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**L.1. Agricultural policy analysis and perspectives**

# **The CAP towards 2020**

## **Impact Assessment of Alternative Policy Options**

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## 1. THE CAP IMPACT ASSESSMENT PROCESS

In spite of the consecutive reforms to the Common Agricultural Policy (CAP) since the MacSharry reform of 1992, moving from product to producer support (decoupling of aid) and a focus on more strategic rural development policy, the CAP has to continue adapting to a changing economic, environmental and policy environment, particularly in the face of recent challenges linked to food security, climate change and territorial and social cohesion. In addition, further reform of the CAP is justified in order to promote greater market competitiveness, efficient use of taxpayer resources and effective public policy returns. The direction of this evolution is consistent with the aims of the Europe2020 strategy of smart, sustainable and inclusive growth, and would be guided by the ambition to support the agricultural sector in performing its role in a sustainable, low carbon EU economy. This requires a rethinking of the effectiveness of current policy instruments and their efficiency in the context of formulating the next Multiannual Financial Framework.

The report reflects the main elements of discussions and analysis conducted within DG Agriculture and Rural Development (DG AGRI), in cooperation with other Directorates General (DGs) and contributed by stakeholders in the consultation process. This work was steered by an Inter-service group, with participants from twenty-one DGs which started in April 2010 and met thirteen times working on the base of a commonly agreed mandate.

The work has benefited from many internal and external sources of information, including Eurostat agricultural statistics, notably the Economic accounts for agriculture and the Farm Structure Survey. The Commission services prepared dedicated reports on particular issues and policy instruments which were presented to the steering group.

The baseline projections on agricultural markets, which provide a benchmark to assess the impact of alternative policy options, were prepared using an economic model. The validation procedure of the results was extended to an external review of the baseline and uncertainty scenarios in a workshop on 5-6 October 2010 in Brussels, gathering high-level policy makers, modelling and market experts from the EU, the United States and international organisations such as the OECD, FAO and the World Bank organised by the Institute of Perspective Technological Studies of the Joint Research Center (IPTS). The income effects of price changes based on the alternative policy options were carried out using a model based on the Farm Accountancy Data Network (FADN). FADN sample accounts for 81 000 farms, the results are extrapolated to depict the EU average situation.<sup>1</sup> Additional analysis is based on the findings of various studies and evaluation reports, as well as research projects funded through the 6th and 7th EU research framework programmes related to various aspects of the Common Agricultural Policy<sup>2</sup>.

Interested parties were invited to submit their contributions and additional analytical elements between the 23<sup>rd</sup> of November 2010 and the 25<sup>th</sup> of January 2011 and a

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<sup>1</sup> For a more detailed description of the methodology see Annex 11.

<sup>2</sup> For a list of relevant evaluation studies and research projects see Annex 13

conference with stakeholders was organised on the 12<sup>th</sup> of January 2011<sup>3</sup>. The stakeholder consultation was very successful. Altogether, 505 contributions were received by the Commission (346 from organisations and 72 from private persons). From the 346 contributions from organisations, a large fraction came from the Farming sector (131) followed by regional and local authorities (44) and environmental organisations (40). Think-tanks and research institutes participated in a smaller proportion (27) as well as organisations from the processing sector (20), development organisations (18), organisations from the trade sector (9), National authorities (6) and Consumer organisations (4). Some other type of organisations participated to the consultation (19), including Health protection organisations, water management bodies or civil society representations. The main elements in the opinions received in the stakeholder consultation can be summarised as follows:<sup>4</sup>

- There is a broad agreement among stakeholders on the need for a strong Common Agricultural Policy based on a two-pillar-structure in order to address the challenges ahead. The majority of stakeholders found the policy scenarios consistent with the objectives of the reform.
- Stakeholders have strong and diverse opinions concerning the targeting of aid. Redistribution of both Pillar I and Pillar II payments between and within Member States, capping and targeting payments towards groups of farmers are the issues where their main concerns were expressed.
- There is agreement that both pillars can play roles in providing public goods to the benefit of EU society. Whereas many farmers believe that this already takes place today, the broader public argues that Pillar I payments can be more efficiently used to step up environmental performance.
- Most respondents find that the CAP should play a role in stabilizing markets and prices.
- The respondents want all parts of the EU, including less favoured areas, to be part of future growth and development.
- Innovation, development of competitive businesses and provision of public goods to the EU citizens are seen as the ways towards aligning CAP with EU2020 strategy.

The present analysis is based on the assumption of a continued trend of current overall spending for instruments that are retained in scenarios. While the analysis assumes an unchanged ('status quo') trade policy environment, an analysis of potential impacts of the DDA agreement is shown, based on the baseline projections.

## **2. PROBLEM DEFINITION**

Over the last two decades, the CAP has undergone a substantial reform process which resulted in the decoupling of farm support, the reduction of market price support

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<sup>3</sup> [http://ec.europa.eu/agriculture/events/cap-towards-2020\\_en.htm](http://ec.europa.eu/agriculture/events/cap-towards-2020_en.htm)

<sup>4</sup> For detailed analysis of the responses see Annex 9.

measures to safety-net levels and the reinforcement of the rural development dimension. Currently two complementary pillars of the CAP provide the general framework that allows the policy to address competitiveness and sustainability challenges of agriculture across the EU territory.

Pillar I includes instruments related to the functioning of agricultural markets and the food chain (Council Regulation (EC) No 1234/2007) and direct payments (Council Regulation (EC) No 73/2009), both of which are conditional upon statutory management requirements and good agricultural and environmental practices. Combined, these measures provide a fundamental layer of support to EU farmers, creating the basis for keeping sustainable farming in place throughout the rural areas of the EU. Pillar I measures are mandatory for Member States and, with very few exceptions, there is no co-financing. This ensures the application of a common policy on the Single Market, monitored with the imposition of an integrated administration and control system.

Pillar II – rural development policy (Council Regulation (EC) No 1698/2005) - includes measures that aim at delivering specific environmental public goods, improving the competitiveness of the agriculture and forestry sectors and promoting the diversification of economic activity and quality of life in rural areas. These measures are largely voluntary, contractual and delivered within a strategic framework which links policy action to European, national, regional and local needs.

The combination of Pillar I basic annual payments and safety-net support at an EU-wide scale with more targeted Pillar II measures adapted to local specificities in a strategic approach allows the functioning of an effective common policy with common EU goals, with enough flexibility to engage every rural region in efficient implementation and delivery of results. This is further enhanced by the solid record of the CAP in ensuring sound financial management of its spending.

European agricultural policy towards 2020 will be facing similar challenges as other sectors in ensuring smart, sustainable and inclusive growth, especially through increased productivity and competitiveness and its contribution to environmental and climate change objectives and balanced territorial developments.

## **2.1. Providing food and raw materials...**

Agriculture faces a global deterioration in its terms of trade and its productivity. In recent years in particular, this is principally the result of a cost-driven commodity boom. During the 2004-2010 period, the *average* level of world agricultural prices increased by 50% from its corresponding level of the 1986-2003 period. By comparison, energy prices jumped by 220% and fertiliser prices by 150%. In real terms, EU farm income has fallen by 30% since the mid 90s, and average agricultural income equals today roughly 60% of the average wage in EU27.

The causes are structural, linked to the economics of the sector, the uneven and asymmetric transmission of price changes and distribution of value added along the food chain, the widening gap between input and output prices (hence the need to continue with decoupled income support and structural adjustment measures), and with the increased exposure of EU farmers to production and price risks due to climate change, increased price volatility and trade liberalization (hence the need to maintain an effective safety-net mechanism and to further reflect on risk management).

The current commodity price boom is an important lesson in this respect. Although agricultural prices are set to remain high, this is not so much related to more dynamic demand growth (which is projected to increase, but at lower rates than in previous decades), but rather to increasing costs of production and the agricultural terms of trade. The slowdown in factor productivity growth (land, energy, fertiliser, labour) puts additional pressure on farm incomes and requires substantial investment in more productive methods to survive on the market. Moreover, farmers experience increased exposure to production and price risks due to climate change, increased price volatility (accentuated by the uneven and asymmetric transmission of price changes and distribution of value added along the food chain) and trade liberalization.

Farm income has been increasing by only 0.6% per year between 2000 and 2009. The dynamics have been very different in the EU-15, where income stagnated for the last decade before falling by 17% following the economic crisis, and the EU-12 where accession led to a large increase in farm income, which remained substantially above the levels at time of accession, despite a drop of 12.5% in recent years.

While the vast majority of farms are able to cover their variable costs, only 35% of farms in the EU-25 were able to cover all costs during the period 2004-2006 (different than the period referred to above). In practice, this means that family labour is not sufficiently remunerated and that family assets do not provide adequate returns. This is especially true for small farms, but the share of profitable large farms is also only just above 62%. The sector is also plagued by income instability, with more than half of EU farms having experienced a variation of farm income by over 30% over 2004-2006, compared to their average income over the previous three years.

Moreover, a persistent fragmented structure of farm holdings in the EU (due to the slow pace of structural change also for social reasons) means that many of them are not realising their full potential. The analysis displays a very large variety of farm structures in the EU-27. Two broad types of situations emerge: out of the 13.7 million farm holdings, 47% are of very small size and account for 23% of labour force and 7% of agricultural area. On the other side of the spectrum, 11% of the farms with a size of above 20 ha account for 77% of agricultural area. This is a situation that is likely to persist in the medium term.

In all, the atomised structure and relatively low profitability, combined with insufficient human capital in the sector limit the possibility of many individual farmers to optimise their production and marketing decisions, as well as their relations vis-à-vis a more concentrated upstream and downstream industry. At the same time, the social capital to build effective collective actions is lacking<sup>5</sup>.

Many of the issues outlined above relate to reduced efficiency of agricultural markets due to the specific conditions under which they function with their exposure to climatic events, sanitary and phyto-sanitary issues, long production lags due to the biological processes involved, atomised structure and difficult logistics, specific commodity character (limiting the scope of product differentiation) and relative lack of mobility of factors of production. Farmers who are able to cut costs or, by following market trends, produce differentiated products for which there is high demand can however achieve profitability.

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<sup>5</sup> These issues have been explored in the Commission Communication on the better functioning of the food chain COM(2009) 591

Today, European consumers are spending on average only 16% of their household expenditure on food. Food security which has traditionally focused on food production subsequently has to be rebalanced considering also access to food by low-income households, availability of safe and high quality food and acceptability by delivering nutritional efficiency at an individual level.

Closely associated with hunger or nutritional deficiency on one hand and dietary excess on the other is the 'double burden of malnutrition'. It is linked with a range of adverse health conditions including obesity, cardiovascular diseases (CVD), cancer and diabetes which collectively pose the greatest burden of disease (77%) in the WHO European Region. This effect is even stronger with lower social-economic groups whose diets tend to be higher in energy, lower in micronutrients and contain less fruit and vegetables.

## **2.2. ...in an environmentally sound way ...**

With agriculture and forests covering about 77% of the EU territory (about 47% for agriculture and 30 % for forests , not including "other wooded land"<sup>6</sup>), they have a major impact on the environment, and are also greatly affected by it. Although progress has been made in integrating environmental concerns into the CAP and in introducing environmental legislation at farm level, considerably more needs to be done to ensure the sustainable management of landscapes and sustainable use of natural resources.

The CAP, notably through its Rural Development pillar, is the major provider of EU financial support for land management measures to protect and benefit the environment, reflecting that fact the farmers and forest managers are the main managers of land. Of the current EU contribution to rural development funds of [about €13bn] a year (which is doubled by Member States' matching funding, state aids, farmers' and other private contributions) about one half goes to measures which protect or enhance the environment. As a result of this, environmental improvements are heavily dependent on CAP funding for its implementation.

Some of the links between agriculture and the environment are positive – for instance well-managed extensive farming systems provide essential habitats for many wildlife species; and much EU farming provides culturally valued landscapes. On the other hand, modern farming also puts many pressures on the environment. For example, the recent tendency towards arable monoculture or short crop rotations increases the risk of depleting soil fertility, releasing green house gases from lost soil carbon, and increasing inputs of fertilisers and plant protection products, which often pollute water and are harmful to biodiversity; uncovered soils on arable and permanent crop farms can lead to soil erosion, and the pollution of water by nitrates, phosphorus and pesticides; the removal of farmland features such as hedges, trees and ponds reduces the habitats available for wildlife on farmland, so threatening biodiversity on and beyond the farm; and the ploughing up of grasslands has a major impact on climate change, as well as leading to the loss of grassland habitats, and other ecosystem functions of grassland such as flood prevention. Moreover, these environmental problems all weaken the ecosystem, making it less resilient to climate change, which in turn risks damaging farming, reliant as it is on soil, water, pollination for its survival. In addition, plant health concerns are of increasing importance as a consequence of the ongoing globalisation of trade, which has led to an

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<sup>6</sup> Forest and other wooded land together cover 42% of the EU land area.

ever increasing influx of pests and diseases previously unknown to the European Union and highly damaging to our forests and landscape.

In the Climate and Energy Package of 2008, the EU committed unilaterally to reduce its overall greenhouse gas emissions by 20 % below 1990 levels by 2020, and by 30 % if other parties would commit to comparable efforts. The Europe 2020 Strategy establishes the reduction of greenhouse gases as one of the EU's five headline targets. The 20 % reduction commitment is mainly implemented through Directive 2009/29/EC and Decision 406/2009/EC which require sectors participating in the EU Emissions Trading System (EU ETS) to jointly reduce emissions by 21 % below 2005 levels and non-trading sectors (including agriculture) under the Effort Sharing Decision (ESD) to reduce emissions by 10 % below 2005 levels. In the longer term, the EU low carbon economy roadmap requires the agricultural sector to reduce its GHG emissions by between 36 and 37 % by 2030 and 42 and 49 % by 2050.

