define schedules for national envelopes related to admissible expenditure categories that largely avoid modulation.

4. Indirect impact of the new model of decoupled payments on other areas of the CAP

4.1. Linkages to market regulation measures

A reform of the SPS should not be addressed independently from another central feature of the CAP, which is market regulation. Currently, market regulations take the form of border protection and of minimum prices set either through public intervention (e.g. for wheat), or some other form of safety net (e.g. beef) and in some cases quotas (e.g. sugar). Most other instruments of the CAP have either been dismantled (e.g. land set-aside), or reduced in effectiveness (e.g. intervention on coarse grains).

Discussing future market regulation is beyond the scope of this report. However, a common argument for defending the need for large payments is that the withdrawal of public authorities from market management since the early CAP reform in 1992 has left direct payments as the sole "cushion" for farmers facing market instability. The recent food crisis has provided an example of the price fluctuations that may be felt more often on EU markets in the future than in the past.

A fixed, per hectare "income support" maintains some financial transfers that stabilises farmers' incomes. However, one must acknowledge that any prespecified path for payments does not address one of the criticisms to the current SPS raised in section 1.5.2., i.e. that direct payments cushion, but do not counteract price instability. In addition, making income support transitory, as proposed here, would require finding other ways for farmers to reduce their income risk.

A response to these criticisms is that with a significant budget devoted to the provision of public goods, farmers can always contract for public goods, as a way to diversify their output and arbitrage between a risky source of income and a certain one, as suggested by optimal portfolio management theory. Longer term contracts would provide a strong incentive to shift to the provision of public goods and services, given that these would offer a stable income. This means that payments for public goods that are tailored so as to compensate for extra costs should consider the cost including remuneration of primary factors rather than marginal variable costs.

A way to cope with higher risk is to diversify production. There is little doubt that the high guaranteed prices of the "old CAP" played a significant role in encouraging specialisation of farms. Specialisation may have negative consequences on soils, and because of the proliferation of pests and weeds, leads to a greater use of herbicides, insecticides and fungicides. A way to cope with market volatility is also the development of pluriactivity on the level of farm households as this also helps to evade a part of the farm income risk, even though the possibilities in this area are clearly dependent on the economic situation prevailing in the region.

Regarding the possible articulation between direct payments and risk management tools, a linkage already exists through Article 68 of Regulation 2009/73, which makes it possible to divert some of the SPS payments to risk mitigation instruments (see section 1.1.3.). In addition, different initiatives, including a High Level Group on milk and a French government initiative are preparing specific proposals on how to deal with market volatility which might introduce a closer link between direct payments and insurance schemes. The

Commission is also studying a reserve for the crisis of prices, building on the experience of the 2009 milk package and linked to the Article 44 of the Single CMO Regulation 1234/2007 which makes it possible to introduce exceptional instruments in case of a crisis.

There are two possibilities for a closer link between direct payments and volatility mitigating instruments. The first one is to adjust future direct payments to market situation. The second one is to introduce an insurance component in the direct payments. As discussed in section 2.3., there are some arguments for making the income support component of the future SPS countercyclical, but there are also a number of objections. Firstly it would raise some administrative problems regarding the EU budgetary procedure. A possibility would be to impose that a multi annual budget be spent over some years with variations over time dependent on market conditions, but the operational design of such a scheme is not a trivial task. If successful, one may wonder which value added brings the countercyclical management: farmers might just as well handle the adjustment themselves with the help of the banking sector if the total value of direct payments over a period of several years is known beforehand. Making payments countercyclical might also create problems regarding international commitments. It would blur the signals of excess supply or excess demand to producers and thus potentially lead to market imbalances. Making the payments dependent on market situation strongly limits the ability to condition payments to GAECs or other cross compliance provisions. Indeed, would be providers of public goods need to have a predictable horizon, given the sunk costs that are often necessary to shift to different production techniques. Finally, designing the income support component of the SPS as a substitute for market regulation would be difficult to manage given that the price of all products do not vary evenly. It would basically require a return to product specific payments, which would be a radical turnaround for the CAP.

Insurance schemes are sometimes presented as a link between payments and market conditions. This is particularly the case in the United States, where public subsidies to insurance now represent a significant share of the overall support to farmers (see EP, 2009 for details on the US insurance schemes). In addition to the United States, where public subsidies to insurance amount to close to 2.5% of the value of agricultural production, Canada and Spain also have ambitious insurance schemes.⁶⁵ The debate regarding the pros and cons of subsidized insurance is beyond the scope of this report. But government intervention has a role to play in insurance, at minimum by providing transparent information that make it possible for private companies to supply index based climatic insurance, for example. In the case of catastrophies, epizooties and other particular hazards, the need for publically-funded insurance schemes or disaster compensations is hardly questioned. However, in the case of crop or revenue risk management, the benefits of a EU wide scheme would need to be more clearly documented. There are at least three important points that need to be considered:

- There is no political consensus between Member States that there is any European value added in subsidizing insurance scheme, or even that any EU budget should be devoted to such schemes. Several Member States, not subsidizing their own insurance system, have repeatedly expressed their reluctance to such a scheme during the Health Check debate, which explains that it has largely been left to Member States' choice under Article 68.

⁶⁵ Public subsidies to insurance schemes amount to roughly 3.7% of the value of production in Canada and 1.1% in Spain, see Perrin et al 2009 and Bielza et al, 2007; 2009 for a review of farm insurance policy in Europe)

- Evaluations of the US insurance scheme stress the cost for the public budget and the low efficiency in transfers when one compares the cost paid by the taxpayer and the government to the payments received by farmers (Glauber, 2007; Babcock and Hart 2006; Gardner 2008, Babcock 2009).
- Because of the predictable budgetary pressure on the CAP budget, and the apparent lack of willingness of Member States to increase the EU budget, one can consider that any EU wide scheme for subsidizing agricultural insurance would have to draw resources on the direct payment budget. Management costs, in addition to possible rents and leakages are associated to insurance schemes. From a transfer efficiency standpoint, it is unlikely that farmers would be better off-with a given budget spent for subsidizing insurance rather than a direct payment, at constant budget (under reasonable assumptions on farmers' expected utility function).

Direct payments could play a role in rescue packages that could be designed as a way to cope with crises situations. From that point of view, the package of measures implemented by the Commission to cope with the dairy crisis in 2009 can be seen as a way to explore for more systematic safety net policies. However, the idea of turning the SPS into a way to regulate markets or counteract price instability is hardly convincing.

While direct payments do provide a form of income stabilization, and they could continue to do so even if they are provided as payment for public goods, adjustments to market fluctuations should be addressed by a greater diversification of the farm's output mix and specific individual risk management tools. The latter could include fiscal instruments so as to provide incentives for precautionary savings in good years. Indeed, there are clearly some potentially useful instruments in this area, as raised by several actors (e.g. SAF, 2009).⁶⁶ A large use of forward contracts, futures and options on agricultural markets offer some opportunity to smooth risks over time (EP, 2007). Individual stockholding, including with public incentives through interest subsidies for private storage are part of the individual risk management toolkit (Wright and Williams, 1991). Contractualisation between farmers and processors is often proposed as a solution to reduce uncertainty in prices for goods, even though it has been argued that asymmetric information makes it difficult to apply any generalized contractual arrangement in markets with non-standardized products (EP, 2007).

4.2. Linkage to coupled payments

Currently, there are few remaining coupled or semi-coupled payments in the CAP (payments for sheep, goats and suckler cows as well as some transitory payments, e.g. for fruits and vegetables). Article 68 also gives some freedom to the Member States to provide limited amounts of payments that can be considered as coupled to particular products, even though under very specific conditions (see section 1.1.3.). Public subsidies to risk management might also be considered as coupled.

As explained in section 3.1., the proposed model does not rule out the possibility of indirectly providing coupled support if this occurs through support for the provision of public goods. There are cases where the jointness between the agricultural production and public good provision is very close in the sense that continuation of (particular) farming

⁶⁶ The proposed reforms of the French "Déduction pour aléas" provides an example of measures that may achieve some stabilisation in net incomes at a rather moderate cost (Perrin, 2009).

practices (e.g. extensive grassland use through one late, annual cut) is needed for a particular public good (e.g. some meadows types or particular biotopes threatened by afforestation and scrub encroachment). Unless it is required that the jointly produced agricultural outputs must not be used, there will be a stimulating effect on agricultural production.

Thus, payments coupled to farming are defensible under the "contract for services" component of the proposed model, but with some conditions. For example, if the presence of animals is required or clearly less costly than alternative means to provide a particular public good such as a landscape with well-recognized aesthetic value, there is a justification for support to grazing. This could take the form of a particular payment per livestock unit (LU) without distinction of animal types. If there are reasons why a particular landscape is dependent on cattle rather than sheep, the support may be granted exclusively to cattle grazing, providing indirect support to beef and milk production⁶⁷. At the bottom line, support for the preservation of some landscape may thus boil down to support traditional forms of agriculture. For several reasons, however, it is recommendable to define the services intended as precisely as possible, acknowledging measurement costs, rather than giving unconditional support to agriculture:

- Direct support to agriculture has no chance to qualify for the green box of the WTO;
- Not all profitable forms of agriculture are beneficial to the environment, even in LFAs, and it makes sense to support only those farming practices that provide demonstrable public goods and services;
- Even if not harmful, agriculture's intensity may exceed or fall short of the optimal (cost minimising) intensity to preserve a particular service (overgrazing or undergrazing, if stocking density is uncontrolled).

It may be recommended therefore to reconsider the current coupled support to suckler cows and sheep and goats under the SPS to clarify the motivation for such support and add appropriate conditions in view of this motivation. This should be left to the MS but the Commission needs to retain the right to question overtly coupled support, if only to comply with the permitted AMS and the *de minimis* clause under a Doha agreement. Furthermore, uncontrolled "recoupling" by Member States would also generate distortions of competition within the EU.

4.3. Linkages with rural development and regional policy

As proposed here, a new approach to decoupled payments would contribute to the overall goals of a new agricultural policy and more specific goals of rural development policy much more substantially than the current policy. The payments for public goods would be aimed at many of the objectives set out in current rural development policy, so that there would be consistency and greater complementarity between the main strands of the CAP. While these payments are currently divided into two separate pillars this distinction would decrease in importance. Both strands would reflect European objectives with flexibility to

⁶⁷ The example the Irish Burren, a limestone area which is characterized highly valued landscape attracting hundreds of thousands of tourists a year is particularly compelling. This area rapidly loses its aesthetic value when cows no longer prevent the growth of hazelnut trees. It calls for supporting farmers who maintain a (rather non profitable) livestock production.

accommodate regional requirements, both would be co-financed, and the main differences would be in the machinery of policy making and delivery, with one strand continuing to be programmed and reviewed on a regular cycle of 5 or 7 years and the other operated by a lighter system without a full programming structure. Allocations of funding between Member States would be based on objective criteria, not previous levels of expenditure which still play a large role in the distribution of direct payments and the allocation of rural development budgets in the EU-15.

New priorities have been added to rural development policy in the 2002 mid-term review and subsequently in the Health Check. These include a greater emphasis on agriculture's contribution to mitigating climate change and adapting to unavoidable change. It is clear that rural development policy as it stands has not been able to meet all its objectives. For example, about half of all wildlife species in need of protection in Europe have an unfavourable conservation status (ECA, 2009). There continues to be a gap between the current EU objective of halting biodiversity loss by 2010 and what has been achieved on the ground, partly because of the lack of incentives available to land managers. With the addition of further objectives to rural development policy, including a potentially demanding new role for agriculture in addressing climate change, the shortfall between objectives and achievement is likely to get greater. This points to the need for closer alignment between the goals of the recent strands of the CAP and a greater concentration of budgetary and administrative resources on those goals. An improved level of funding for the new public goods strand of the CAP would be a major step in this direction.

Under the TFEU, there is a new reference to territorial cohesion, which is now additional to the economic and social dimensions. This reinforces the need for regionally specific rural policies which would be delivered primarily through regional policy, Pillar 2 measures, and supported by a revised Pillar 1. Under the approach proposed in this report, there would be a distinction between measures to address the goals of sustainable agricultural land management (broad scheme direct payments, operated either under Pillar 2, similar to current LFA payments, or under Pillar 1) and those which were more precisely targeted at a national and regional level and developed in response to specific objectives (operated like current agri-environmental schemes). Forestry would remain in rural development policy, and for the time being also the measures concerned with improved productivity, innovation, investment aid, training, product development, processing and marketing, the management of special sites such as the Natura 2000 network, local capacity building, infrastructure assistance and measures to address rural vitality.

The nature of the rural development challenge varies within the EU and there are several specific priorities concerning rural poverty, very small farm structures, lack of capital and training and pressing infrastructure requirements in the new Member States for example. This implies a continued concern with the social, environmental and broader rural fabric and infrastructure. It also underlines the need for a more localised and programmed approach. How far this would involve new approaches, such as more precise targeting of measures, or more focus on capacity building is outside the scope of the paper.

In this context, it has to be stressed as well that this study cannot assess which type of measures are most effective for the economic and social development of rural regions: Classical regional policy measures have often favoured small urban centres, but in principle they are open to farm sector support as well. Rural development measures from Axis 3 (say village removal) partly overlap with regional policy in that they clearly go beyond agriculture, and sometimes direct payments to farmers are also advocated with their alleged impacts or even necessity for the "rural fabric". The relative effectiveness and

efficiency of these measures cannot be assessed in the context of this study, and it also extends to the appropriate institutional responsibility (e.g. DG Regio vs. DG Agriculture) for such general economic policies in rural regions. This was at least the conclusion from the first discussions in this consortium. However, the recommended re-focusing of direct payments does not pre-empt any decisions in this domain.

A new pattern of direct payments would alter the distribution of CAP funds between farms, regions and Member States. Given the objectives proposed and the current distribution of public good provision in Europe (more concentrated in southern and central Europe for many public goods), there is however the likelihood of a more equitable pattern of distribution across Europe in the future. This would address some of the well-known criticisms of Pillar 1 as being in conflict with regional and cohesion policy.

4.4. Linkages to other policies

Over the last years, there has been an intense debate on the issue of "policy coherence". Indeed, many stakeholders have emphasized some contradictions between the CAP and EU environmental policy, structural policy or development policy. There is a need to consider the proposed model for direct payments in a broader context.

Assistance policy

Regarding the compatibility of the proposed model and the food programmes, there is no apparent source of incoherence. Historically, food programmes in the EU (i.e. "Programme for deprived persons", the "School milk" and the "School fruit" programmes) have attempted both to reduce surplus quantities and give support to the poor, through free or low cost food. Due to market developments and the ongoing reform processes, these programmes have undergone large changes.⁶⁸ As intervention stocks gradually declined in the past the bulk of the budget went to monetary transfers (90% in 2008). This trend will be set to continue regardless of the reform of the SPS and the proposed model will not have any special impact.

The only possible concern would be that more explicit targeting of the CAP budget towards public goods might lead to a reduction in EU agricultural supply. The availability of surplus quantities that can be granted to charities and other assistance institutions might decline. There is, however, no obvious sign that the current SPS has a significant impact on production. With the proposed model, supply might even increase if current decoupled payments are replaced with payments for public goods produced jointly with food products. Conversely, a more ambitious assistance policy for EU poor consumers (which is requested by some of the stakeholders as explained in section 2.1) would provide some indirect support to markets prices, as suggested by the US example (see EP, 2009).

Development policy

Past CAP reforms have largely addressed the criticisms of organizations that have long accused the CAP of hurting farmers in poor countries because of subsidies and export refunds. The current CAP no longer has dramatic consequences in this area. In that

⁶⁸ The Programme for deprived persons has the largest volume compared to the other programmes and is the only one so far solely financed by EU budget. It is covered under the budget line for intervention and therefore has not to be co-financed. The overall budget tripled since the beginning up to €300 million in 2008. For 2010, €480 million is foreseen for food aid programmes plus 1.7 million tons intervention products (cereals, butter, milk powder).

respect, the proposed model would not make a considerable difference with the current system of payments either. By targeting the CAP budget more explicitly on the provision of public goods, the distortions on world markets should be even further reduced.

The proposed model should not raise any problem of incoherence with EU trade and development policies (see section 3.6.1.). Alternative options for a reformed SPS, in particular if direct payments were made countercyclical, could have such consequences, by encouraging more production and potentially affecting price variability in third markets.

Competition policy

There are several areas in which there is an apparent lack of coherence between the CAP and EU competition policy. Even under the single Common Market Organization, some producers in particular sectors benefit from guaranteed prices and pre-determined quantities whose economic effects are close to the ones encountered with a producers' cartel (e.g. sugar). Others benefit from financial incentive to be organized in a way that is rather similar to collusion (e.g. fruit and vegetables). The proposed model for direct payments does not introduce modifications to these issues. By lowering the income support component of the direct payments, it might nevertheless expose more farm producers to the excessive concentration that seems to be accepted in the retail sector and parts of the food industry.

With the proposed model, the main concern regarding competition issues is the possibility of distortions that could result from the flexibility left to Member States to adjust the level of payments. This is already an issue, given the different attitudes adopted by Member States in terms of voluntary modulation and Article 68 provisions (Regulation 73/2009). Even the current Pillar 2 measures lead some countries to focus more than others on helping farmers to become more competitive (e.g. Belgium decided to spend 50% of its second pillar payments for the 2007-2013 programming period on this objective. Ireland, in contrast, spends only 10% to enhance farm competitiveness, but 80% to improve the environment and the countryside, although national payments should also be taken into account for a complete picture).

The flexibility left to Member States in the definition of the "income support" component may be an extra source of concern. For subsidiarity reasons, the regional variation of payments, the exact rules for capping par ha payments and the (co-financed) overall amounts should be ultimately decided at the Member State level, within certain limits. As the income support should be at least as decoupled as the current SPS, any distorting impacts on competition will be limited. The "public goods" component of the proposed model could be a genuine source of worry, given that it might increase the risk of unfair competition in the single market, in particular in the case of broad schemes with moderate conditionality. But these differentiated policies are not more worrying than other forms of distortions, such as the hidden subsidies for farmers (very low prices for water used in agriculture in some countries, tax reductions for fuel, privileged social security arrangements and subsidized loan interests) and the different production standards (implementation of EU law and more far-reaching national legislation). To ensure that the interference with the internal market arising from more decentralized direct payments is minor, it is advisable to tighten the control exercised by the European Commission.