With on average 100 and 150 tonnes of carbon per hectare on arable and grass land respectively in the EU in 1990<sup>7</sup>, agricultural soils contain a large stock of terrestrial carbon in the form of soil organic matter. Agricultural practices can have a positive or a negative effect in terms of soil organic matter levels. The drainage of peatlands and their conversion to arable land, grassland or forestry gives rise to large greenhouse gas emissions.

The EU energy policy has been drafted to both increase security of energy supply and reduce greenhouse gas emissions. Biomass for energy is mainly provided by forestry, agriculture (the share of agriculture, still small but is growing fast) and organic waste, and currently contributes around 7% of final energy consumption in the EU-27 (Eurostat). The European Environmental Agency (EEA) in 2006 estimated that in 2020 biomass can contribute to 13% of our primary energy requirement<sup>8</sup>. According to the first analysis of the National Renewable Energy Action Plans (NREAPs), submitted by Member States to the European Commission under the renewable energy Directive<sup>9</sup>, in 2020, biomass would contribute to more than 10% of EU final energy consumption.

By 2020, in the context of revising the EU Biodiversity Strategy the target is to, maximise areas under agriculture across grasslands, arable land and permanent crops that are covered by biodiversity-related measures under the CAP so as to ensure the conservation of biodiversity and to bring about a measurable improvement in the conservation status of species and habitats that depend or are affected by agriculture and in the provision of ecosystem services as compared to the EU2010 Baseline, thus contributing to enhance sustainable management.

The main drivers affecting environmental sustainability of agriculture are intensification of production in some areas with abandonment and under management of land in others, as well as changing land use patterns and agricultural and forestry practices. Certain farming

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<sup>7</sup> To a depth of 30 cm. Elaboration on the basis of data from the European Soil Database of the Joint Research Centre (EU-27, except Cyprus; the average for grassland doesn't include Finland and Sweden as well).

<sup>8</sup> [http://ec.europa.eu/agriculture/bioenergy/potential/index\\_en.htm](http://ec.europa.eu/agriculture/bioenergy/potential/index_en.htm)

<sup>9</sup> Directive 2009/28/EC

systems and practices are particularly favourable for the environment. These include extensive livestock and mixed systems, traditional permanent crop systems or organic farming. Many valuable habitats and the related biodiversity developed over centuries in interaction with farming, systems. Whilst these environmental features depend on appropriate management practices, those practices have been subject to changes, driven by competitive pressures. The problem of environmental sustainability of farming is related to farmers' decisions whether to produce and what and how to produce. The market prices do not reflect the externalities linked to agricultural production and in many cases the supply of environmental public goods is insufficient.

### **2.3. and embedded in local communities**

In the EU-27, 54% of the territory is classified as predominantly rural (NUTS3) areas, representing 19% of EU population. The results of the SCENAR2020 study suggest that most of the economic growth in rural areas now tends to be mainly driven by urban rather than rural economies, with increased urbanisation and a growing service sector, making the issue of rural-urban interaction an important factor. There are large disparities between rural areas themselves depending on their proximity to urban areas: from peri-urban areas, which are well integrated in the metropolitan systems to remote rural areas, which are suffering poor accessibility to services of general interest and population decline.

In predominantly rural areas the primary sector still represents 4.9% of value added (and more, if related food industry is considered) and 15.7% of employment. This is where the role of agriculture can be particularly important, not only directly but also indirectly - through the generation of additional economic activities. It is estimated that an increase in agricultural output produces an additional 150% increase in output among local purchasers and consumers of that output. Especially strong forward linkages exist with food processing, hotels and catering and trade, all sectors that, in turn, have further high links with the rest of the rural economy.

The problems of economic and environmental sustainability of farming have to be considered in the wider perspective of viability of rural areas. Since main drivers for the development of rural areas such as globalisation, demographic patterns and human capital, the transition to a low-carbon and bio-based EU, the changes to agricultural policy should maximise the positive effects on rural economies and allow requires a concerted actions of different policies at EU, national and regional levels.

The question of sustainable management of natural resources is relevant to all regions. Not only rural areas use and need services, they also produce important public goods and ecological services. Rural and mountain areas are the basic source of EU water provision; landscape is an important public good (and many city dwellers are taking profit from it); biodiversity protection and valorization (NATURA 2000); good agriculture practices are important for water quality improvements and saving; soil quality and CO2 reductions (to be developed by AGRI).

The key role of small and medium towns as centers of key services and social life for surrounding rural territories and as provider of territorial cohesion has to be recognised. These towns also provide access to a large number of mobile consumers which provide an opportunity for small-scale producers of "niche" and high quality products (process of "filières courtes"); in the most accessible areas, this process creates positive migration trends (counter-urbanisation). A stronger linkage between urban and rural areas,

especially considering peri-urban rural areas, is engendering interesting counter-urbanisation phenomena and new forms of rural growth, at the same time it is worsening urban sprawl phenomena, generating strong pressure on peri-urban natural resources. The increasing value placed by the society upon rural environment and heritage creates important diversification opportunities in areas having a high level of recreational amenities attracting urban populations.

#### **2.4. The global dimension**

Food security is one of the major challenges of the future given the current outlook of increasing global demand faced with considerable uncertainties of supply linked to unpredictable economic, climate, animal health, etc. developments. The EU policy should lead to a sustainable agricultural sector participating in the efforts to assure food security, and as such, it is essential that EU agriculture improves its potential production capacity while respecting EU commitments in international trade and Policy Coherence for Development. A strong agricultural sector is vital for the highly competitive EU food industry to remain an important supplier of high quality and safe agricultural and food products on a growing world market

The problems of a more balanced food supply chain, from sustainable production to sustainable consumption, also needs to address the issue of global poverty and food security as agriculture and food production are major contributors to fighting poverty in less developed countries. This requires a commitment to science-based standards in order to create better market opportunities for developing countries while ensuring that imported food and feed, animals and plants are safe. Food and feed safety and animal and plant health for this reason are key elements in the Union's import regime. Prevention is better and cheaper than cure.

#### **2.5. Scope for policy action**

While farmers are the main recipients of CAP support, the main beneficiaries of the public goods are all the EU citizens. The focus on financial incentives for farmers stems from the fact that altering the economic conditions of farms will have a direct impact on production intensity and practices with the largest leverage on addressing the environmental and territorial problems. This is because agricultural production and practices are the main drivers for economic and environmental sustainability of EU agriculture. However, when assessing the policy outcomes, the main beneficiaries to consider should be the rural population in general, consumers, in relation to food production, and all EU citizens through agricultures' role in providing environmental public goods or sources of renewable energies. Finally, taking into account the global dimension of agricultural policy, it has an effect on farmers, consumers and citizens of third countries.

The basis for the Common Agricultural Policy is formulated in the Treaty on the Functioning of the European Union, where article 38 stipulates that “The Union shall define and implement a common agriculture and fisheries policy.” with objectives set out in article 39 and detailed provisions in articles 40-44. Reverting to national policies to achieve these objectives would lead to disruptions of the principles of common market and non-discrimination of producers and consumers.

A Community approach allows common rules in a single market in order to ensure fair conditions throughout the EU with a common set of objectives, principles and rules. A European level policy is necessary to deal with a common market facing increasing

competitive pressure while applying agreed European common standards such as food safety and animal welfare but also exchange of experiences and know-how. It safeguards the progress made in recent reforms towards increased competitiveness of European agriculture and provides a common trade policy allowing the EU to negotiate as one vis-à-vis the global trading partners. Finally, as more targets and objectives are set at EU level (such as in climate change, environmental or energy policies) which relate to agriculture, a common set of policy instruments and common frameworks can provide for a better response. Finally, many issues, such as animal and plant health cannot be tackled effectively at national levels.

At the same time, for the policy to be effective certain flexibility is necessary in its implementation and both the direct payments and rural development instruments permit Member States to adjust the policy to localised needs. In the direct payments there is scope to define certain parameters of the Single Payment Scheme (SPS) and the Good Agricultural and Environmental Conditions (GAEC) expected from farmers. Rural development policy is based on regional strategies based on SWOT evaluation that allows selecting appropriate measures from those agreed at EU level which covers the potential needs and capacities of Member States and regions in achieving common EU objectives.

### **3. OBJECTIVES**

The Lisbon Treaty has confirmed the relevance of CAP objectives of increasing agricultural productivity, ensuring a fair standard of living for the agricultural community, stabilising markets, assuring the availability of supplies and ensuring that supplies reach consumers at reasonable prices. Yet, the challenges to EU agriculture have become broader (beyond the agricultural markets) and more complex (due to inter-linkages of economic, social, health, consumers and environmental issues and their global dimension). This is recognised in the Treaty, which adds the territorial cohesion to its economic and social dimensions, includes environmental protection, policy coherence for development, as issues that must be integrated into the implementation of the Union's policies. Therefore broad CAP objectives are defined as:

- Contributing to a viable, market oriented, food production throughout the EU - by acting on drivers related to income derived from the market (structuring the market, improving farmers' capacity to valorise product qualities, bargaining power and transparency of the food chain, providing a safety-net in case of excessive price drops,), promoting sustainable consumption, enhancing the competitiveness of agricultural holdings (innovation, modernisation, resource efficiency) and assuring income support that is better targeted to needs. This is related to the smart growth objective of Europe 2020.
- Ensuring the sustainable management of natural resources and the provision of environmental public goods such as the preservation of the countryside and of the biodiversity, integrating and promoting climate change mitigation in actions supported by the CAP and enhancing farmers' resilience to the threats posed by a changing climate - by encouraging good management practices that lead to the provision of environmental services, and by reducing environmental damage by agriculture. This is reflected in the sustainable growth objective of Europe 2020 with the aim to contributing to low carbon economy, expanding bioeconomy and protecting environment

- Contributing to the vitality of rural areas and territorial balance throughout the EU - by responding to the structural diversity in the farming systems and assuring positive spill-over from agriculture to other sectors of rural economy and vice-versa, improving its attractiveness and economic diversification. This is related to the inclusive growth objective of Europe 2020 considering the relative lower level of development of rural areas and the aims of social and territorial cohesion within but also between Member States.

In order to achieve these, the current CAP framework should be reformed along the following operational objectives:

- Improving the environmental and climate change benefits of the CAP – providing more environmental public goods and climate action in the first pillar (through specific green direct payments and cross-compliance) and improving the effectiveness of environmental measures in the second pillar
- Gearing the CAP measures towards increasing the agricultural productivity and competitiveness of the food supply chain - by fostering conditions for innovation and knowledge transfer, resource efficiency and encouraging joint action among farmers and across the food chain and active risk management.
- Better targeting of aid to the needs and objectives for a more effective and efficient policy – through a more equitable distribution of direct support to those recipients who need it most and better targeting of rural development strategies to EU objectives

The broader frame of agricultural policy, reflected in the horizontal Treaty obligations and the principles of smart regulation, require that any policy option be judged again following requirements:

- animal health and welfare
- public health
- international obligations (WTO and other trade agreements)
- coherence with development policy objectives
- budgetary efficiency
- simplification
- coherence and coordination with other instruments

#### **4. POLICY OPTIONS**

The present report aims to present in a synthetic manner the possible general reorientation of the Common Agricultural Policy. In practice this means a review of numerous individual measures and provisions, which can be usefully grouped with regard to their nature (financial, regulatory), scope (generally applicable throughout the EU or more place-based) and duration (continuous or based on strategic planning).

The different reform ideas have been grouped here under three broad policy reform scenarios to better present the interdependencies between different elements of the reform and which correspond to the opinions expressed in the public debate. The reference "status quo" scenario was defined to help measuring the effects of the policy reform scenarios. All three policy reform scenarios respond to the objectives of the reform. What distinguishes them is the weight they give to particular objectives, the way of achieving them and their expected impacts.

#### **4.1. Status quo**

This scenario examines the effects of current trends as regards social, economic, environmental and climate change-related factors relating to EU agriculture with the current policy provision maintained, including those that foresee the elimination of measures in the future (e.g. with regard to measures in the sugar sector).

#### **4.2. Adjustment**

This scenario assumes the continuation of this process with further gradual changes to the current policy framework. The Single Payment Scheme (SPS) would remain a basic policy instrument to address income support and environmental public goods to the extent that there is jointness between providing agricultural products and public goods, which arises due to interdependences in production of both. These objectives would be reflected in the redistribution of direct payments according to the criteria reflecting the income support and public goods role

- For general economic criteria, PPS (purchasing power standard) and GDP/cap: an index is used for the adjustment in relation to the EU average with the Member States with higher GDP/capita (expressed in PPS) receiving higher DP/ha.
- For economic criteria related to agriculture, AWU (annual working unit) and GVA/AWU (gross value added per AWU): comparison to the EU average with the Member States with higher GVA/AWU receiving higher DP/ha.
- For the environmental criteria, areas in LFA, Natura 2000 zones and permanent pasture: The index compares the share of the relevant area in the Member State's total UAA to the EU average. Thus MS with a higher share of Natura 2000 get higher DP/ha.

In addition, a certain level of convergence would be achieved between MS and farmers by ensuring that each of them gets at least a share of the EU average (e.g. 80% 85%).

Existing market instruments would be streamlined (exceptional measures, public intervention and private storage) and retained as safety-net in times of excessive price drops to avoid drastic income decline in periods of market crises, through:

- Rearranging and streamline special intervention measures and disturbance clauses, through an horizontal instrument that may include two kinds of actions/situations: i) market disturbances in all sectors, and ii) mitigate market impact from animal or public health risks in animal products, with a review of the product coverage and the possibility of urgent delegating acts.

- Sugar quota phasing-out in 2014/2015 or in 2017/2018.
- Intervention: Removing of automatic purchases up to the quantitative ceilings for common wheat, butter and SMP. The system will open automatically via tendering procedure. Intervention is foreseen for wheat and beef, while opening would be optional for barley, maize and rice, and removed for durum wheat and sorghum. Reference/intervention prices remain unchanged.
- Private storage aid: the aid would be foreseen for butter, beef, pig meat, sheep and goat meat, sugar, and olive oil. Optional private storage aid for SMP and flax fibre. Aids for sugar will be removed after quotas expire. In alternative, private storage would be foreseen as an optional tool only; with butter not longer eligible for mandatory aid but added to the list of optional products. Option to extend the aid to other products by means of delegated acts in the light of market circumstances.