Cohesion policy

Current Pillar 1 budgets do not contribute much to cohesion objectives, given their uneven benefits across countries, regions and sectors (see section 1.4.). However, the proposed model may raise some inconsistencies with the cohesion policy. The principle of national envelopes, together with the flexibilities left to Member States on how to spend these can be seen as being contrary to cohesion principles. However, it would clarify the debate that has often mixed cohesion objectives and some petty "juste retour" calculations. Member States and the European Parliament would have to agree on which matters they want to decide on and finance together at the EU level, and which should be left to the national or local governments.

Social problems are not immediately addressed by the CAP or cohesion policies, but they are nonetheless important high ranking objectives. The proposed model also does little to address social issues, in particular in New Member States, where rural poverty is widespread. In these countries, the access to the SAPS has played an important role in improving the life of farmers, but also in engendering stronger support for European integration in rural areas, even though the polarity of farm structures has made the benefits uneven and has induced some social controversies. The shift towards remuneration for the provision of public goods may be difficult because of the limited ability of small farmers to enter a contractual framework. A social policy remains necessary in the New Member states, but also in other Member states, where rural areas have been hit by the economic crisis.

There is arguably some degree of specificity in the situation of farmers. For example, a consequence of the special use of land as a collateral is that poor farmers would be eligible for regular social safety nets only after selling their land. Farmers are a particularly poor segment of the population in some Member States. Often they live in economically fragile areas that deserve special attention. In some regions, particularly in the New Member States, small farms also need some resources to improve their efficiency and competitiveness. But in most cases these issues fall under general welfare support or social policy under national competence, where consideration of particularities of farm households may be needed.

The question as to what measures are most conducive to cohesion and effectively support the economic catching up process of lagging European regions and Member States is a difficult one. Consideration should be given as to whether direct payment to farmers are the most effective policy in view of cohesion. But the co-financing needs to obtain CAP funding will weigh more heavily in those poorer countries that are supposed to use their scarce funds for growth stimulating policies. It is recommendable therefore to vary the co-financing rates in some relationship to GDP to avoid this drain of funds from poorest countries.

5. Conclusions and strategic recommendations for the European Parliament with regard to codecision

Setting objectives and principles first

Decisions taken at the Council level have often reflected compromises preserving national interests. Budgetary returns and the externalization of costs onto other Member States have often played an important role. The new institutional framework resulting from the TFEU and the new role of the European Parliament provide the opportunity to implement policies that put the European interest ahead of legislative obstacles that may be overcome and considerations of net returns.

Because of the share of the SPS in the overall CAP budget, the future SPS model will be a key component of the future CAP. The design of the future scheme should be part of a global vision for the future European agricultural and rural development policy. This requires agreeing first on long term objectives and on principles regarding subsidiarity as well as the way in which agricultural and rural development policies should be financed. One difficulty is that there is no longer a consensus on the official objectives of the CAP, defined some 50 years ago but in practice amended by many Council declarations and Commission initiatives.⁶⁹

Defining new objectives is clearly beyond the scope of this report. In our propositions, we rely on the idea that the CAP objectives should keep pace with the demands of the European society. This includes food security and safety, which refers more to market management and regulation; the competitiveness of the agrifood sector, that should be fostered by investment in research and an appropriate legal framework; and the provision of public goods, that should be targeted by direct payments to a greater extent than under the current CAP. We also rely on the idea that general principles should be based on the concept of fiscal federalism. In brief, the CAP budget should focus on remunerating the provision of the public goods associated with agriculture and to those cases where the lack of common policy results in an inefficient outcome at the national/local level, but acknowledging social and economic cohesion within the EU.

In the current situation, Pillar 2 measures are co-financed by national budgets and imply some effort in their implementation and justification. At the same time, Pillar 1 measures are funded by the EU budget, and their implementation is quite straightforward. This leads to a preference on the part of some Member States to implement Pillar 1 policies over Pillar 2 policies, while the former have less convincing social benefits. Co-financing of support for public goods is necessary in order to ensure a proper definition, enforcement and control of measures that need to be defined both at the EU and local level, reducing the risk of jeopardizing the single market through a renationalization of agricultural policies. It is therefore proposed to move towards a generalized co-financing of all CAP direct payments, in spite of economic, institutional and legal difficulties.

⁶⁹ As an illustration, Member States have opposed to any reference in recent Council declarations to "community preference" even though this has been a basic principle of the CAP for a long time and has never been officially repealed.

Guidelines for a reformed SPS

We draw several conclusions from our analysis of the various proposals tabled for a reform of the SPS. In the short run, income support is needed, because the dependency of farm income on the SPS would make a large part of farmers insolvent in case of a sudden abolition of Pillar 1 payments. A predictable horizon is necessary, in particular for farmers in New Member States who will be receiving increasing payments until 2013 or 2016. However, there should be a scheduled phasing out of the SPS payments and an expansion of schemes that remunerate the provision of public goods and services by farmers. Phasing in co-financing to this transitory income support scheme is also recommended.

The proposed model includes two main components, i.e. income support and contracts for the provision of services and public goods. They are in the line of the current Pillar 1 and Pillar 2 components of the current CAP, but several fundamental adjustments are proposed.

- The transitional income component would share many aspects with the current SPS, for example, the decoupling principle. But it is proposed to move further towards a flatter system. This system would rely on a per hectare basis, with caps based on labour units. Flexibility would be left to Member States to adjust and to implement other forms of means testing. There would be scope to vary the payments and cap thresholds according to regional conditions. While it is proposed that income support is progressively decreased and co-financed by Member States in similar proportions to public good payments, Member States would be allowed to transfer funds from the income support component to the second (public goods) component from the predefined national envelope and thus to speed up the transition. The co-financing rates would be adjusted so that it could vary between different categories of Member States according to a set of objective criteria such as GDP per capita. In spite of some attractive features it appears that several undesirable consequences are strong arguments against a countercyclical implementation of future direct payments.
- The public goods component of the proposed scheme, scheduled to increase over time, would combine targeted payments under contracts for specific services and a more standardized payment for desirable farming practices of a more general character, both tailored to regional conditions by Member States. This would not necessarily mean that all these schemes would remain under Pillar 2. Pillar 2 involves particular programming and administration procedures and some of the more basic public goods provision could also be handled under the lighter administrative procedures of current Pillar 1. However, the extension of co-financing would make the distinction between the current pillars mostly a managerial issue.

Assessment of the consequences of this proposal using microeconomic data suggest that the proposed criteria for allocating budgets between Member States (i.e. national envelopes based on objective criteria) and between farmers of a region (per hectare, with a cap per labour units for the income support component, and contract payments for services, without cap) would generate significant redistributions in the current budgets. These redistributions go in the direction that has been adopted by those countries that opted for the dynamic regionalization of the SFP. The shift from the current Pillar 1 payments towards a more even payment per hectare result, globally, in moving income support towards the more extensive (i.e. land intensive) sectors and regions. However, the introduction of a cap per worker generates potentially large budget savings, but also some

complex redistribution with potentially undesirable effects. This pleads for leaving Member States with a large degree of flexibility in this area.

A common framework should be maintained for the CAP to be able to appropriately address transnational challenges and European concerns such as climate protection, biodiversity, landscapes, food security and vitality of rural areas. In practice, this means that far reaching renationalization of the CAP is not justified from an economic point of view. With the public goods component becoming the key element of the future CAP, it is increasingly important to have an harmonized legislative baseline, with respect to what farmers are required to do in order to be eligible for EU support. Beyond that, a high degree of subsidiarity should be left to Member States in order to better address demands for services, better known at the local level, and to tailor measures so as to match the increasingly heterogeneous structures and situations within EU agriculture.

Implementability

Generalization of co-financing and extension of subsidiarity raise considerable economic as well as institutional issues. Common sense (and basic fiscal federalism principles) suggests that co-financing can only work as in present Pillar 2 measures, that is national funding is required in order to trigger the payment of the EU share. However Member States may decide to forego EU payments and thus also to avoid national co-financing. This implies the risk of an uneven implementation of the CAP schemes across Member States. The definition of national envelopes on the basis of objective criteria, such as land, farm population or natural resources to protect, would put a ceiling to the would-be users of EU budgets. The risk that Member States do not use their envelope is reduced in case of generalised co-financing (the small degree of utilization of Pillar 2 programmes by particular Member States comes from the availability of Pillar 1 money). Adjustment in the rate of co-financing, which could vary across Member States and possibly programmes according to objective criteria, together with the common guidelines defined above could help to address this risk. A natural criterion for variation across Member States would be GDP per capita to reflect the low funding capacity in many new Member States and some old Member States. A natural criterion for variation along programmes would be the EU level interest compared to local benefits which would be very high, for example, for climate related measures, and rather low for the transitory income component.

In a wider political perspective a durable new approach to direct payments would probably result in some redistribution of the CAP funds and the EU budget as a whole. Consequently, distributional questions going beyond the confines of the CAP will arise. These are best addressed in the debate on the EU budget for the period 2014 – 20 where questions such as the future of the structural funds, national rebates and other issues can be resolved within one package, not separately. Here the European Parliament, as a budgetary authority, also has an important role.

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Annex I. The Health Check Agreement provisions

The Health Check Reform was politically agreed by the Council of Ministers on November 20 2008 and formally adopted in January 2009. The provisions can be found in Regulations (EC) 72,73 and 74/2009 of 31 January 2009, Official Journal of the European Union L30. The main elements are indicated below.

Intervention mechanisms: Intervention is abolished for pigmeat and set at zero for barley and sorghum. For (bread) wheat, intervention purchase is possible during the intervention period at the price of €101.3 per tonne (unchanged) up to 3 million tonnes. Beyond that, purchase is done by tender. For butter and skimmed milk power, limits are 30 000 tones and 109 000 tonnes respectively, beyond which intervention is by tender.

Abolition of set-aside: The requirement for arable farmers to leave 10 percent of their land fallow is abolished. The energy crop payment is also abolished.

Phasing out milk quotas: As milk quotas will expire by April 2015 a 'soft landing' is ensured by increasing quotas by one percent every year between 2009/10 and 2013/14. For Italy, the 5 percent increase will be introduced immediately in 2009/10. In 2009/10 and 2010/11, farmers who exceed their milk quotas by more than 6 percent will have to pay a levy 50 percent higher than the normal penalty.

Decoupling of support: Payments that some Member States maintained as commodity specific under previous reforms will now be decoupled and moved into the Single Payment Scheme, with the exception of suckler cow, goat and sheep premia, where Member States may maintain current levels of coupled support.

SPS implementation: Member States are given new flexibility to opt out the historical model of allocation and opt for a regional implementation of the SPS from 2010 onwards.

Extending SAPS: EU members applying the simplified Single Area Payment Scheme will be allowed to continue to do so until 2013 instead of being forced into the Single Payment Scheme by 2010.

Assistance to sectors with special problems (so-called 'Article 68' measures): Before 2009, Member States could retain by sector 10 percent of their national budget ceilings for direct payments for use for environmental measures or improving the quality and marketing of products in that sector. This possibility will become more flexible. The money will no longer have to be used in the same sector; it may be used to help farmers producing milk, beef, goat and sheep meat and rice in disadvantaged regions or vulnerable types of farming; it may also be used to support risk management measures such as insurance schemes for natural disasters and mutual funds for animal diseases; and countries operating the SAPS system will become eligible for the scheme.

Additional funding for EU-12 farmers: €90 million will be allocated to the EU-12 to make it easier for them to make use of Article 68 until direct payments to their farmers have been fully phased in.

Using currently unspent money: Member States applying the Single Payment Scheme will be allowed either to use currently unused money from their national envelope for Article 68 measures or to transfer it into the Rural Development Fund.

Shifting money from Pillar 1 aid to Rural Development: In 2008, all farmers receiving more than €5,000 in direct aid have their payments reduced by 5 percent and the money is transferred into the Rural Development budget. This rate will be increased to 10 percent by 2012. An additional cut of 4 percent will be made on payments above €300,000 a year. The funding obtained this way may be used by Member States to reinforce programmes in the fields of climate change, renewable energy, water management, biodiversity, innovation linked to the previous four points and for accompanying measures in the dairy sector. This transferred money will be co-financed by the EU at a rate of 75 percent and 90 percent in convergence regions where average GDP is lower.

Investment aid for young farmers: Investment aid for young farmers under Rural Development will be increased from 55 000 to 70 000 euros.

Cross-compliance: Aid to farmers is linked to the respect of environmental, animal welfare and food quality standards. Farmers who do not respect the rules face cuts in their support. This so-called Cross-compliance will be simplified, by withdrawing standards that are not relevant or linked to farmer responsibility. New requirements will be added to retain the environmental benefits of set-aside and improve water management.

Payment limitations: Member States must apply a minimum payment per farm of €100 or a minimum size of 1 hectare. However, minimum thresholds can vary by country from €100 to €500 and from 0.1 hectare to 5 hectares depending on the difference between the EU average farm size and payment.

Other measures: A series of small support schemes will be decoupled and shifted to the SPS from 2012. The energy crop premium will be abolished.

IACS. Each Member State is to set up an integrated administration and control system which enables farmers' payment applications to be checked. Through this electronic system, the State is able to deal with aid applications and be assured that payments are made properly, through administrative checks and on-site checks of information provided by farmers, inter alia concerning agricultural parcels and payment entitlements.

Source: European Commission, Official Journal of the European Union, and press release http://ec.europa.eu/agriculture/healthcheck/index_en.htm

Annex II. Regulatory issues under criticism

Even though they sometimes focus on the distortions of competition that take place between EU Member states, due to different national legislations on social, fiscal and regulatory issues, farmers' associations often complain that the EU regulatory framework imposes more constraints and therefore results in higher production costs than the regulations faced by third countries producers. It is unclear to which extent these claims are well grounded, and how much this explains a lower level of competitiveness. However, different surveys and administrative enquiries in the food chain have led to identify several issues that might make EU producers in a less favourable position than foreign producers. The issues that have been identified include:

- Environmental regulations that are more constraining than in other countries, namely on pesticides and nitrates. This seems to be an issue, in particular, in the pork sector. Fruits, vegetable and wine producers also point out the fact that EU Member states have implemented taxes on some active ingredients that third country producers.
- Genetically modified products impose a growing distortion of competition. The EU livestock sector is increasingly forced to import non GM maize (mainly from Brazil) while Brazilian exporters of beef that compete with them are allowed to use their GM maize. This leads to the paradox where Brazilian meat producers imports GM maize from the US while Brazilian maize producers export non GM maize to the EU. In practice this "triangular trade" results in EU meat producers to be levied some 70 dollars per ton of maize because of the EU regulation on GM, for not importing directly maize from the US. Even for non GM crops, EU producers are subject to intellectual property rights that seem to be enforced in a much stricter way than in transition countries, where non compliance of foreign producers with intellectual property rights allow access to cheaper seeds.
- Growth promoting hormones and other activators in the beef sector, and somatotropin (rbGH) an hormone that increases milk yields by 8 to 15 percent depending on the type of livestock production are not allowed in the EU while they are used extensively in most other countries (the EU prohibits imports of hormone treated beef, but not all activators can be detected by the analysis of the meat, and the EU does not impose restrictions on dairy products, in particular because the use of hormones cannot be detected in the final product)
- The obligation of traceability and segregation has increased the costs along the food chain, while the obligations on imported products seem to be less constraining, in particular in the beef sector.
- Animal welfare regulations are seen as involving a cost increase between 3 to 15 percent in the poultry sector (eggs), and to some extent in the pork sector.
- Market authorization for phytosanitary products. Even though the conditions differ a lot between Member states, some of them (Poland, Spain) allowing products that other prohibit, it seems that the present procedures result in significant distortions of competition in the fruits and vegetable sectors, compared to countries such as China. In these distortions of competition, differences in the list of authorised molecules are emphasised by cumbersome administrative procedures and delays regarding homologation and approval.

- Regulations on mycotoxins, heavy metals and pesticide residues are said to be stricter in the EU, even though inspection also deal with imported products. Regulations on animal waste impose costs that might not be faced by South American producers. This involves compulsory procedures for rendering, restrictions to the utilization of byproducts (some by products cannot be used in pet food and gelatins, some offals are not allowed to be sold resulting in an extra cost compared to foreign producers). The conditions of cleaning for decontamination of poultry carcasses are more lenient in third countries, and the ex post use of chlorine is widespread while in the EU low levels of salmonella must be achieved by risk management techniques. The definition of "ovoproducts" seem to be more lenient in third countries, making EU processed products less competitive. The list of additives subject to regulation is larger than in other countries, and there is a lack of a harmonized list for authorized additives in feedstuffs. The terms of references for obtaining the "organic" label seem to be stricter, at least in some Member states, than outside the EU while imports are allowed.

Annex III. Budgetary allocation between Member States

This section presents the results of the budgetary allocation of payments between Member States, as presented in section 2.3

Table AIII.1 shows member states' likely share for all agriculture-related individual allocation criterion presented in section 2.3 (that is, all except GDP per capita and Purchasing Power Standards). These shares can be interpreted as extreme scenarios if the individual criteria would serve singly to define national budgetary ceilings. Current shares according to the most recent data available have been used. The exception is agricultural labour, where a future value based on recent trend has been constructed because changes are important and relatively reliable. The value is calculated taking 2008 data as a baseline and assuming that 70% of the percentage changes that occurred between 2005 and 2009 will occur again until the data is used for assigning payment entitlements.