While this option does not foresee additional changes to the CAP, it considers the possibility of a more efficient use of measures currently available. Of most importance is the better use of the wide range of possibilities farmers have under the current competition rules in order to engage in several forms of cooperation, relating to joint production and marketing, including a consolidation of production assets (in co-operatives), rationalisation of marketing activities and/or vertical integration into the downstream collection and processing stages.

Rural development policy would be see a moderate increase in budget with additional resources made available to target the environmental, climate change and competitiveness issues while maintaining the bulk of the policy within the current structure (addressing competitiveness, environment and vitality of rural areas).

### **4.3. Integration**

This scenario proposes a revised policy framework, which integrates the three broad objectives in both first and the second pillar of the CAP, reinforcing their complementarities. The objective related to agricultural productivity would be addressed through helping farmers rely on the market in achieving their profit margin to a larger extent than currently.

This would be done by increasing the competitiveness of farmers by a number of measures, such as strengthening farmers' bargaining power, helping them to better valorise the qualities and characteristics of their output, and helping them to create better risk management strategies through the use of insurances and involvement in mutual funds. A separate set of instruments would be available for small farmers by setting a minimum payment level and supporting small producers in local markets where they can exploit the attribute of proximity to the consumer. These efforts would be complemented by a basic income support component of SPS at a lower level than currently that could be complemented by an additional payment in regions with natural handicaps, while rural development policy would provide aids to improve competitiveness with innovation as a guiding theme

Possibilities for strengthening the farmers' collective actions, are set out in two options:

- i) Soft regulation - Enhancing horizontal and inter-branch organisations

- Member States shall recognize *producer organisations* (POs) and *associations of producer organisations* (APOs) in all sectors covered by the sCMO, including those where it is not foreseen in the existing legislation. POs may pursue any (or several) of the following objectives: planning production and adjusting production to demand, particularly in terms of quality and quantity; concentration of supply and placing the products produced by its members in the market; optimising production costs and stabilising producer prices; protecting and improving the environment; providing information and improving knowledge and transparency of production and market; and improving quality;
- Rules for *associations of producer organisations* (APOs) would be based on the existing legislation for the fruit and vegetable, wine and olive sectors. Member States shall recognise *interbranch organisations* (IBOs) in all sectors covered by the sCMO, including those where it is not foreseen today, provided that the IBOs are made up of representatives of economic activities linked to the production of, trade in, and/or processing of products in one or more sectors. IBOs are formed on the initiative of all or some of the organisations or associations which constitute them; pursue a specific aim, such as improving knowledge and the transparency of production and the market, helping to coordinate better the way the products are placed on the market, developing methods and instruments for improving product quality at all stages of production and marketing, developing methods and instruments for improving product quality, etc.

Attention would be given to certain activities of interbranch organisations, in order to avoid negative impacts on markets, such as the partitioning of markets, affecting the sound operation of the CMO, distorting or eliminating competition, entailing the price fixing, or creating discrimination. Support for setting up *producer groups* (PGs) would be provided as a single measure under rural development policy for all sectors covered by the sCMO, in all Member States. As such, the existing specific support in the fruit and vegetables sector would become redundant.

#### ii) Hard regulation - Further regulatory provisions

This approach extends the measures suggested under the soft regulation approach, for example to include the obligation to use written contracts, and the permission of collective bargaining by POs, in particular derogation from the prohibition on "price fixing".

An ad-hoc, sector approach is suggested while extending contractual provisions to new sectors, as MS have the possibility to take specific measures, if necessary. In the dairy sector, contractual provisions would be proposed on a voluntary basis, as proposed in the "dairy package". In the case of sugar, in view of the imbalance between beet and sugar producers after the phase out of quotas, and of existing obligatory price and contract requirements, an obligation for written beet delivery contracts should be introduced.

In order to better target the environmental and climate change objectives a separate payment component would be created as part of the Single Payment Scheme. The greening component of direct payments would operate as follows:

- each farmer will be required to undertake a number of environmental actions, such as permanent grassland, green cover, crop rotation and ecological set aside as applicable; some apply to all potentially eligible areas, while others apply only to grassland or to arable land;

- these measures will cover the whole EU territory, will be defined as uniformly as possible, and all farmers in a Member State (or region) will get the same payment per ha corresponding to the share of direct payments allocated to the greening component;
- the greening component will be a decoupled payment applying to all farmers in a specific area (MS or region).
- payment for Natura 2000 would need to be a separate additional payment and organic farming receive automatically the greening component

Contractual and more complex environmental services would be supported by the Rural Development Policy, both through the more advanced agri-environmental measures, setting as priorities promoting resource efficiency in agriculture and the agri-food sector, promoting sustainable production and use of renewable energy in agriculture and forestry, cutting greenhouse gas emissions from agriculture (including carbon from soil and vegetation); and protecting and enhancing eco-systems. Climate change and provision of environmental public goods would constitute guiding themes throughout the policy.

The objective of territorial cohesion would be tackled by improving the coordination of EU funds that are applicable to rural areas (EAFRD, ERDF, ESF and EFF footnote) under a Common Strategic Framework, setting the realisation of growth potential of rural areas as one of the priorities.

#### **4.4. Re-focus**

This scenario assumes the gradual re-focus of support solely around ensuring the environmental and climate change objectives through the rural development policy strategic framework and targeted measures. It assumes that production capacity can be maintained without support through the reliance on market signals to allocate the resources<sup>10</sup>. The objective of contributing to the vitality of rural areas and territorial balance would be achieved by the cohesion policy.

The SPS system would be progressively phased out to allow a smoother adjustment within the timeframe of 2020, with parallel abolition of all existing market measures, with the exception of disturbance clauses that could be activated in times of severe crises. It would be focused on climate change and environment aspects with certain temporary measures to support the phasing-out of direct payments, fostering innovative approaches and with a simplified management system. Funding for Rural Development would be increased significantly and redistributed between Member States based on criteria related to environment and climate change.

This scenario would move the territorial cohesion objective to the cohesion policy, with the rural development policy re-focusing only on environmental and climate change objectives. The total exclusion of the territorial objective would undermine the nature of this policy.

**Table 1:** An outline of main policy changes by scenario and objective

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<sup>10</sup>

	Economic viability	Environmental sustainability	Territorial cohesion
Status quo	Evolution of the situation with current policy measures.		
Adjustment	Redistribution of direct payment, streamlining of market measures	redistribution, enhanced cross compliance + moderate increase in funding in the second pillar geared to new challenges	Effects of spill-over of first pillar and current rural development measures
Integration	Focus on food chain (unclear) and risk management, supplemented by basic payment with additional aid for areas with natural handicaps	Greening first pillar + enhanced cross compliance + reinforced strategic targeting in RD	Common Strategic Framework for EU funds and reinforced strategic targeting
Re-focus	Temporary support to innovation during the phasing out of market measures	Doubling second pillar with an exclusively environmental and climate change focus	No 'axis 3' type measures in the CAP.

#### 4.5. Rejected options

In the course of the process certain options which were assessed in the analysis (and are described in more detail in the annexed documents) were judged less relevant to the objectives. One of such options is the introduction of an EU-wide income stabilisation tool, which would be very difficult to implement because of the differences in the risks that farmers in EU are facing and the diversity of agricultural production and would lead to large budgetary variations<sup>11</sup>.

The suggestions to link intervention prices for main commodities to the development of production costs in Europe could lead to reintroducing the distortions on EU markets given the wide variation of costs throughout Europe. Similarly introduction of a counter-cyclical payment would link support back to agricultural prices and distort farmer's production decisions<sup>12</sup>. Another discarded option regards introduction of a uniform flat-rate payment through the distribution of current support per hectare of utilised agricultural

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<sup>11</sup> For a detailed description of such a tool see Annex 6.

<sup>12</sup> The implications of linking support to agricultural prices are discussed in Annex 6, while the discussion of the differences in competitiveness across the EU can be found in Annex 5.

area. Such a system would neither respond to the need for better targeting nor to the actual needs faced by the farmers<sup>13</sup>.

## **5. ANALYSIS OF IMPACTS**

### **5.1. Status quo**

#### *5.1.1. Economic impacts*

Recent years have seen a reversal of the situation on agricultural markets, whereby traditionally prices have shown a decreasing trend because of productivity growth. The DG AGRI Prospects for agricultural markets and income in the EU 2010-2020 projects firm prices for agricultural commodities, supported by the growth in global food demand, the development of the biofuel sector and the long-term decline in food crop productivity growth.

The medium-term prospects for the EU cereal markets depict a relatively positive picture with tight market conditions, low stock levels and prices remaining above long term averages. The domestic use of cereals in the EU is expected to increase, most notably as a result of the growth in the emerging bioethanol and biomass industry. Bioenergy demand will also shape the prospects for the EU oilseed markets with strong demand and high oilseed oil prices.

Total meat production is expected to recover over the near term from the decline suffered in the wake of the economic crisis, but longer term growth prospects remain modest at an annual rate of 0.3% on average. By 2020 beef/veal and sheep/goat meat production is projected to drop by 7% and 11% respectively while pig and poultry meat production would expand by 7% each, driven by demand growth for pig and poultry a.

Milk production is expected to return to an increasing path, driven by a fairly optimistic demand outlook based on improved macroeconomic prospects. EU-27 milk production in 2020 is projected to exceed the 2009 level by less than 4% with the quota abolition leading to a very modest effect on production. The outlook appears favourable for higher value added dairy commodities, driven by growing demand for cheese and fresh dairy products.

As a result of the reform of the sugar sector, all of the principal provisions for sugar, including quotas, apply until 1 October 2015. As a result of the reform production under quota fell substantially from about 18 million tonnes to less than 14 million tonnes and, for the first time, the EU switched from being a net exporter to a net importer of nearly 3 million tonnes/year.

In this context there is little risk of persistent reliance on market intervention (only the SMP market will remain sensitive to global supply-demand developments over the near term). However, with the alignment of EU and world prices as well as adverse climatic events and uncertainties regarding the macroeconomic situation, the relatively strong volatility of prices will most likely continue with large price drops.

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<sup>13</sup> For the discussion on the impacts of flat rate payments see .

Despite the price evolution, EU output would remain subdued as the expected increase in input costs would limit the profitability of production. In addition, crop yields are expected to grow at a slow pace, continuing the decline in the rate of growth observed during the previous decade. The assumed appreciation of the EUR would further weaken the competitiveness of EU exports on world markets, leading to a loss in world market share at a time when global demand is growing at a relatively fast pace. The deteriorating competitiveness of the EU under the current setting is further emphasized in the analysis of alternative assumptions on yield and global demand growth rates.

For many products, the projected increase in EU imports compared to the baseline at the horizon 2020 is considerable. For sensitive products, DDA provisions allow for lower tariff cuts conditionally to the opening of a new Tariff Rate Quota (TRQ). In this case, the increase in imports is generally linked to the size of new TRQs. For beef however, the total increase in EU imports is expected to go well beyond the size of the DDA TRQ, due to the cut in tariff, while out of quota imports are already taking place under the baseline. The abolition of export refunds exerts a pressure on the EU export capacity, particularly for sugar and some dairy products. EU producer prices would drop for most of the products, and the production in quantity is expected to fall accordingly. The sharpest price fall (more than 10%) is forecast for sugar and beef. The drop in prices would in most cases trigger an increase in consumption, which would somewhat mitigate the fall in domestic production. As a whole, the estimated overall impact of the DDA on EU agriculture results in a drop of about 8% in agricultural income in 2020 compared to the baseline. Impacts are particularly harsh for all meats and the sugar sector.

The importance of the primary sector in the economy of the EU-27 is declining, supported by the significant productivity gains of labour and capital and the sharp decline in relative prices. This trend should increase in the coming years as, between 2002 and 2007, the relative importance of the primary sector in the economy of the rural areas in the EU-27 decreased by 1.9 percentage points in terms of employment and by 0.8 percentage points in terms of value added.

The Food supply chain makes ~5% of total value-added in the EU25 and ~6% in the new Member States and is thus an important sector of the European economy, however growing slowly compared to the overall European economy (+1.2% per year vs. 3.2%). In 2005, value-added was distributed between the 3 main activities of the chain according to the following pattern: agriculture (24%), food industry (33%) and distribution (43% – 13% for wholesale and 30% for retail). Moreover, this situation has become more marked over time.

Agriculture is the only sector of the chain where the value-added price index has significantly declined over the 1995-2005 decade (-2.6% per year). The volume growth of the agricultural sector has not been high enough (1.1%) to compensate this price decrease. The sharp decrease of the value-added price index in the agricultural sector has been due to the conjunction of a very sharp increase in prices of agricultural means of production (+5.1%) and of stable agricultural commodity prices.

The relative size of food industry vs. agricultural sector and the relative size of distribution vs. the food industry have increased. This highlights the fact that more and more of the value-added of the chain is created downwards along the chain. This trend is likely to continue.

### 5.1.2. Social impacts

With 12.2 mio persons employed in 2009 in the EU-27, the primary sector (agriculture, hunting and forestry) represents 5.5% of the total employment for the EU-27, ranging from 1% in the United Kingdom to around 28% in Romania, 20% in Bulgaria and 13% in Poland. In terms of value-added, the EU-27 primary sector reached €168 billion in 2009 and accounted for 1.6% of the total gross value added, ranging from less than 0.5% in Luxemburg to around 8% in Bulgaria and 7% in Romania.

In 2007 in the EU-27 there were 13.7 million agricultural holdings (5.6 in the EU-15, more than 8 in the EU-12). The number of agricultural holdings is decreasing at an annual rate of 2.2 % both in the EU-15 and in the EU-12. Romania (3.9 million holdings), Poland (2.4 million) and Italy (1.7 million) are the Member States with the largest numbers of farms, with Romania representing 29 % of all holdings. Similarly to the number of holdings, the agricultural labour force fell by around 2 % per year between 1995 and 2007 in the EU-15<sup>14</sup>. It now stands at 11.7 mio AWU for the EU-27, of which less than 1 mio correspond to non-regular workers.