Table AIII.1: Member states' share in potential allocation criteria

Member states	Agri. area % share	Arable crops % share	Perm. grassland % share	Perm. crops % share	Less Favored % share	Forest % share	Natura 2000 % share	Organic farming % share	Agri. labor % share
Austria	1.8	1.3	3.0	0.6	2.2	2.3	1.8	5.1	1.4
Belgium	0.8	0.8	0.9	0.2	0.3	0.4	0.6	0.5	0.6
Denmark	1.5	2.3	0.4	0.1	0.0	0.3	0.5	2.0	0.6
Finland	1.3	2.2	0.1	0.0	2.3	13.2	6.6	2.0	0.8
France	15.9	17.5	14.3	9.7	13.0	9.8	8.7	7.7	7.8
Germany	9.8	11.4	8.5	1.8	9.4	6.3	7.6	12.0	4.8
Greece	2.4	2.0	1.4	10.3	3.4	3.7	3.6	4.2	5.2
Ireland	2.4	1.0	5.5	0.0	3.4	0.4	0.9	0.6	1.4
Italy	7.4	6.6	6.1	21.2	6.9	6.2	8.1	13.3	10.7
Luxembourg	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.0
Netherlands	1.1	1.0	1.4	0.3	0.2	0.2	0.8	0.7	1.7
Portugal	2.0	1.0	3.1	5.4	3.4	2.2	2.5	3.0	2.9
Spain	14.4	11.4	15.2	39.7	21.6	15.9	20.8	15.0	8.2
Sweden	1.8	2.6	0.9	0.0	1.6	17.5	8.0	4.5	0.5
UK	9.4	5.8	17.7	0.3	9.1	1.6	3.1	9.8	2.5
EU-15	72.2	67.0	78.7	89.7	77.0	80.0	73.6	80.4	49.1
Bulgaria	1.8	2.6	0.5	0.8	0.8	2.1	5.3	0.2	3.1
Cyprus	0.1	0.1	0.0	0.3	0.1	0.2	0.1	0.0	0.2
Czech Republic	2.0	2.5	1.6	0.3	1.8	1.5	1.6	4.5	1.2
Estonia	0.5	0.6	0.5	0.0	0.4	1.4	1.3	1.1	0.2
Hungary	2.5	3.4	0.9	1.4	0.9	1.1	2.6	1.6	3.7
Latvia	1.0	1.1	1.1	0.2	1.4	1.8	1.3	2.1	0.7
Lithuania	1.5	1.7	1.4	0.2	1.6	1.2	1.1	1.6	1.3
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Poland	9.0	11.3	5.8	3.4	10.3	5.2	7.1	4.2	21.1
Romania	8.0	8.3	8.0	3.1	3.5	3.7	3.0	1.9	17.8
Slovakia	1.1	1.3	1.0	0.2	1.9	1.1	1.7	1.9	0.7
Slovenia	0.3	0.2	0.5	0.2	0.3	0.7	1.1	0.4	0.7
EU-12	27.8	33.0	21.3	10.3	23.1	20.0	26.4	19.6	50.9

Data sources: Natura 2000: DG Environment, Natura 2000 Barometer, Terrestrial Special Protection Areas and Terrestrial Sites of Community Importance, July 2009. Organic farming: FIBL, update October 24, 2009; Forest: UNECE, forest & other wooded land, 2005. All other: Eurostat.

The use of past data for UAA and forests is relatively unproblematic because these areas change little. The assumption of an unchanging distribution of agricultural land across arable crops, permanent grassland and permanent crops is more demanding. However, it is difficult to anticipate future developments, in particular because this distribution is strongly influenced by policy choices (with a shift in favor of grasslands notably in France). Similarly, recent trends cannot be used for anticipating future Natura 2000 and organic farming areas. One may rather expect relatively stronger growth in those member states that are currently trailing behind.

Based on these criteria and data, four scenarios are constructed reflecting the major dimensions of the proposed model. The weights of the respective criteria in each scenario are summarized in Table AII.2.

**Table AIII.2: Scenarios for the distribution of CAP payments
(with weights for all criteria)**

Scenarios	Primary criteria						Agricultural area differentiation		
	Ag. area	Less favored	Organic	Natura 2000	Forest	Ag. Labour	Arable crops	p. grassland	p. crops
Agricultural area	1,00	0,00	0,00	0,00	0,00	0,00	1,00	0,85	1,25
Agricultural labour	0,85	0,00	0,00	0,00	0,00	0,15	1,00	0,85	1,25
Sustainable farming	0,70	0,15	0,10	0,05	0,00	0,00	1,00	0,70	1,50
Sustainable land use	0,55	0,10	0,10	0,10	0,15	0,00	1,00	0,70	1,50

Scenario 1). The agricultural area scenario is the simplest case and can serve as point of comparison for the other scenarios. The distribution corresponds to a CAP where a significant share of the money is dedicated to income support, with a relatively flat rate across the EU that is somewhat responsive to different GDP per capita levels but independent of past entitlements. Public goods payments are supposed to be linked to agricultural areas without accounting for special areas, such as less favored or organic farming areas.

Looking at table AIII.2., this means that payments are determined exclusively by agricultural areas (factor 1.0). While the income support may be identical for all types of agricultural area, the public goods payments are differentiated to ensure adequate incentives for the provision of public goods. Each hectare of permanent grassland is rewarded somewhat less than arable crops (85%) and each hectare of permanent crops somewhat higher (125%).

As argued in section 3.4.1 a correction for member states' differences in GDP per capita is needed. Member states get the more for each hectare, the higher their GDP per capita (this is equally handled in all scenarios). The relationship is exponential, with an exponent of 0.25, so that the effect of differences in GDP per capita is softened. This means, for instance, that a country that has a GDP for per capita that is 50% above the EU average will receive only about 10% more payments for a given level of entitlements based on the other allocation criteria.

Scenario 2). The agricultural labour scenario considers a distribution in which 15% of the payments are determined by agricultural labour. This could, for instance, result from a future CAP in which 30% of the direct payments are dedicated to income support, whose allocation depends for 50% on labour, whereas the remaining direct payments for the provision of public goods are independent of labour. The GDP factor (with the same exponent of 0.25) is applied to the entitlements stemming from agricultural labor, partly because labour-related expenses will be higher in high-income countries.

Scenario 3). The sustainable farming scenario differs from the agricultural area scenario in two regards. First, less favoured areas (that would need a clear agri-environmental focus, unlike current schemes), organic farming and Natura 2000 are responsible for 15%, 10% and 5% of the payment allocation. Second, the differences in payments per hectare of arable crops (100%), permanent grassland (70%) and permanent crops (150%) are more pronounced. The reason for this is that a larger share of the budget is invested into public goods schemes (rather than income support) and that these schemes need such differentiation to set adequate incentives for farmers. Such a differentiation can also be found in many current second pillar programs.

Scenario 4). The sustainable land use scenario expands on the sustainable farming scenario by also including forest areas as an entitlement criterion (15%) and by placing additional value on Natura 2000 areas which may cover forests (10%).

The weights given to each criterion appear to be within a reasonable range but their only purpose is to illustrate. Past payment levels for different areas cannot be used to derive weights because they differ exceedingly across member states, and there is no evidence as to what would constitute optimal payment levels. This depends on society's valuation of public goods; on the efficiency of the measures corresponding to the allocation criteria in producing the public goods (e.g. the relative cost of greenhouse gas emission reductions through sustainable forest management vs. organic farming); and governments' ability to tailor payments to the necessary minimum for the delivery of the desired quantity and quality of public goods. Furthermore, optimal distribution will depend on the size of the total available payments – that is, on the CAP budget and co-financing rates – and on the share dedicated to public goods payments. For example, the marginal return for society of dedicating money to less favoured areas will probably decline more strongly than the marginal return for agri-environmental schemes eligible in all areas. The greater the funds available for public goods payments, the smaller thus the share that should be given to less favoured areas. Last but not least, land-use related payments outside the CAP influence the optimal allocation of CAP money. This concerns especially the future financing of environmental payments under the structural and cohesion funds.

Table AIII.3 shows the distribution of payments across member states. It compares the 2008 and 2013 distribution (based on direct payments and the second pillar but excluding market intervention) as well as the four scenarios.

One result is that the distribution of payments between the EU-15 and the EU-12 will remain quite stable after 2013 compared to 2013 levels, regardless of the criteria that are used. The share of the EU-15 will decrease slightly in the agricultural labour scenario, compared to 2013 levels, but slightly increase in the three other cases. The sustainable farming and sustainable land use scenarios are the most favourable for the EU-15.

Another crosscutting finding is that the distribution across individual Member States varies strongly from one scenario to another. The payment differences are extreme for Sweden (and Finland), which would get 1.9% (1.5%) under the agricultural labour scenario but 5.8% (4.4%) under the sustainable land use scenario. In both countries, employment in agriculture is low, whereas forests and Natura 2000 sites are considerable.

A large group of Member States will win in some scenarios and lose in others. The only Member States that would win in all scenarios are Luxembourg, Spain, Sweden, Estonia, Latvia and Lithuania. The persistent losers would be Belgium, Denmark, Germany, Greece,

Ireland, Italy, the Netherlands, Bulgaria, the Czech Republic, Hungary, Slovakia and Malta. The results for individual member states can be explained by looking at their weight in the distribution criteria (table AIII.2) and the weights associated to each criterion in the scenario description (table AIII.2). It is worth noting that national interests, even from a purely financial perspective, are broader than the CAP payments considered (depending also on their budget contributions and their shares in alternative spending items).