With large structural differences across agriculture, the character of employment is very different. Out of the 13.7 million farm holdings, 47% are of very small size and account for 23% of labour force and 7% of agricultural area. On the other side of the spectrum, 11% of the farms with a size of above 20 ha account for 77% of agricultural area. This is a situation that is likely to persist in the medium term given the current trends of structural adjustment and is reflected in the distribution of income

Agricultural income is expected to recover from the significant low level in 2009 with an outlook for a gradual, albeit modest growth in aggregate EU income over most of the projection period that would exceed the 2005-2009 average (base) level by around 20% in 2020. This overall gain would mask uneven developments for the EU-15 and EU-12; whereas agricultural income in the EU-15 would show a more moderate increase to almost 10% above the base level, it is foreseen to display a more pronounced picture in the EU-12 rising 45% above the base level by 2020 and converging towards the EU average. In 2007 the average income per worker in the EU15 was around €26 000, with about 10% of the farms above €53 000, and over 50% below €17 500. In the EU10 average income was at around €7 900, while over 50% of the farms were below €4 000. In the EU2, half of the farms had an annual income of less than €1 300 per worker.

The study on Employment and Renewable Energy Sources (EMPLOY-RES)<sup>15</sup> presents the approach and findings of the project carried out on the employment and growth impacts of sustainable energies in the European Union. The report assesses the agriculture and forestry sector as a primary producer of renewable energy, and does not however assess the sectors as consumers. According to this report in 2005 in terms of economic

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<sup>14</sup> In the EU-15 the annual reduction in labour per production unit is 1.4 % in the recent years in contrast to 3 % in the long term trend. In the EU-10 the average reduction is 3 % per year.

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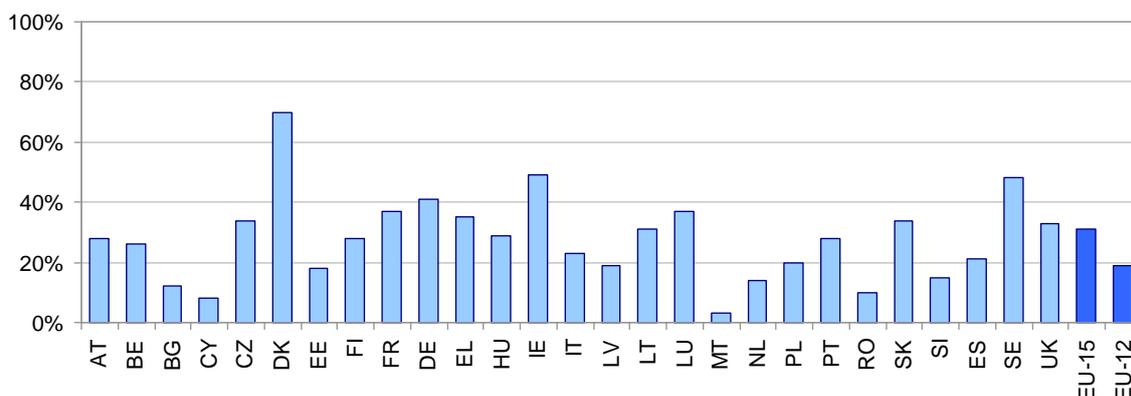
[http://ec.europa.eu/energy/renewables/studies/doc/renewables/2009\\_employ\\_res\\_report.pdf](http://ec.europa.eu/energy/renewables/studies/doc/renewables/2009_employ_res_report.pdf)

impacts renewable energy sources (RES) deployment generated gross value added of over 9 billion € in the primary sector and sustained 210,000 jobs across the EU (15% of total RES related employment). The share of the primary sector varies considerably across Member States depending on their respective profile of RES technologies and sectoral characteristics.

This report also used the indicators of GDP and employment to assess a number of RES scenarios which were projected forward to 2030. The impact of RES policies from the point of view of GDP was positive for all scenarios, which in turn resulted in employment increases. This is reflected in the agriculture and forestry sectors where production of the global agricultural sector increased by 0.06% of GDP in 2030 compared to the no policy scenario, and employment increases by 65,000 new jobs

While the assumed decline in agricultural labour remains an important factor behind the income prospects for both EU-15 and EU-12, the increase in the subsidies granted to agricultural producers in the EU-12 over the phasing-in period should remain a key driver of income growth in these Member States.

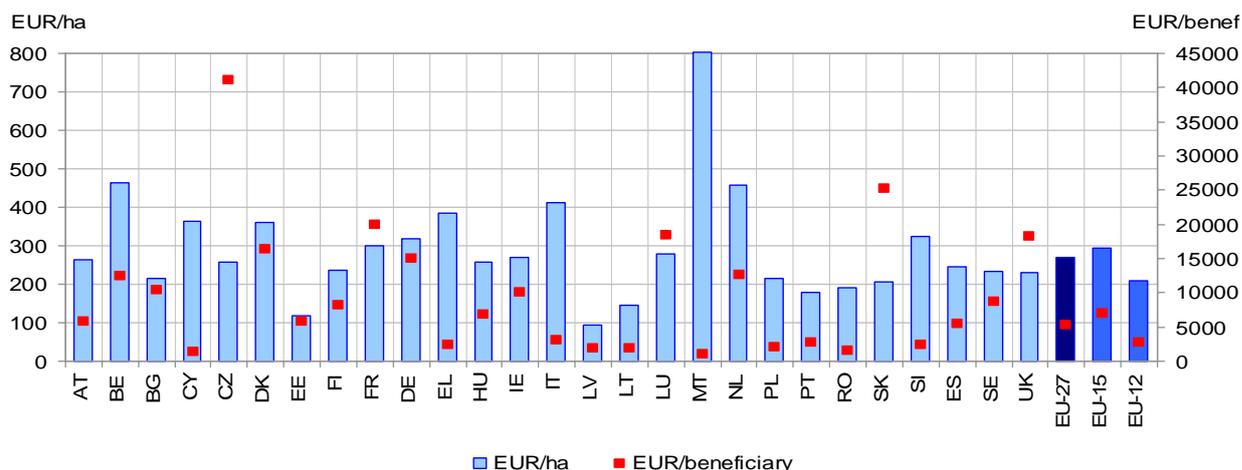
*Figure 1: Share of direct payments in agricultural factor income (avg. 2007-2009):*



Source: DG AGRI

The current distribution of direct payments per hectare is based on historic parameters that reflect the production and support of farms in a reference period. In addition, the flexibility let to the Member States in the choice of their direct payment model (historic, regional, hybrid) has led to large variations in the level of aid per ha received by the farmers, depending on the region they are located in. While the volume of support reflects, at least partly, objective criteria they do not reflect the fact that farm structures and production pattern have changed since the reference periods. Even if this historical basis helped the acceptance of the implementation of decoupling as from 2005, in the long run, it becomes hard to justify this reference to past production. In the case of EU12 the level of DP was established on the basis of the production within pre-accession period which was strongly influenced by national policies and budget limits. After the enlargement structural changes in agriculture and the relative alignment of the cost of production among MS makes difficult to justify continuation of this historical distribution in the future.

Figure 2: Average payments per beneficiary and per hectare<sup>16</sup>



Source: DG AGRI

Many rural areas are now driven by urban economies as in-migration has occurred around metropolitan centres, and most of the economic activity in rural areas depends on the service sector. The average annual increases of both employment and added value in the non-agricultural sector for all the regions stood around 1.3% and 2.5% per year respectively between 2002 and 2007: as a result, in 2007, 85% of employment and 95% of value added in predominantly rural areas of the EU-27 came from the non-agricultural sectors. Among these, tourism is one of the key opportunities in terms of potential growth for rural areas. With nearly three quarters of bed places in the EU-27 located in rural areas, this sector already plays a major role. The income per inhabitant in predominantly rural regions represents only 68% of the EU-27 average, whereas in intermediate and predominantly urban regions it reached 84% and 126% respectively of the EU-27 average.

Within rural development business creation and diversification measures are particularly important in areas where there is a high share of part-time farmers or where significant restructuring of the agricultural sector is still under way. The provision of basic services is considered to be one of the main drivers for the development of rural areas, and is particularly important for social inclusion in poor regions.

### 5.1.3. Environmental impacts

Despite the progress that has been made in integrating environmental concerns into the CAP and in introducing environmental legislation at farm level, water quality and quantity, soil quality and land availability are still areas of major concern, together with the question of how to protect, maintain and further enhance farmland habitats and biodiversity and to enhance the role of agriculture in preserving ecologically valuable landscapes.

According to the European Environment Agency (EEA), 24% of water abstraction is used for agriculture (and up to 80% in certain areas of southern Europe) with a relatively low return flow, as often just a third of the withdrawal water is returned to a water body. The

<sup>16</sup> This figure is a simplified calculation of direct payments based on the national envelopes of Member States after full phasing-in of direct payments in the EU-12 and the number of potentially eligible hectares in IACS for 2008.

data further show that agricultural water use across Europe has increased over the last two decades. In addition an estimated 25% of EU soil suffers from unsustainable erosion and 45% of European soils have low organic matter content. A further decreasing trend for soil organic matter levels in the past 25 to 50 years has been suggested for a number of Member States.

The assessment of the conservation status of Europe's most vulnerable habitat types and species protected under the Habitats Directive shows that while nearly 65 % of all habitat assessments are unfavourable, generally habitat types associated with agriculture have a worse conservation status than other types.

As regard the use of farm inputs, there has been a substantial decline from the fertiliser consumption peak of the seventies and eighties (by 2017 projections show a decrease of 28% for nitrogen compared to 1988, 67% for phosphorus and 61% for potassium in the EU-27 compared to 1979). The current use is rather steady with a general decrease of all nutrients in the EU-15, but an increase in the EU-12. The total volume of plant protection products used in the EU-25 increased steadily in the 1990s, stabilising in the late '90s and then declining continuously from 1999 until 2003 (declining in EU-15 and slightly increasing in EU-10),<sup>17</sup> New approaches to agricultural management are gaining ground, but slowly: organic farming and the use of integrated crop management techniques develop in many pesticide-intensive farming systems.

In term of the reduction of greenhouse gases, non-CO<sub>2</sub> emissions from the sector fell by some 20% in the period 1990-2005 to a level of around 9% of the EU total greenhouse gas emissions (excl. land use, land use change and forestry). However, baseline projections show that emissions in agriculture are predicted to largely remain at current levels in 2020 and 2030 unless further action is taken.

Although direct payments support both basic income and, through the combination with cross-compliance, the provision of some public goods, their current amount and distribution is based on historic criteria of production and they are therefore concentrated in the most productive regions (and to a lesser extent in the regional model) without being explicitly adjusted to environmental objectives beyond the link to basic standards under cross compliance. The way entitlements were allocated when decoupling was put in place did not envisage a specific targeting e.g. to farms that operate in the more environmentally valuable areas. Indeed, the level of the aid is in general lower in areas with natural handicaps, while income needs and provision of public goods in these areas are important.

The link of direct payments to cross compliance (together with farm advisory services) has increased the awareness of farmers about existing environmental standards and about good environmental and agricultural practices such as preservation of landscape features, crop rotation, etc. Although not designed directly to that purpose, cross compliance has been contributing to climate change mitigation and adaptation (by reduction of greenhouse emissions and by carbon sequestration in soils and by promoting good agriculture and environment conditions) at farm level in the EU. However implementation differs among MS.

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<sup>17</sup> Yet, some of the more modern substances are needed in smaller quantities but can be more toxic.

Rural development agri-environment measures (AEM) support the provision of a wide range of environmental public goods going beyond legal obligations, from biodiversity, water, soil, to climate change and genetic resources. The measures often address a number of environmental objectives simultaneously, e.g. reduction in chemical inputs has a positive impact on water quality while also contributing to climate change mitigation, adaptation and preservation of biodiversity. To achieve their environmental goals, some AEM need to be complex, sometimes involving more than one obligation, and needing to be implemented in a spatially differentiated manner and where compliance must be continuous or at different points in time. But this is precisely the strength of this policy tool and essential to achieve significant environmental benefits, the focus is necessarily on management requirements rather than results, partly because of WTO rules and partly because the results are subject to multiple drivers that are only partly under the control of beneficiaries.

## **5.2. Adjustment**

### *5.2.1. Economic impacts*

Lessons from the recent experience in the dairy sector show that current market instruments proved their function as a safety-net mechanism in exceptional circumstances. However, the necessary adaptation of policy instruments to stabilise the dairy market and support dairy farmers (private storage aid for butter was prolonged and intervention continued above quantitative ceilings and beyond the usual buying-in period) illustrates the need to be able to tailor the existing market measures to the actual market problems in every sector. The impacts of such an exercise of adjusting would be minor under normal market conditions, however in the times of crisis it will allow the EU to act faster and more efficiently.

Opening public purchases via tendering from the very first tonne without fixed price / fixed initial quantities may create some initial uncertainty about the actual level of the safety net. On the other side, removing the fixed price allows intervention to act only when necessary in the market place, thus eluding in certain cases unnecessary expenditure. Indeed, one of the disadvantages of the previous system was although public purchasing is at a fixed price (until 3 million tonnes for wheat) operators may be willing to offer wheat at a lower value under a tendering system.

Maintaining private storage without any change would be in line with the recommendations of the dairy HLG and the subsequent Council conclusions regarding the importance of the existing instruments to manage the dairy market. The disadvantage is that in normal economic circumstances the private storage aid finances normal storage costs for the dairy industry, thus being a windfall profit for the processors concerned. Optional private storage was suppressed for SMP in the Milk mini package in 2007. It was not used since 1991 as other instruments existed (intervention, export subsidies, disposal measures for SMP in feed and casein). The reintroduction of private storage, could be seen as an alternative to public intervention and a step backward market orientation.