Table AIII.3: Distribution of CAP payments across member states (in percentages)

Member states	2008 distribution % share	2013 distribution % share	Agricultural area % share	Agricultural labour % share	Sustainable farming % share	Sustainable land use % share
Austria	2.50	2.15	1.99	1.95	2.35	2.50
Belgium	1.20	1.16	0.87	0.84	0.72	0.66
Denmark	2.11	1.93	1.89	1.72	1.62	1.39
Finland	1.65	1.44	1.56	1.47	2.11	4.41
France	17.32	16.38	17.46	16.31	15.56	14.14
Germany	12.80	12.10	10.70	10.01	10.64	9.91
Greece	5.50	4.83	2.54	2.97	3.01	3.16
Ireland	3.12	2.83	2.60	2.49	2.36	1.91
Italy	10.40	9.71	8.11	8.70	8.78	8.53
Luxembourg	0.09	0.08	0.10	0.09	0.10	0.10
Netherlands	1.66	1.67	1.24	1.35	1.00	0.88
Portugal	2.22	2.03	1.86	2.02	2.16	2.15
Spain	12.39	10.74	15.30	14.45	16.86	16.89
Sweden	1.91	1.73	2.12	1.92	2.72	5.83
United Kingdom	7.97	7.92	9.57	8.64	8.88	7.41
EU-15	82.83	76.71	77.91	74.94	78.87	79.88
Bulgaria	1.43	1.63	1.23	1.38	1.16	1.33
Cyprus	0.08	0.12	0.09	0.12	0.10	0.12
Czech Republic	1.48	2.23	1.85	1.75	2.01	1.92
Estonia	0.26	0.36	0.45	0.42	0.52	0.67
Hungary	2.07	3.18	2.11	2.28	1.87	1.73
Latvia	0.69	0.50	0.84	0.81	0.98	1.07
Lithuania	0.78	1.06	1.25	1.23	1.23	1.17
Malta	0.05	0.03	0.01	0.01	0.01	0.00
Poland	6.09	8.18	7.39	8.98	7.07	6.39
Romania	3.01	4.38	5.65	6.82	4.50	3.98
Slovakia	0.85	1.18	0.97	0.93	1.15	1.14
Slovenia	0.38	0.43	0.26	0.33	0.55	0.60
EU-12	17.17	23.29	22.09	25.06	21.12	20.12

Source: Own calculation. Data sources: Natura 2000: DG Environment, Natura 2000 Barometer, Terrestrial Special Protection Areas and Terrestrial Sites of Community Importance, July 2009. Organic farming: FIBL, update October 24, 2009; Forest: UNECE, forest & other wooded land, 2005. All other: Eurostat.

Future calculations of payment distributions could unbundle some of the criteria. Entitlements for organic farming could be further differentiated on a product basis (e.g. separate rates for vegetables). Forest areas may be treated differently according to their public goods value (see e.g. the MCPFE classes). Payments for Natura 2000 areas could be

made conditional on the type of land-use within these areas (e.g. somewhat higher for agricultural area than for forests and significantly higher than for non-productive alpine areas). One could also include marine Natura 2000 areas (with a suitable entitlement level per hectare) if land use is interpreted broadly. The definition of less favoured areas is rightly being reconsidered by the Commission. A new definition might permit to differentiate payment entitlements across types of less favoured areas, in response to the degree of disadvantage of these areas and the provision of public goods that can be expected from them.

Another improvement would be to add additional criteria. For instance, the scenarios discussed above do not address the livestock sector. However, significant investments will be needed to reduce the greenhouse gas emissions of livestock. It may thus be reasonable to provide payment entitlements to member states for livestock units, possibly weighted by livestock intensity (so as to encourage extensive livestock management and to account for the higher costs of greenhouse gas emission reductions in extensive livestock management).

Finally, one should account for overlaps of areas. One piece of land may, at the same time, be less favoured, located in a Natura 2000 area and organically cultivated. Such a piece of land should not give full entitlement to payments under all three area-based criteria.

The non-linear adjustment for differences in GDP per capita on which above scenarios are based is only one approach to handle income differences. Table AIII.4 compares the agricultural area scenario with a non-linear adjustment (column 3, keeping the exponent of 0.25 as in Table AIII.3) with the results obtained without adjusting for GDP-per-capita differences (column 1) and with a linear 100% reflection of GDP-per-capita differences (column 4). In the latter case, a Member State that has identical agricultural areas as another but a GDP per capita that is 20% higher, it will also obtain 20% more money. These two variations mark the outer boundaries of reasonably imaginable approaches to handling income differences and they show the sensitivity of the results with regard to this issue. The share of the EU-12 is almost three times larger without any adjustment than with linear GDP-per-capita adjustment, and Bulgaria would even get five times as many payments without any adjustment.

It is also possible to disregard GDP-per-capita differentials and to adjust for differences in purchasing power instead. Column 2 of Table AIII.4 does this with a linear adjustment (i.e. a Member State where the costs of living are 20% above EU average sees its entitlements increased by 20%). Purchasing-power adjustment is less beneficial for the EU-15 than GDP-per-capita adjustment, but the non-linear GDP-per-capita adjustment is preferable for the EU-15 compared to the linear purchasing-power adjustment. However, this aggregation masks country-level differences: Finland, for instance, is affluent but even more expensive to live in, so that a strong consideration of purchasing power standards is especially desirable for Finland. The linear adjustment for purchasing power differences and the non-linear adjustment for GDP-per-capita differences produce rather similar results compared to the extreme case of a linear GDP-per-capita adjustment.

Adjustments for differences in GDP per capita and purchasing power can also be combined. Since high GDP per capita and high costs of living are strongly correlated, this would lead to strong differences across Member States. These differences can be accommodated through a low weight attributed to GDP-per-capita and cost-of-living differentials in the distribution key. In sum, much depends both on the basis for adjustment (GDP, purchasing power) and on the formula being applied.

Table AIII.4. Distribution of CAP payments across member states (in percentages), variations of the agricultural area scenario

GDP adjustment PPS adjustment	no	no	non-linear	linear
	no % share	linear	no % share	no % share
Austria	1.77	1.98	1.99	2.56
Belgium	0.78	0.92	0.87	1.08
Denmark	1.58	2.38	1.89	2.88
Finland	1.37	1.82	1.56	2.05
France	15.93	18.75	17.46	20.79
Germany	9.77	10.77	10.70	12.74
Greece	2.54	2.54	2.54	2.32
Ireland	2.21	2.99	2.60	3.87
Italy	7.68	8.62	8.11	8.67
Luxembourg	0.07	0.09	0.10	0.25
Netherlands	1.08	1.20	1.24	1.68
Portugal	2.00	1.85	1.86	1.35
Spain	14.83	15.04	15.30	15.21
Sweden	1.86	2.27	2.12	2.83
United Kingdom	8.79	9.34	9.57	11.17
EU-15	72.27	80.55	77.91	89.45
Bulgaria	1.81	0.97	1.23	0.35
Cyprus	0.09	0.09	0.09	0.09
Czech Republic	2.04	1.58	1.85	1.24
Estonia	0.52	0.43	0.45	0.27
Hungary	2.51	1.82	2.11	1.13
Latvia	1.01	0.78	0.84	0.44
Lithuania	1.52	1.04	1.25	0.63
Malta	0.01	0.00	0.01	0.00
Poland	9.02	6.62	7.39	3.68
Romania	7.80	5.05	5.65	1.94
Slovakia	1.12	0.83	0.97	0.57
Slovenia	0.27	0.24	0.26	0.21
EU-12	27.70	19.45	22.09	10.55

Column 1 = weighted average of arable land, grassland and permanent crops area shares with weights from Table III.2

Column 2 = Column1*PPS(MS)/100 where PPS = purchasing power standards in 2008 from Eurostat, table 'Comparative price levels of final consumption by private households including indirect taxes (EU-27=100)'

Column 3 = Column1*(GDP (MS)/100)**0.25 where GDP = GDP per capita compared to the EU average in 2008 from Eurostat, table 'GDP and main components - Current prices'

Column 4 = Column1*GDP (MS)/100 where GDP is taken from the same source as in column 3

An additional scaling has been applied for each transformation to ensure that shares add up to 100%.

Annex IV. Tables underlying figures

Data used for Figure 1.1. Direct payments, national values in FADN million Euros

Subsidies per farm in 2006				Subsidies per farm in 2007			
	Coupled	Decoupled	Second pillar		Coupled	Decoupled	Second pillar
DAN	1421	28258	2566	DAN	1513	28452	1820
ESP	1797	3759	509	ESP	1731	3285	372
BEL	3529	13693	2254	FRA	7193	17100	3191
ELL	783	4451	758	BEL	4838	14233	2733
FRA	7626	17097	4001	DEU	496	27867	4194
CYP	2108	807	503	ELL	709	4467	814
DEU	499	27816	4957	ITA	414	4431	839
ITA	476	4715	975	CYP	3429	908	1069
HUN	3297	4817	1661	NED	1608	11657	3597
NED	8591	4775	3122	UE25	1551	7356	2578
UKI	426	38625	9610	UKI	131	36363	11389
MLT	8315	0	2158	POR	1446	2506	1368
UE25	1867	7283	2531	HUN	2831	5460	3316
CZE	19085	20846	14927	SVE	2866	21797	10716
POR	1848	2081	1595	IRE	1	13362	6477
SVE	5303	18944	10031	MLT	7681	788	4168
IRE	5	12973	6200	SVK	35615	43766	60914
LTU	2587	2393	2805	LTU	1691	2900	3728
SVN	2777	0	1650	LUX	22	21849	18450
EST	4844	4660	6889	SUO	12956	11670	22160
SUO	12562	11631	18741	OST	1204	8142	9516
LUX	151	22031	18371	SVN	234	2887	3262
SVK	19411	33520	44274	LVA	2736	1997	5767
LVA	3827	1633	5807	EST	2533	5481	11355
OST	2476	6815	10991	CZE	168	23668	34566
POL	55	1207	2351	POL	44	1376	2323

Sources FADN, 2006 and 2007

Data used for Figure 1.2. Share of direct payments in total output, national values in FADN