The abolishment of sugar quotas is expected to result in an increase in sugar beet area in the EU (+7.1% in 2020 with respect to 2009/10). Prices for sugar beet and white sugar would be considerably below the current support prices (-12.3% and -8.5% respectively in 2020). As a consequence, domestic production would shrink, and EU consumption would be fulfilled by imports. In terms of world prices the effects are expected to be very limited

the price transmission between the EU market and the world market is low due to the trade regime. The effects on the isoglucose market are small. Both production and domestic demand for isoglucose is expected to increase, although the higher rise in production would result in greater exports. In case of a implementation of a transition period before quota abolition, there will be a shorter time to adjust to the new market conditions for farmers and the sugar industry. Maintaining the support price for three more seasons results in a higher starting base and consequently larger production increase with respect to 2009/10

Another factor that would affect the profitability of farms is the redistribution of direct payments between MS. Indeed, due to the fact that direct payments are to a certain extent capitalised in land values<sup>18</sup>, substantial changes in the payments per hectare will have an impact on farms' asset values (especially land), which will in turn influence their access to credit and ability to address existing liabilities.

A recent study<sup>19</sup> uses the partial equilibrium CAPRI model together with a specific tailed farm group component called CAPRI farm type (CAPRI FT) to analyze the impact of a flat rate for direct payments at Nuts 1, MS and EU levels (with the level of redistribution and potential impacts increasing in moving to an EU flat rate).

The study shows relatively small production and price impacts. In the EU flat rate scenario, the most responsive to price, the maximum price increase was for cereals of 1.5% for the EU15 and 2.9% for the EU10. The small magnitude of the impact is also due to the role of entitlements in limiting land use expansion while allowing for some substitution between grassland and arable land.

Given the small price and production changes, income effects were mainly driven by the redistribution of decoupled payments and to a lesser extent by land use changes.

As regards farm types, large and medium size farms and dairies, mixed crops and livestock, general field and mixed cropping, olives, cereals and oilseeds and permanent crops are particularly negatively affected. Small farms tend to be less affected. On the other hand, the most extensive production systems, such as sheep, goats and grazing, the residual farm category and mixed livestock farms, realized higher premiums and incomes.

Given that the obligation to establish national Farm Advisory System is recent and the related advisory bodies have only been certified in the last years, the outreach of the FAS would certainly increase, though to perhaps modest levels. In any case, results in terms of knowledge dissemination and innovation adoption would most certainly fall far short of the challenges if not just for lack of a coherent framework for the use of available measures. The support under rural development for the use of advisory services by farmers and for the delivery of the AKIS across Member States would be maintained, thus affecting the capacity of the agriculture sector to cope with the new challenges.

A moderate increase of RD budget should lead to a small overall positive impact on competitiveness due to investments in human and physical capital that increase

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<sup>18</sup> The move to a regional model throughout the EU is likely to increase the rate of capitalisation of support in land prices as compared to the historic model as the flexibility for activating entitlements with eligible land is reduced due to the existence of only a very limited amount of "naked" land in the regional model.

<sup>19</sup> Farm level policy scenario analysis, Final report, 15 March 2011 (IPTS contract no 151582-2009 A08-DE)

productivity. There is strong evidence of a positive contribution of investment aids to reducing production costs and improving quality thus having a positive impact on income. There is also a positive impact in terms of securing employment, and this measure has a high leverage effect. Investment in physical and human capital may also accelerate existing trends towards fewer, larger farms. On the other hand a small positive effect on agricultural employment may result from supporting more extensive production systems, which are more labour intensive. Increased support for LFA and agri-environmental payments may help maintain the economic viability of farms that would otherwise disappear.

Additional resources made available to the development of renewable energy projects could affect the regional economies.

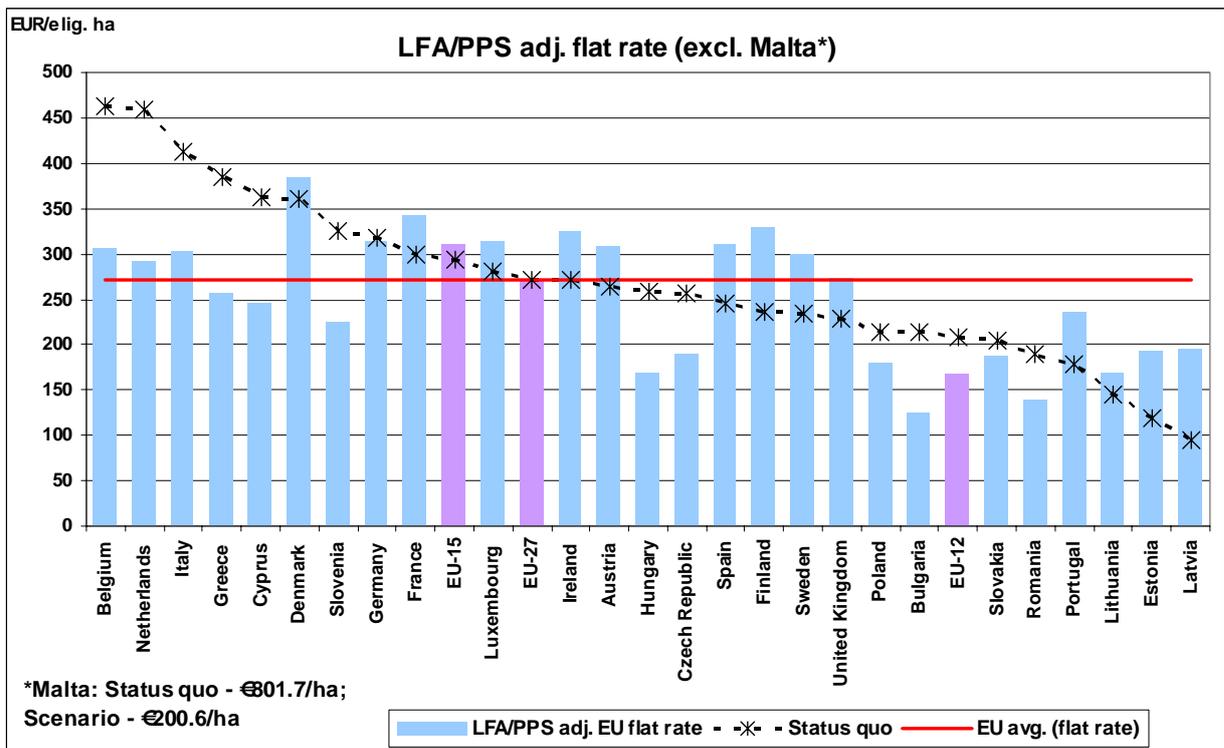
### 5.2.2. *Social impacts*

The impact of the scenario on agricultural employment will be influenced mostly by the effects of redistribution of direct payments which would lead to an increase by 1.3% of farms which are not able to remunerate family labour in comparison to the status quo.

The use of objective criteria giving more weight to economic criteria would accentuate the gap between EU15 and EU12 (with the exception of the Baltic States). The UK would significantly improve its situation. Same for AT that would benefit on both environmental and economic grounds, as well as for ES, PT and IE on environmental grounds. FR and DE retain their current distribution. In addition to the EU12 (and in particular HU, CZ, PL, BG and RO), BE, IR, EL CY and DK are among the most negatively affected. For the smaller MS (MT and LU) an *ad hoc* solution would be most likely in any case when using objective criteria.

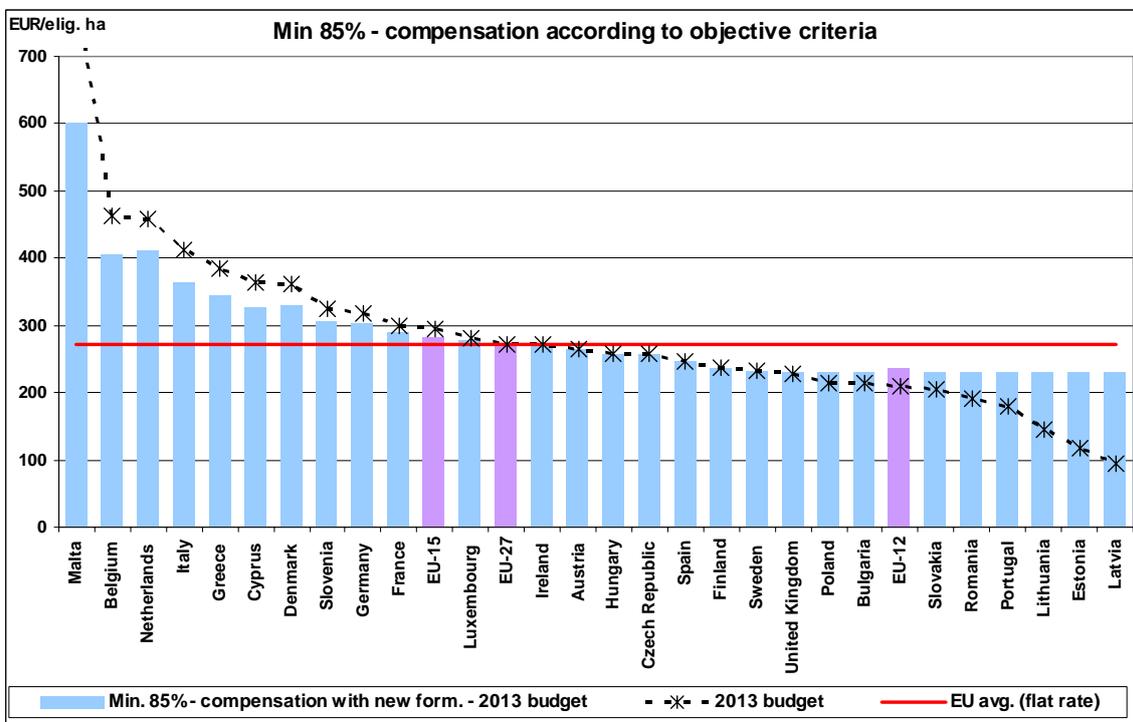
The main problem with this option is the fact that it would entail massive redistributions (e.g. with the latter new formula, the total amount redistributed comes to €4,5 billion) as compared to the status quo (however depending on the exact implementation, e.g. the weighting of the different objective criteria taken into account), which is likely to make it politically unacceptable for many MS to agree to such a redistribution

*Figure 3: Distribution of DP per hectare of eligible land in the adjustment scenario:*



Source: DG AGRI

To ensure a minimum level of convergence (e.g. that all Member States get at least 85% of the EU average) while using objective criteria to define the level of MS currently above the EU average. The total amount redistributed would be €1,4 billion.



The move towards a regional model, independently of the options chosen for redistributing the envelopes between MS, would redistribute direct payments between farmers at least in those MS currently applying an historic model. Indeed, within a region, entitlements would then be spread over all eligible hectares declared in the reference year.

This would result in bringing into the system the currently eligible agricultural lands that are not covered by entitlements (so-called "naked land") at farmer's level.

At farm level, a flat rate would imply that the amount of support received would change considerably compared to the current situation. Farms with a high payment level per ha would lose DP and farms with comparatively low payment level would gain. The general trend shows that field crop, mixed and milk farms would lose payments compared to the status quo while payments would increase in grazing livestock, wine and horticulture farms. As a general matter, a uniform flat rate would reduce support in more productive regions and sectors in favour of more marginal regions.

In addition, the move to a regional model in all MS is likely to increase the rate of capitalisation of support in land prices. Indeed the flexibility for activating entitlements with other piece of eligible land is reduced due to the existence of only a very limited amount of "naked" land (i.e. eligible land without corresponding entitlements) and the absence of differences in the entitlement level in the regional model<sup>20</sup>. Thus, substantial changes in the payments per hectare, inherent in the "EU flat rate" option and, albeit to a lesser extent, in the other options, may have an impact on farms' asset values (especially land) and affect the profitability of farms, which would in turn influence their access to credit and ability to address existing liabilities.

### 5.2.3. *Environmental impacts*

The effect of the redistribution in itself would have an important effect on the support to more environmentally sustainable farming. Grazing livestock farms and farms in least favoured areas would benefit from the redistribution, which would to a certain extent be favourable for the maintenance of permanent grassland and all its environmental benefits, while more intensive crop production would be supported to a lesser degree.

At the same time the inclusion of LFA criteria in the distribution of support between MS, which potentially would adjust the payments better to the natural handicap areas which are associated with better delivery of public goods has less impact than the fact of redistribution of payments itself. Moreover, exact effects would depend strongly on the implementation, e.g. the distribution of direct payments between regions in MS. Furthermore, if no additional environmental performance criteria were linked to direct payments (or at least to a part of the DP), the targeting of additional amounts to environmentally sensitive regions could be suboptimal.

Cross compliance links the reception of full direct payments to the respect of regulatory standards related to environment, plant, animal and public health and animal welfare and to GAEC (Good Agricultural and Environmental Conditions). For instance, GAEC obligations are related to preserving landscape features, permanent grassland conservation and water courses, and obligations related to soil conservation. A reinforcement of GAEC with climate-friendly measures would increase the environmental performance of DP. Same for the future inclusion of the Water Framework Directive once implemented.

Finally, a moderate increase of the available rural development funds could positively benefit measures that aim to improve environmental conditions. The effects of this are

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<sup>20</sup> See Study on the functioning of land markets in the EU Member States under the influence of measures applied under the CAP, CEPS, Swinnen, Ciaian & Kancs, November 2008

difficult to quantify since it depends on how Member States use the available funds. Where an increased focus is put on competitiveness and innovation, positive effects would mainly come through increased resource efficiency and through modernisation implementing more environment friendly systems. Where an increased focus would be on environment ('new challenges'), it is likely that this would see more funds being used for agri-environment measures with positive effects for biodiversity, water, soil and climate change.

#### *5.2.4. International dimension*

The redistribution of DP between MS and farmers should not affect the classification of EU support at WTO. provided direct payments are distributed at MS level would have to be in line with WTO rules (in such a manner that farmer anticipation and effect on production level is avoided).

#### *5.2.5. Administrative issues*

In the first year of implementation of the new system, there would be and administrative burden associated with the redistribution (distribution of new entitlements and/or recalculation of the value of entitlements) and possibly transition (defining steps for progressive modifications in following years for each farmer). In spite of its many advantages, the implementation of the current intervention system remains complex and articulated, with numerous different trigger mechanisms, ceilings, and time constraints across sectors. Harmonisation and streamlining of existing parameters could bring about greater efficiency, decreasing administrative costs and easing controls, although the specificity of each sector may imply differing arrangements.

### **5.3. Integration**

#### *5.3.1. Economic impacts*

The effects of greening of the first pillar on the competitiveness of agricultural holdings has been examined using farm level data. It has not been possible to quantify economic benefits, due to the lack of data on the impact of the agricultural benefit of the measures on yields; moreover, any benefits would have in most cases a medium- to long-term time horizon and would vary significantly across regions and farming systems.

In relation to costs, the analysis indicates that there are wide variations across Member States / regions and farming systems, reflecting differences in land use and profitability as well as in current environmental practices (and hence the area whose land use and production methods would need to be modified). The Member States that would be facing the highest overall costs are MT, NL, SI, and BE (the latter three mostly due to the significantly higher opportunity costs for permanent grassland). On a regional level, the average total cost of the greening component ranges from €0,9/ha in Wales to €182/ha of potential eligible area in Flanders.

A more ambitious crop diversification under option 2 would bring average cost up to €11,3 per ha of potentially eligible land (€20,1 per ha of arable land; €288/ha of land to be diversified). The costs would be highest for horticulture, followed by field crops and granivores. Similarly, a more ambitious ecological set aside under option 3 would bring average cost up to €13,8 per ha of potentially eligible land (€297 per ha of land that

needs to be set aside). The costs would be highest for granivores, followed by horticulture and field crops.

The introduction of the greening component would on average have a moderate negative effect on income that could vary substantially between Member States, regions, farming systems etc. which shows that the definition of the measures strikes the right balance in terms of costs and benefits. This negative effect would be considerably exacerbated in the case of the more ambitious crop diversification measure but alleviated in the case of the more ambitious set aside (due to the market impact that would compensate for the increase in cost).

One of the main elements of the integration scenario for economic viability of farming is to review and improve the measures that encourage cooperation and collective actions of farmers in facing the environmental and competitiveness challenges and assuming a stronger position in the food chain. Apart from cooperatives, which were a traditional response of farmers to the developments in the food chain, producer organisations and inter-branch organisations can potentially play useful roles in research, improvement of quality, promotion and diffusion of best practices of production and processing methods.

While the main focus of the current policy options are agricultural producers, the assessment of the economic advantages and disadvantages of these policy options have to take into account the impact at the various stages of the supply chain, "from farm to fork". Since the policy options stipulate that participation to horizontal organisations will continue to be on a voluntary basis, and given the largely heterogeneous nature of markets and supply chain structures at product and Member State levels, the economic assessment is based on a qualitative analysis of the potential impact of the options. Given the sensitivity of the policy proposals with regard to competition rules, this aspect is given great attention.

The "soft regulation" approach aims at enhancing horizontal and interbranch organisations by extending the scope of sectors where Member States shall recognise POs, APOs and IBOs. In general, based on economic literature, the economic advantages of agricultural cooperation would come from increased bargaining power of the participants, improved economies of scale in selling and purchasing, opportunity to increase added value by entering into other (processing) stages, easier access to information. In addition, improved economies of scale can enable marketing through multiple channels and decrease risks.

Provisions to improve the functioning of the food chain, in particular the possibility for farmers to stipulate written contracts may have a positive impact on price stability, diminishing uncertainties regarding quantities and expected revenue. The impact of contract schemes would depend, among others, on the characteristic of the product, processing and marketing, how the food chain is organised (vertical integration), market power of the different actors, share of the internal market on global demand, net trade balance<sup>21</sup>, and even the different application of rules among the Member States.

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<sup>21</sup> The following issues are at stake: i) potential risk of excessive producers bargaining power or even producer monopoly, which would be as negative as any other monopoly, ii) potential impact in medium and small enterprises and their capacity to compete and develop; iii) potential slow down in the modernisation path of the industry, as a by-product of the reduced competition; iv) potential loss of long term competitiveness and innovation capacities, as also a by-product of the reduced competition; v) impact on consumers prices, and in particular on low-income consumers.

Experience from the fruit and vegetable (F&V) sector indicates that producers in very "well-organised" regions (with a high number of farmers being part of a PO) are on average better paid than producers in areas where the rate of organisation is very low. Producers join these organisations in order to ensure reliable payments and the guarantee of purchase of produce, whereas the level of producer pricing and support services provided by POs are secondary factors. This notion is supported by an evaluation study carried out on the F&V sector, which observed that POs have almost no influence over the price of products supplied to large-scale distribution.

The objectives of POs and IBOs, as they appear in the policy option, have been defined to be in conformity with the spirit of current competition rules that allow several forms of cooperation among farmers as long as they entail efficiency gains from consolidation of production assets, rationalisation of marketing activities and/or vertical integration into downstream collection and processing stages. Furthermore, attention would be given to certain activities of IBOs, in order to avoid negative impacts on markets, such as the partitioning of markets, affecting the sound operation of the CMO, distorting or eliminating competition, entailing the price fixing, or creating discrimination.

In the second sub-option of "hard regulation", this approach extends the measures suggested under the soft regulation approach, for example to include the obligation to use written contracts, and the permission of collective bargaining by POs, in particular derogation from the prohibition on "price fixing".

On the other hand, allowing POs to enter into collective negotiations involving price-fixing agreements on terms and conditions without appropriate safeguard clauses could entail a substantial reduction of competition in agricultural markets, with detrimental consequences on SME processors. The need for safeguard clauses are also justified within the context of the objective to improve the competitiveness of EU agriculture in an increasingly global market, in order to ensure that the CAP maintains its market-oriented approach and does not deter modernisation and innovation. As such, efforts would be necessary to ensure that enhanced cooperation of producers and/or POs are not based solely on achieving higher prices through increased bargaining power, but on incentives to optimise production costs, improve market transparency and production planning.

Caution is necessary with regard to contract details, particularly regarding price determination. In order to avoid possible collusive behaviour, contracts should refrain from any type of price indicator that could interfere with freedom to agree on mechanisms to determine the price. As such, while the factors determining the price should be explicitly indicated in the contract, it would be necessary to ensure that all elements of the contract are freely negotiated by the parties.

Moreover, in order to address the income variability issue, this option would allow the possibility for MS to create an income stabilisation tool. When a farmer has an income drop of more than 30% in comparison with, then compensation may be paid out, however, the level of compensation would be no more than 70% of reference income. Because farmers' deductible is set to be at least 30% this avoids threshold effects and as a consequence moral hazard behaviour from farmers. The impacts, as regards the number of farmers eligible, total compensation paid out and average compensation vary greatly by MS.

Reinforcement of the FAS and of the support to farmers for the use of advice increases significantly the number of producers taking advantage of advisory services on a broad

range of issues. The setting up of the European Innovation Partnership fosters the involvement of stakeholders (researchers, advisors, farmers) in innovation processes contributing to achieving EU goals of sustainable agricultural production. The Agriculture EIP and the creation of an innovation network ensure better flows of information between the stakeholders increasing not only the use of research results by producers but also allowing research programmes to better take the needs of the stakeholders into consideration. The EIP network and the inclusion of actions targeted towards innovation among the services to be provided by the FAS ensure that Member States and concerned national institutions adopt a proactive approach towards innovation. Hence the risk that the EIP gains ground primarily in those Member States and regions where network-based AKIS are already established and producers and other stakeholders are the most proactive (e.g. more organised sector, etc.) is minimised. Exchange of experiences and good practices among Member States promote better delivery of the AKIS in the various Member States on EU priorities.

### *5.3.2. Social impacts*

The effect of the redistribution of payment on the profitability of farms is smaller than in the case of adjustment scenario, with an increase of farmers that do not remunerate family labour increasing by 0.3%. However taking into account the assumptions used on additional costs related to the greening component, the increase is of 1.4% (therefore around the level of adjustment scenario).

Since the basic rate of support which would be calculated on the basis of a share of the total national envelope is the only component of the direct payment system to which all farmers are entitled (subject of course to having entitlements), some farmers may see their basic income support substantially reduced in particular in the MS whose budget envelope decreases. The move to a flat rate would be more abrupt in MS which now have high average levels of payment per ha... The impacts of this reduction may be mitigated by a transitional period in order to allow the adjustments to farm structures.

At Member State level substantial income gains would be concentrated on few MS that currently receive very low levels of direct payments while income losses would concern many MS without reaching an unacceptable extent in any of them.

In addition, for a large share of farms, there will be costs associated to the environmental measures required to get the greening component of the DP. According to analysis on FADN, it would be particularly true for the field crop farms and milk farms which will face additional costs for implementing the environmental measures of the greening component of DP.

However, those farmers who can profit from many components of the system, e.g. being located in areas with specific natural constraints thus eligible to the NC component of the DP and efficiently carrying out the environmental measures of the greening component can profit from the new design. Indeed, it appears for instance from the analysis on FADN that grazing livestock farms (beef and sheep) and farms located in LFA would profit the most.

Simulations show that, depending on the option chosen capping would release for the EU27 between €270 million and €860 million. This represents between 0,6% and 2% of the total amount of direct payments at EU level which is quite low compared to the current amount resulting from modulation (around €3 billions for budget year 2013). This

is due to the thresholds of capping which affect only a limited number of farms in comparison to the modulation. As a consequence capping would really affect very few countries<sup>22</sup>: mainly BG, GR and UK and to a lower extent HU, SK and RO while some MS would not be affected at all like BE, CY, IE, LU, MT, AT, FI, SL or almost not affected like FR, PL, SE, PT.

On average for the EU27 average income per unit of work would be little affected (between -0.2 and -0.6%), but there are important variations for some MS depending on formula chose for the mitigation of labour effect. Where the mitigation by labor is the lowest (50% wages), countries most affected would be SK and BG but also CZ, HU, RO which is not surprising at they have a high share of large farms, cooperatives, etc.

As regards smaller farms, a specific scheme would acknowledge the contribution such farms make to rural employment, viable rural areas and cultural heritage in many regions. It could allow small farms to restructure, diversify and increase their competitiveness, e.g. by exploring new local market opportunities and providing specific regional products. To achieve this, the scheme would have to be designed either in a way to encourage development and structural change or to allow small farmers to choose the development path they wish (getting more competitive or maintaining local small-scale production) by narrowing the income gap with bigger structures. However a targeted type payment focusing on competitiveness would better fit in the second pillar, also because a support scheme for small farmers within direct payments would offer only limited possibilities of targeting or imposing requirements in terms of e.g. development possibilities, investments, or the commitment to continue farming. Therefore a general increase of DP ("bonus") should be considered as more appropriate under the 1<sup>st</sup> pillar. With this option, it would be basically up to the farmer to decide which development path it chooses. The "bonus" could either consist in:

- The completion of the support to the level of a threshold: this would however grant a disproportionately high bonus to those with the lowest payments compared to the ones that are just below the threshold.
- An increase by progressive percentages (the lower the payment below the threshold, the higher the percentage – possibility of bands). This would assume setting up bands under the threshold to the limit of which the payment of the farmers falling in the band would be completed. This option would mitigate the above option by completing only to the limit of the band but it would be complicated to apply.
- The attribution of a fixed (standard) EU-wide support (lump-sum) for farmers below the threshold but limited to the level of the threshold.

It has to be noted that, even if the total amount concerned by the scheme would have to be balanced with the controls and administration of the scheme, the risk of splitting of holdings would appear and would increase the higher the small farmer payment would be.

Better targeting of support to active farmers would help to increase the acceptance of payments by society at large but poses substantial practical difficulties. First, as there are

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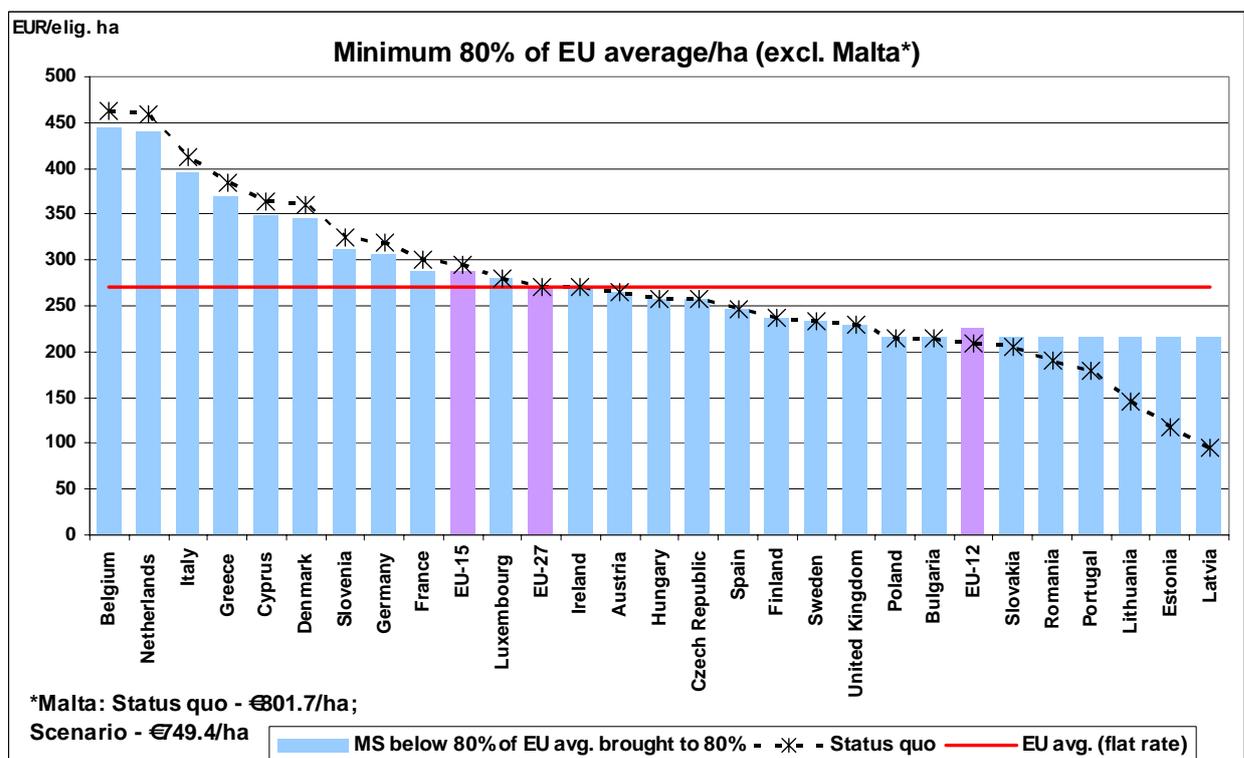
<sup>22</sup> The FADN is a sample survey. As the capping concerns only a very limited number of very large farms it cannot be always guaranteed that this type of large farms is well represented in all MS. Thus, the figures provided should be considered as indicative.

no data on the exact dimension of the problem ("sofa-farmers", landowners now receiving direct support) and as situations at MS level are very different, it is rather difficult to make a quantitative analysis of impacts. Second, the exclusion criteria need to be fine tuned to reliably exclude non-active farmers while at the same time not affecting the access of genuine farmers to support. Criteria would have to be set so that part-time farmers are not excluded as it is clear that diversification of activities is a valuable alternative to limited growth opportunities within the farm sector and contributes to maintaining farming in areas where agriculture is socially and environmentally valuable. Certain criteria could be applied such as farmers' registration, proportion of management contribution, composition of income, etc. but not all of them are available across all MS and some may cause difficulties in terms of WTO compatibility (support must not be linked in any way to factors of production). In addition, the administrative burden associated with the control of those conditions may be extremely high. Thus, the definition of exclusion criteria would require close cooperation with MS.