	% output 2006	% output 2007
NED	4.7	4.3
BEL	11.4	9.7
ITA	11.8	11.4
DAN	12.7	11.6
CYP	14.8	12.6
POL	16.1	14.0
ESP	16.6	15.6
DEU	18.6	16.3
MLT	18.9	18.8
UE25	18.9	18.9
HUN	21.4	19.3
FRA	22.1	20.4
CZE	23.1	21.1
UKI	23.5	21.4
LUX	23.9	22.4
POR	24.8	22.7
EST	25.5	23.7
SVE	25.5	23.9
SVK	28.7	27.0
SVN	30.7	27.1
OST	32.8	27.6
LTU	33.7	28.1
ELL	34.0	29.5
LVA	34.7	31.2
IRE	52.0	46.1
SUO	61.7	57.3

Sources FADN, 2006 and 2007. Output defined without direct payments. Pillar 1 and Pillar 2 payments are included in the percentage

Data used for Figure 1.3. Direct payments per worker (AWU), national values in FADN, 1000 euros

	Pillar 1	Pillar 2	Direct payments
Poland	0.718	1.366	2.084
Slovenia	1.52	0.965	2.486
Cyprus	2.587	0.446	3.034
Portugal	2.391	0.984	3.375
Lithuania	2.511	1.49	4.001
Italy	3.909	0.735	4.644
Spain	4.252	0.413	4.665
Latvia	2.161	2.672	4.833
Greece	4.363	0.633	4.995
Estonia	3.203	2.395	5.599
Malta	4.587	1.19	5.777
Hungary	4.26	1.707	5.966
Slovakia	3.3	2.783	6.084
Netherl	5.033	1.191	6.224
UE25	5.681	1.691	7.372
Czech	4.785	2.591	7.377
Belgium	9.012	2.058	11.07
Austria	5.83	7.409	13.24
France	12.83	2.076	14.9
Germany	12.34	2.88	15.22
Ireland	11.47	5.479	16.95
UK	16.58	4.087	20.66
Denmark	19.14	2.184	21.32
Sweden	16.08	7.09	23.17
Luxembg	13.5	11.99	25.49
Finland	16.35	12.66	29.01

Source FADN, 2006

Data used for Figure 1.4. Direct payments, national values in FADN, 2006 and 2007

	BEL	CYP	CZE	DAN	DEU	ELL	ESP	EST	FRA	HUN	IRE	ITA
Subsidies / AWU by quintile												
Without subsidies												
Q1	1.1	0.4	1.3	6.8	2.8	0.7	0.5	1.0	3.0	0.5	5.1	0.4
Q2	6.3	1.2	4.7	17.5	9.9	2.1	1.2	3.0	11.8	1.7	10.6	1.5
Q3	11.8	2.0	6.8	22.8	14.5	3.9	3.2	4.5	18.2	3.8	15.7	3.0
Q4	17.8	4.1	10.2	29.5	20.4	7.1	6.8	7.0	25.6	7.4	21.8	5.5
Q5	33.0	11.5	23.7	48.1	34.2	19.9	20.9	16.6	42.7	17.2	36.2	20.2
Total	11.1	3.0	7.4	21.3	15.2	5.0	4.7	5.6	14.9	6.0	16.9	4.6

% farms without subsidies												
%	3.0	0.5	7.1	1.7	4.0	5.4	20.5	2.8	9.6	5.0	0.0	22.4

	POL	SVN	CYP	POR	LTU	ITA	ESP	LVA	ELL	EST	MLT	HUN
Mean	2.1	2.5	3.0	3.4	4.0	4.6	4.7	4.8	5.0	5.6	5.8	6.0
Quintile 5	5.7	7.5	11.5	13.4	11.2	20.2	20.9	14.0	19.9	16.6	17.1	17.2
Quintile 1	0.4	0.5	0.4	0.5	0.8	0.4	0.5	0.7	0.7	1.0	0.8	0.5
Mean	2.1	2.5	3.0	3.4	4.0	4.6	4.7	4.8	5.0	5.6	5.8	6.0
%	1.3	2.2	0.5	0.4	0.0	22.4	20.5	0.7	5.4	2.8	6.8	5.0

	LTU	LUX	LVA	MLT	NED	OST	POL	POR	SUO	SVE	SVK	SVN	UKI	EU25
Subsidies / AWU by quintile														
Without subsidies														
Q1	0.8	6.2	0.7	0.8	1.0	4.0	0.4	0.5	10.4	7.2	1.4	0.5	6.1	1.6
Q2	1.5	20.3	1.7	2.1	5.1	8.6	1.0	1.4	20.7	15.3	3.5	1.3	16.3	4.4
Q3	2.3	26.9	3.0	3.5	10.0	12.1	1.6	2.4	30.9	21.1	5.6	2.1	23.3	7.0
Q4	3.6	34.9	5.6	6.5	15.5	17.1	2.4	4.3	47.4	30.8	8.9	3.2	32.8	10.6
Q5	11.2	50.0	14.0	17.1	32.8	32.0	5.7	13.4	85.0	56.8	20.1	7.5	56.9	21.7
Total	4.0	25.5	4.8	5.8	6.2	13.2	2.1	3.4	29.0	23.2	6.1	2.5	20.7	7.4

% farms without subsidies														
%	0.0	0.4	0.7	6.8	19.6	0.0	1.3	0.4	0.0	3.3	1.9	2.2	4.6	10.8

	SVK	NED	EU25	CZE	BEL	OST	FRA	DEU	IRE	UKI	DAN	SVE	LUX	SUO
Mean	6.1	6.2	7.4	7.4	11.1	13.2	14.9	15.2	16.9	20.7	21.3	23.2	25.5	29.0
Quintile 5	20.1	32.8	21.7	23.7	33.0	32.0	42.7	34.2	36.2	56.9	48.1	56.8	50.0	85.0
Quintile 1	1.4	1.0	1.6	1.3	1.1	4.0	3.0	2.8	5.1	6.1	6.8	7.2	6.2	10.4
Mean	6.1	6.2	7.4	7.4	11.1	13.2	14.9	15.2	16.9	20.7	21.3	23.2	25.5	29.0
%	1.9	19.6	10.8	7.1	3.0	0.0	9.6	4.0	0.0	4.6	1.7	3.3	0.4	0.0

Source FADN, 2006 Annual Worker Units

Data used for Figure 2.1. Changes in direct payments following a flat rate per ha either at the EU level or at the Member state level (compared to the 2013 benchmark)

	Member State	Flatrate €/ha	
		MS	EU
EU-15	BEL	-1.23	-41.20
	DAN	2.56	-30.68
	DEU	-5.83	-27.46
	ELL	-23.44	-64.54
	ESP	-15.77	8.63
	FRA	-5.39	-18.76
	IRE	5.54	-13.24
	ITA	-1.87	-23.79
	LUX	-0.24	-6.24
	NED	11.04	-36.95
	OST	-17.65	-6.96
	POR	12.01	70.96
	SUO	-8.31	-1.90
	SVE	-6.11	1.13
	UKI	-7.31	-0.16
nEU-10	CZE	3.47	6.60
	EST	2.67	145.09
	HUN	23.64	5.56
	LTU	1.99	89.27
	LVA	3.37	233.34
	POL	-1.17	33.80
	SVK	6.67	41.72
	SVN	-3.73	-13.13
nEU-2	BGR	44.11	43.77
	ROU	-33.74	36.30

Source: EU-FADN 2007

Data used for Figure 2.2. Change in direct payments (DP) following modulation and a cap per AWU, in percentage change compared to the 2013 benchmark

	Member State	Nat. implem.	Nat. implem. incl. Capping/AWU
EU-15	BEL	-7.97	-10.93
	DAN	-8.53	-15.29
	DEU	-8.95	-17.73
	ELL	-4.21	-4.31
	ESP	-6.69	-10.13
	FRA	-8.35	-10.78
	IRE	-6.78	-7.53
	ITA	-6.41	-13.98
	LUX	-8.06	-8.08
	NED	-7.57	-9.24
	OST	-5.59	-5.60
	POR	-5.69	-8.69
	SUO	-6.68	-7.02
	SVE	-8.12	-11.86
	UKI	-8.92	-17.46
EU-10	CZE	-10.11	-11.49
	EST	-7.17	-7.42
	HUN	-8.36	-11.45
	LTU	-5.25	-5.50
	LVA	-4.74	-4.94
	POL	-2.85	-3.11
	SVK	-10.28	-12.39
	SVN	-2.75	-2.75
nEU-2	BGR	-8.21	-10.90
	ROU	-4.79	-6.53

Source: EU-FADN 2007

Data used for Figure 2.3. Changes in direct payments (DP) with modulation and capping / AWU, scenario of a uniform rate per ha at the Member State level