Depending on the detailed measures of and budget allocation to the green component and the specific natural constraints payment of the scheme, the redistribution effect of the integration option towards areas where the maintenance of agriculture is important for the provision of public goods would be important, in particular areas in Natura 2000 and areas with natural constraints. For instance, if all current less favoured areas (LFA) are used for the specific natural constraint payment, the direct payment granted to farms located in those areas would increase at EU level by 38% in mountainous areas and by 15% in other LFA compared to the status quo in 2020.

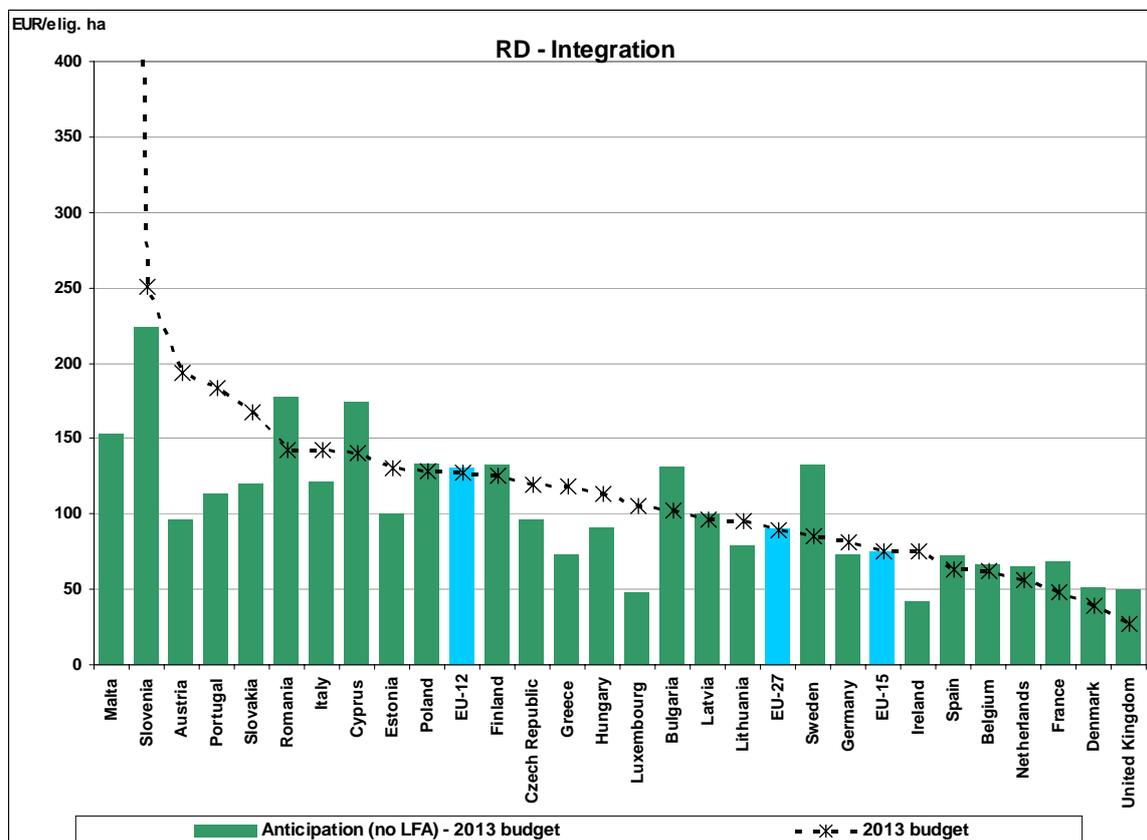
At Member State level substantial income gains would be concentrated on few MS that currently receive very low levels of direct payments while income losses would concern many MS, but their extent would be quite limited.

Figure 4: Distribution of DP per hectare of eligible land in the integration scenario:



However, in this scenario also proposes a redistribution of rural development support based on the formula (what formula) that would take into account the competitiveness of the agricultural sector (agricultural area, labour force and labour productivity), climate change and the environment (agricultural area, Natura 2000, LFA, forest and permanent pasture areas) and balanced territorial development (rural population) and calibrated by GDP/capita in PPS (the lower the GDP in the MS, the higher the MS envelope)<sup>23</sup>.

Figure 5: Distribution of RD per hectare of eligible land in the integration scenario:



In terms of the impact on rural areas of the rural development programmes, business creation and diversification are particularly important in areas where there is a high share of part-time farmers or where significant restructuring of the agricultural sector is still under way. The provision of basic services is considered to be one of the main drivers for the development of rural areas, and is particularly important for social inclusion in poor regions. Among the changes the conditions for start-up aid for non-agricultural businesses would be defined, to make the aid more effective; support for further development of non-farm businesses would be extended from micro- to small businesses.

This scenario allows for using measures in combination and supporting integrated projects provided that the Member State concerned can develop a good strategy to make the best use of the funds available in line with the EU priorities. The Member States that are most advanced in reaching Europe's 2020 socio-economic objectives may choose to channel funds more towards objectives other than those currently covered by axis 3

<sup>23</sup> A possible formula taking into account the three elements equally would be:  $\frac{1}{3} \left[ \left( \frac{1}{2} \text{Area} + \frac{1}{2} \text{Labour} \right) \times \text{labour productivity inverse index} \right] + \frac{1}{3} \left( \frac{1}{3} \text{Area} + \frac{1}{3} \text{Natura 2000} + \frac{1}{6} \text{Forest} + \frac{1}{6} \text{Permanent pasture} \right) + \frac{1}{3} \text{Rural population} \times \text{GDP inverse index}$

measures (e.g. they might spend more on the environment), but this would have to be justified within the process of strategic programming. For the Member States that are yet to achieve a significant progress towards Europe2020 socio-economic targets, support for general socio-economic development would probably continue to be a priority.

The mainstreaming of Leader (add reference for non-insiders) has at times compromised the "bottom-up" philosophy; moreover, issues of co-ordination with other funds are often a significant obstacle to action. Therefore, its bottom-up character will be reinforced, to increase its value as an engine for innovation; joint action at local level with other funds – among other things, to support rural-urban action.

It is proposed that a Common Strategic Framework (CSF) should set out the priorities of four important EU funds<sup>24</sup> and their contributions to achieving the objectives of *Europe 2020*. It would help them to complement each other better – at EU level. This would mark a step forward from the current period, in which efforts to ensure complementarity are made essentially at national and regional level. The CSF also has a role to play in helping the funds to work together at sub-regional level (i.e. in Leader-type roles). This scenario allows for putting measures together and supporting integrated projects provided that the Member State concerned can develop a good strategy to make the best use of the funds available in line with the EU priorities.

### 5.3.3. Environmental impacts

The expected environmental benefits of introducing greening measures in the first pillar are set out in the table below, along with main costs for farmers, as described in the section 5.3.1.

<p><b><i>Green cover - a temporary plant cover of arable land that would otherwise remain bare at certain times in the year</i></b></p>	<p>Benefits for water quality (esp. reduction of nitrate leaching); soil quality and reduction of erosion; climate change mitigation (increase in soil organic matter and reduction in chemical fertilizers) and adaptation; flood prevention</p> <p>Cost of seeds, machinery, energy and labor for sowing in autumn and mechanical destruction and ploughing in spring; in the case of winter stubble, income foregone (no selling or grazing of the straw); possible cost savings on fertilizer and impact on yields for the next crop</p>
<p><b><i>Crop rotation - planned and ordered succession of different crops on the same field (usually lasting 3-5 years)</i></b></p>	<p>Benefits for soil organic matter and structure; reduction of soil erosion and nitrate leaching; nutrients management and input reduction; pest and weed control; water quality and quantity; climate change mitigation and adaptation; improved habitats and landscape diversity</p> <p>Significant short term costs to put in place (may require new equipment and skills, different marketing outlets); income foregone for the main crop, esp. in case of monoculture; short-</p>

<sup>24</sup> The European Agricultural Fund for Rural Development (EAFRD), the European Regional Development Fund (ERDF), the European Social Fund (ESF) and the European Fisheries Fund (EFF).

	<p>term impact on yields clearly negative in intensive farming</p> <p>Long-term benefits (improved yields and profitability over time, disease control, less need for chemical inputs) require clear quantitative assessment, in addition to qualitative assessment – "fallacy of composition" risk (what is good in smaller scale could be bad in larger scale if global price impact too strong)</p>
<p><b><i>Permanent grassland - that has not been in arable rotation for at least 5 years, thus ranging from HNV to semi-natural to cultivated grassland</i></b></p>	<p>Benefits for climate change mitigation (esp. peatlands) and adaptation, biodiversity, soil, water management, flood prevention and landscape amenities</p> <p>Opportunity cost of not converting into arable land may be high, given the increased demand for arable land that can be put to a more profitable use; hence the need to support on environmental grounds grassland-based livestock systems</p> <p>Relatively low cost of maintenance (mowing, grazing, avoiding shrubs and bushes)</p> <p>To note that there are important differences in the amount of permanent grassland in the different Member States.</p>
<p><b><i>Ecological Set aside - land left fallow (not in production) for environmental purposes</i></b></p>	<p>Benefits for biodiversity; soil and water quality; climate change mitigation and adaptation; pest control; landscapes</p> <p>Impacts vary depending on whether set aside is rotational, on how land is maintained and on its location (e.g. buffer strips along water courses)</p> <p>Opportunity cost of no production (income foregone, to be balanced with possible increase in prices)</p>
<p><b><i>Natura 2000 - the EU wide network of Special Areas of Conservation under the Habitats Directive and Special Protection Areas under the Birds Directive</i></b></p>	<p>Benefits for biodiversity, water quality and climate change mitigation, that largely depend on conservation measures put in place in each Member State</p> <p>No additional cost given that relevant requirements are already mandatory</p>

The greening component of the first pillar foreseen in the integration scenario and Rural Development interventions should be developed in a complementary manner and, thereby, foster HNV farming. Given that the first pillar greening requirements form part of the baseline for agri-environment measures, there is a certain risk that the latter are simply substituted by green requirements established under the first pillar. Introducing additional green requirements to the first pillar would not go along with increasing payments as compared to current levels. Therefore, expanding green first pillar requirements to a degree that squeezes significantly the scope for agri-environment payments would mean

on balance less payments for environmental undertakings. This would certainly be counterproductive for promoting 'HNV farming'.<sup>25</sup>

The exact implementation of these measures and articulation with both cross compliance and agri-environmental measures of rural development play a crucial role for the extent to which environmental benefits can be achieved, as much will depend on aligning correctly the incentives for farmers.

It could be complemented by rural development measures on the same issues which add value by being more ambitious or better tailored to the local situation, by being part of a package of measures, or by encouraging connectivity of environmental features between farms. In such cases, the possibility should be granted to go beyond the 'greening' component (double 'baseline' to ensure no double funding for the same measure).

The shift of some agri-environmental actions to the green component of the direct payment scheme, would free up some funds that might be used for more targeted and ambitious agri-environment measures, thus producing a further reinforcement of the environmental outcome of the policy. The policy objectives would be fully aligned with Europe 2020 priorities, including the objective of "Resource Efficient Europe" which refers to biodiversity and climate change targets. In order to strengthen the contribution of rural development programmes to the attainment of the EU targets, quantitative targets would be set. This should incentivise MS to improve the framing of their policy and to programme and target those measures where they will have the most beneficial effects in particular as regards biodiversity and climate change. The focus on innovation should have the effect of a better dissemination of efficient measures that improve resource efficiency.

Farms located in LFA/NHA would benefit both from the additional income support to areas with specific natural constraints in 1<sup>st</sup> pillar and the move to a flat rate whatever the redistribution option. This would be favourable for the continuation of farming in areas with a high risk of land abandonment, which is in turn positive for biodiversity. In addition, farms in LFA/NHA have generally a high share of permanent pasture. Keeping the distribution of DP as in Status quo 2020 would miss the opportunity of meeting to specific needs of LFA areas.