	BEL	DAN	DEU	ELL	ESP	FRA	IRE	ITA	LUX	NED	OST	POR	SUO	SVE	UKI
1	1211	812.0	-4.2	258.1	200.7	979.0	778.7	336.1	327.5	897.4	332.8	222.1	247.3	255.2	-20.2
2.5	233.2	82.1	1.1	46.8	45.2	270.2	193.0	48.8	120.8	266.5	98.3	89.6	165.5	102.6	31.7
5	115.1	40.5	-0.9	-7.5	15.4	110.9	76.6	15.0	41.8	130.3	24.3	7.2	88.3	26.0	-6.2
7.5	59.8	23.6	-7.1	-27.1	-20.6	69.9	65.9	11.8	34.3	64.4	-5.1	-8.1	43.4	7.4	11.7
10	37.6	7.3	-9.9	-44.3	-17.4	37.2	34.6	8.0	4.5	51.1	-6.2	-18.3	22.1	5.4	-16.5
12.5	12.4	15.4	-10.9	-42.6	-25.9	15.9	14.9	5.3	1.4	36.6	-27.6	-9.9	-15.1	-0.3	-15.6
15	8.8	9.5	-11.8	-46.2	-25.5	22.9	4.9	-13.1	1.2	14.4	-31.9	-24.2	3.5	-5.1	-17.0
17.5	2.3	-3.0	-12.1	-40.0	-31.0	-0.5	-4.2	-12.2	-3.9	9.5	-36.9	-12.2	-20.2	2.7	-21.1
20	-7.3	6.0	-12.9	-54.3	-37.1	-6.4	-18.2	-19.8	-6.2	1.8	-30.5	-30.1	-5.8	-5.9	-24.1
25	-7.2	0.1	-13.6	-51.0	-31.6	-12.0	-8.7	-9.4	-13.1	-10.5	-38.5	-24.0	-29.5	-7.9	-8.7
50	-13.4	-4.7	-14.0	-56.3	-34.9	-18.6	-29.0	-30.6	-17.9	-18.8	-46.1	4.0	-37.4	-18.9	-9.5
100	-29.8	-13.5	-15.6	-63.8	-49.8	-26.2	-41.3	-46.1	-10.7	-34.0	-42.4	-22.0	-61.5	-22.3	-29.1
200	-50.7	-30.1	-33.2	-60.9	-58.7	-37.1	-50.4	-59.6		-59.9		-63.8	-69.7	-37.4	-36.2
300		-49.9	-39.4		-65.4	-57.4		-69.1		-63.6		-81.5		-52.4	-49.7
399		-64.5	-38.5		-80.2			-83.0						-73.6	-57.6

Source: EU-FADN 2007

Data used for Figure 2.4. Changes in direct payments, modulation and capping / AWU, scenario of a uniform rate per ha at the Member State level

DP class 1000 €	CZE	EST	HUN	LTU	LVA	POL	SVK	SVN	BGR	ROU
1	15.6	465.4	29.1	1.7	52.9	-1.2	6.0	149.7	33.2	-31.9
2.5	12.4	202.3	23.8	4.0	10.1	-1.2	47.5	27.9	30.3	-34.9
5	6.6	12.8	22.4	1.9	7.2	-1.2	62.0	3.2	30.6	-32.9
7.5	2.5	8.0	18.9	-0.2	-1.0	-2.8	6.5	-18.2	35.8	-35.2
10	-1.3	2.5	16.3	-2.7	-4.2	-5.2	3.3	-28.8	23.2	-36.5
12.5	-1.9	-7.2	15.3	-4.0	-0.3	-6.6	0.9	-24.7	21.5	-37.4
15	-3.0	-5.7	14.2	-4.5	-6.3	-7.4	-0.7	-43.9	23.2	-37.6
17.5	-3.7	-5.5	13.5	-5.3	-3.7	-8.0	-1.4	-24.5	20.8	-36.9
20	-4.5	-13.3	13.9	-5.7	-8.2	-8.4	4.1	-29.0	20.1	-39.0
25	-5.0	-13.1	12.6	-6.2	-4.4	-8.8	-2.3	-45.4	19.0	-35.7
50	-5.6	-10.8	12.0	-6.7	-10.1	-9.6	-2.2	-51.8	24.6	-39.2
100	-6.2	-13.3	11.2	-7.6	-13.3	-10.3	-3.2	-44.5	22.5	-40.0
200	-6.3	-15.2	10.9	-8.0	-14.9	-10.7	-4.0		17.2	-38.5
300	-6.8	-16.4	11.3	-8.2	-17.8	-10.9	-4.0		17.0	-41.1
399	-8.6	-18.1	9.2	-9.4	-17.2	-12.6	-5.5		15.7	-43.1

Source: EU-FADN 2007

Data used for Figure 2.5. Change in FFI and labour costs, modulation incl. capping/AWU scenario of a uniform rate per ha at the EU level

DP class 1000 €	CZE	EST	HUN	LTU	LVA	POL	SVK	SVN	BGR	ROU
1	2.3	131.6	1.6	6.8	61.9	3.5	0.0	22.6	4.1	8.4
2.5	2.8	59.0	2.3	28.7	72.7	9.3	13.3	20.9	8.5	11.4
5	3.7	65.4	3.0	32.1	67.5	10.8	28.0	-4.5	13.8	13.4
7.5	4.3	94.6	2.7	33.9	72.1	10.2	20.9	-14.4	22.4	13.3
10	3.3	69.9	2.9	34.8	78.9	9.9	27.3	-18.8	19.0	16.0
12.5	4.4	76.6	3.3	29.1	74.8	9.8	20.2	-12.5	23.7	26.2
15	3.7	70.8	2.6	26.9	63.7	10.9	19.9	-72.2	25.3	15.7
17.5	3.9	48.6	3.3	28.3	76.9	11.9	11.3	-11.2	16.7	43.2
20	2.6	57.8	3.1	29.0	63.6	11.5	44.5	-7.9	19.9	38.5
25	3.6	44.0	2.8	24.2	69.6	12.8	24.7	-24.1	14.9	493.0
50	3.7	45.9	2.7	26.6	57.7	11.1	29.5	-25.0	24.1	19.6
100	2.9	26.7	2.3	19.2	37.1	11.8	23.8	-13.0	25.1	16.5
200	-0.6	25.5	-1.8	14.8	36.9	8.3	21.2		15.7	12.5
300	2.2	33.1	-2.3	25.8	56.0	11.3	24.8		10.6	10.5
399	2.3	38.9	-3.2	21.4	35.1	10.1	21.9		9.9	0.4

Source: EU-FADN 2007

Annex V. Distribution of payments in the FADN sample

	BEL	CYP	CZE	DAN	DEU	ELL	ESP	EST	FRA	HUN	IRE	ITA	LTU	LUX	LVA	MLT	NED	OST	POL	POR	SUO	SVE	SVK	SVN	UKI	EU25	
Pillar 1 payments in the FADN (1000 euros)																											
Total	549	57	587	968	5238	2823	4081	69	8784	650	1386	3849	197	36	125	12	795	677	963	429	974	646	209	112	3472	37 689	
Pillar 1 per hectare average payment (euros)																											
Field crops	334	255	172	328	312	671	184	79	354	144	348	347	106	222	80	1411	281	308	77	261	283	223	112	279	289	263	
Milk	414	706	176	486	375	864	335	86	317	210	326	502	97	278	105	3830	532	245	71	484	647	302	90	325	323	305	
Other grazing livestock	492	624	130	683	383	1003	209	63	282	142	288	249	111	311	97	715	454	349	72	121	627	272	91	240	183	246	
Granivores	343	980	158	303	311	1735	156	51	363	508	303	517	101	252	154	23450	418	292	71	66	847	221	87	299	281	230	
Horticulture	230	166	133	339	260	509	128	35	310	113		127	62		95	1194	85	231	70	98	7466	181		148	86	224	
Quality wine		840	135		95	172	70		144	96		72		130				220		54			76	34		107	
Other wine		567	76			1117	27		175	94		102				244				28				36		157	
Other permanent crops	61	483	125	148	145	763	237	38	272	116		280	66	286	82	525	83	168	71	111	118	310	77	190	85	301	
Total	394	401	168	369	336	740	197	79	320	154	300	315	103	276	92	2473	419	276	74	154	467	253	103	261	243	265	
Pillar 1 per AWU average payment (1000 euros)																											
Field crops	13	3	6	23	18	8	10	5	22	6	19	6	4	15	3	3	8	11	1	3	20	19	4	2	24	9	
Milk	12	13	4	26	13	7	5	3	14	5	11	7	2	16	2	9	15	5	1	5	15	15	2	2	14	7	
Other grazing livestock	19	6	8	31	19	4	9	4	17	6	11	7	3	20	3	1	7	9	1	5	26	20	4	2	23	9	
Granivores	5	0	1	10	9	1	3	0	9	2	7	5	1	9	1	14	3	5	1	0	21	8	1	2	3	3	
Horticulture	1	0	1	1	0	1	0	0	1	0		0	0		0	2	0	3	0	0	8	2		1	0	0	
Quality wine		5	1		0	2	1		1	0		0		1				3		0			1	0		1	
Other wine		3	1			4	0		3	0		1				1				0				0		1	
Other permanent crops	0	2	1	1	1	3	2	0	2	1		2	1	8	1	2	0	1	0	1	5	15	1	1	0	2	
Total	9	3	5	19	12	4	4	3	13	4	11	4	3	14	2	5	5	6	1	2	16	16	3	2	17	6	
GINI coefficients																											
Pillar 1 payments/AWU	0.57	0.65	0.35	0.42	0.46	0.58	0.71	0.5	0.54	0.54	0.39	0.75	0.5	0.37	0.56	0.64	0.76	0.45	0.49	0.76	0.34	0.38	0.36	0.53	0.47	0.7	
Income / AWU	0.39	0.88	0.31	0.76	0.42	0.42	0.52	0.47	0.43	0.64	0.52	0.61	0.56	0.49	0.49	0.52	0.52	0.42	0.55	0.62	0.6	0.93		1.16	0.52	0.61	

Source FADN 2006

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **B** STRUCTURAL AND COHESION POLICIES

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