In addition, the possibility to mobilise support from different sources (pillar 1 and pillar 2) together with maintenance of lands in Good Agricultural and Environmental Conditions (GAEC) would allow MS to better calibrate the support needed against risk of land abandonment. International impacts

Bottom-up approaches and efforts to enhance collaboration of farmers in terms of implementation of agri-environmental actions for better effect at the landscape scale will yield higher benefits for biodiversity, for mitigating effects of climate change and for improved resilience. In view of this, measure enhancing connectivity for environmental and climate change reasons should be given a higher rate of cofinancing and/or farmers should receive transaction cost payments to encourage uptake by MS and farmers. In addition, there would be more guidance in terms of how to best use packages of measures in order to maximise positive outcomes, e.g. advice and training offered alongside

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<sup>25</sup> For a more detailed discussion of the High Nature Farming in the CAP see Annex 2 p.

demanding agri-environment measures. Enhanced support to small farms could help addressing the risk of land abandonment in marginal areas.

#### 5.3.4. *International impacts*

The redistribution of support should not affect the EU's situation in international negotiations. However the way direct payments are distributed at MS level would have to be in line with WTO rules, and the extent of coupled support would need to remain within clearly defined limit.

To retain the WTO green box nature of 1<sup>st</sup> pillar payments, the 'greening' component will need to be a decoupled, fixed payment applying to all farmers in a specific area (MS or region); in this respect, care should be exercised in rewarding specific types of production e.g. through a grassland premium, and certainly not production *per se*.

#### 5.3.5. *Administrative impacts*

In the first year of implementation of the new system, there will be administrative burden associated with the redistribution (recalculation of the value of entitlements) and possibly transition (defining steps for progressive modifications in following years for each farmer). For the farmers, the introduction and application of a new model is burdensome and possible additional control requirements could create an additional burden. .

Simplification as the current overlap between agri-environmental actions in Art 68 and in rural development would disappear and there would be only one mechanism for all coupled payments (clarify art68). However, the introduction of a possible approval process by the Commission would go against the simplification and be more burdensome, mainly for the Commission services. Improving the targeting of payments to active farmers would require careful fine tuning of definitions in cooperation with MS and selecting criteria at MS level to be integrated into the IACS register which would require substantial administrative effort for them and certainly for farmers to prove eligibility, as they would have to provide supplementary detailed information and possibly submit accompanying documents with their application.

For controls, the current system as regards decoupled payments relies on two layers: 100% IT cross checks (LPIS) and 5% on-the-spot checks. With the introduction of the greening component, the system will rely essentially on on-the-spot checks, thus higher costs for controls. However, where possible, the use of remote sensing for on the spot checks could help keep costs down compared to field visits.<sup>26</sup>

Further criticism (e.g. from the European Court of Auditors) has focused on the fact that some beneficiaries of direct support seem to carry out no or only very limited agricultural activity which should not entitle them to support as “active farmers”. Better targeting of support to active farmers would help to increase the acceptance of payments but poses substantial practical difficulties. Thus, the exclusion criteria need to be fine tuned to reliably exclude non-active farmers while at the same time not affecting the access of genuine farmers to support. Certain criteria could be applied but not all of them are available across all MS and some may cause difficulties in terms of WTO compatibility. Certainly, the definition of exclusion criteria would require close cooperation with MS.

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<sup>26</sup> For more detailed analysis about the controls for different measures see Annex 2.

## **5.4. Re-focus**

### *5.4.1. Economic impacts*

While the decoupled payments do not have a direct influence on farmer's production choice, they nevertheless allow some of those who would otherwise have been forced out of the sector to continue producing. Also, a safety-net intervention system provides support to those farmers who are viable in normal conditions but cannot survive a period of excessively low prices. Therefore, the elimination of those tools would lead to strong restructuring in the agricultural sector.

Undoubtedly this option will imply more market orientation, but it is not certain that market would be more stable. Moreover, the recent experience of the intervention system during the dairy crisis should be taken into account (add reference). It can be argued that the intervention purchases had a considerable contribution in limiting the drop in market prices.

The end of direct support would result in structural changes by accelerating the move towards larger farm sizes. The main impacts would likely be not on the overall quantity of agricultural production in the EU but on the way this production is distributed over the EU territory. The lack of regional production in many areas could have negative consequences for local markets and products and could negatively affect certain up- and downstream enterprises with possible negative repercussions on territorial cohesion. Since the phasing out would take place gradually, these changes would be mitigated over time.

Without FAS obligation at the EU level, Member States have full liberty to organise their advisory system at national level. They can for instance decide not to organise any coordinated system and leave advice provision to farmers completely to the initiative of the private sector. A minimum offer of advice for farmers on the basic cross-compliance rules is not guaranteed. The capacity of producers to improve their competitiveness, to comply with environmental standards and to adapt to climate change is reduced. This translates in an agricultural sector which cannot contribute to a full extent to solving the important challenges of restoring biodiversity or adaptation/mitigation of climate change as the initiatives and supply of AKIS services from the private sector will most likely fall short of the farm sector demand for the provision of public goods. In particular, the farming sector of Member States where the development of the AKIS is not a priority, or is strictly resource-constrained, is at a strong disadvantage in comparison with other Member States.

Recently completed research (see the Policy Brief of the research project CAP-IRE) indicates that a more radical scenario of abolition of the CAP would entail a lower number of farms adopting innovation.

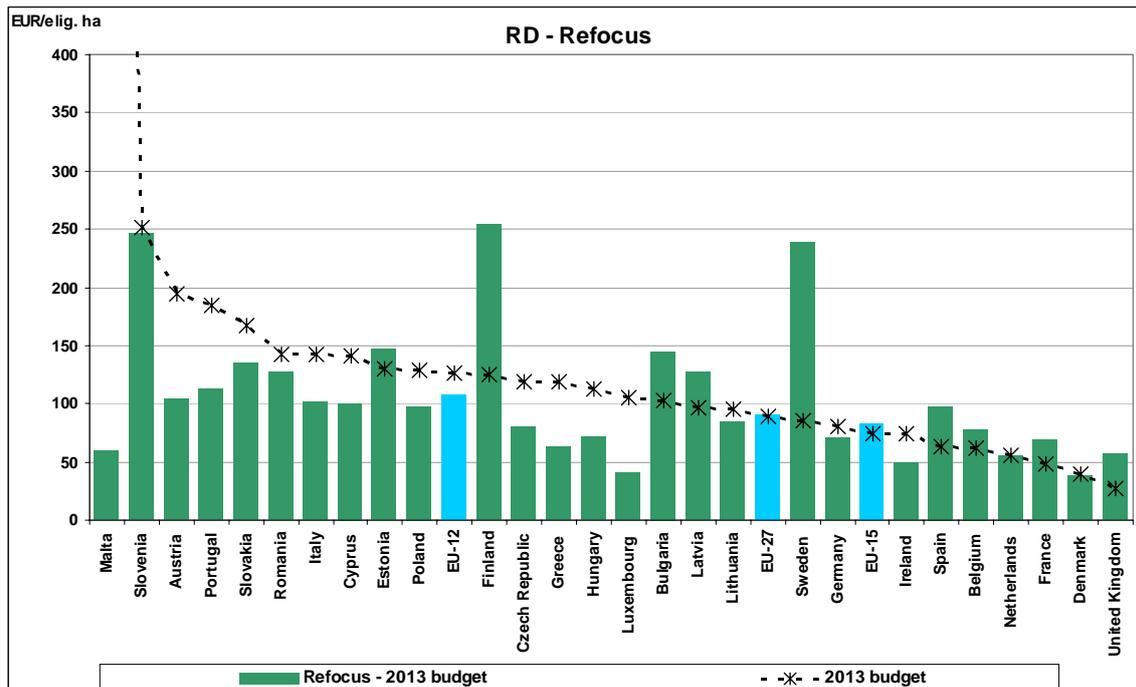
### *5.4.2. Social impacts*

The phase out of direct support would lead to substantial reductions in farm incomes, forcing many producers out of business. Even generally economically viable farms could be affected by this in years of difficult market situations as the role of direct payments in reducing income volatility would be lost. Structural changes are likely to result in loss of employment in the farm sector and possibly also in up- and downstream sectors. With concentration of agricultural production in some and abandonment in other areas, negative effects on the vitality of rural areas are likely to appear. Large field crop, grazing livestock

and mixed farms would be particularly affected due to their high dependence on DP. [so, to summarize, we will have difficulties for large field crop, but concentration of agriculture production and the same level of production], The additional employment and income opportunities for farmers as land managers under the 2<sup>nd</sup> pillar will not make up for the significant impact of the phasing out of direct payments.

The scenario would also imply a redistribution of the rural development funds based on the environmental criteria (agricultural area, Natura 2000 area, forest and permanent pasture)<sup>27</sup>.

Figure 6: Distribution of RD per hectare of eligible land in the re-focus scenario:



The results shown above differ considerably from the current distribution, and it may be considered to what extent the current distribution should also be taken into account.

A negative impact on the socio-economic development of rural areas, including the loss of the valuable social capital formation and the undermining of micro- and family business development, which is currently an essential element of the rural economies, would result. This would be especially felt in regions where agriculture is the main driver, as well as in regions most dependent on rural development funding.

In relation to the absence of axis 3 measures in particular, a positive impact may result from replacing axis 3 measures by axis 2-type measures in regions with a high share of agriculture (on the condition they are not too much affected by land abandonment following structural change due to the change in pillar 1 policy). Repealing current support to diversification measures would also affect already diversified rural economies and in a longer term would hamper the diversification of agricultural rural region, thus not allowing the reinforcement of the necessary base for a rural growth. All in all, the impact depends to a large extent on the situation of the area concerned.

<sup>27</sup> (1/3 Area + 1/3 Natura 2000 + 1/6 Forest + 1/6 Permanent pasture) x GDP inverse index

### 5.4.3. Environmental impacts

The main environmental impacts of the end of direct support would be due to the changing territorial distribution of agricultural activity. Both the concentration of production in particularly productive areas and the abandonment of production and land in more marginal regions would have far reaching consequences for the environmental balance in these areas with, e.g. loss of biodiversity and loss of possibilities to contribute to the mitigation of climate change, slow down adaptation or even increase vulnerability (e.g. fires). Such developments would result in increased environmental pressures and the deterioration of valuable habitats with serious economic and social consequences including an irreversible deterioration of the European agricultural production capacity. With the end of direct payments, the enforcement and sanctioning mechanism of cross compliance would depend on the amount transferred to the rural development measures currently concerned by cross compliance.

The extent of many of these impacts depends strongly also on whether and how policies of Pillar 2 would be adapted to mitigate the consequences. The doubling of funds under this scenario and the clear focus that these are to be spent on measures for the improvement of the environment and climate change actions, should normally result in significant positive impacts on these aspects but may fall short to address alone all the risks mentioned above.

However, the fact that in this scenario direct payments under the 1<sup>st</sup> pillar are phased out could severely compromise such an outcome. Without basic income support, the less competitive farmers who very often manage marginal land and land in remote areas in an extensive manner, thereby helping to maintain environmentally valuable areas, may cease their agriculture activity because they no longer make a sustainable income. On the other hand, agriculture activity may be concentrated and intensified in the most competitive areas. It is thus questionable to what extent the increased budget that can be made available can make up for the loss of direct payments. While GAEC rules would still apply for the beneficiaries of the rural development aid, they would not cover all the agricultural sector.

### 5.4.4. International impacts

The Amber box value will certainly diminish. The end of direct payments could further improve the EU's position in international trade negotiations

### 5.4.5. Administrative impacts

In the long run, the phasing out of direct payments would bring administrative facilitation since the scheme would not have to be administered anymore.

## 6. COMPARING THE OPTIONS WITH RESPECT TO OBJECTIVES AND IMPACTS

**Table 1: Comparison of options by objective**

	<b>Adjustment</b>	<b>Integration</b>	<b>Re-focus</b>

Contributing to a viable, market oriented, food production throughout the EU			
Ensuring the provision of environmental public goods such as the sustainable management of natural resources and the preservation of the countryside			
Contributing to the vitality of rural areas and territorial balance throughout the EU			

**Table 2: Comparison of options by impact**

		<b>Adjustment</b>	<b>Integration</b>	<b>Re-focus</b>
<b>Economic</b>	<b>Profitability of farming</b>			
	<b>Functioning of the food chain</b>			
	<b>Resistance to crisis situations</b>			
<b>Social</b>	<b>Employment</b>			
	<b>Income level</b>			
	<b>Territorial cohesion</b>			
<b>Environmental</b>	<b>Biodiversity</b>			
	<b>Resource efficiency</b>			
	<b>Climate change action</b>			
<b>International trade</b>				
<b>Simplification</b>				

## **7. MONITORING AND EVALUATION**

The first pillar is monitored through continuous reporting of Member States on the use of direct payments and the situation on agricultural markets. In the context of the focus on environmental aspects, DG AGRI is working on a set of indicators that would describe economic and environmental sustainability at farm level. Retrospective evaluations will be carried out according to the DG AGRI multi-annual evaluation plan, which will be

annually reviewed and updated. The evaluations will assess the efficiency, effectiveness and relevance of the policies against their specific objectives.

The design of individual evaluation studies will benefit from the experience gained over the last years in the implementation of cross-sectoral evaluations in agriculture, such as the evaluation of market effects of partial decoupling (completed in 2010) and the evaluation of income effects of direct support (to be completed in 2011).

For the second pillar, the monitoring and evaluation system will reflect the strategic approach to planning and programming of rural development interventions. Building on the Common Monitoring and Evaluation Framework (CMEF) that was developed for the 2007-2013 programming period, the monitoring and evaluation system will be adapted to a more outcome oriented policy approach.

The core objectives of the monitoring and evaluation system will be to demonstrate the progress and achievements of rural development funds, contribute to better targeted and more effective support and implementation, and support common learning.

The system will consist of:

- a common methodological framework, including a set of common indicators linked to the structure of the policy framework, allowing assessment of policy implementation against priorities and targets;
- a Monitoring Committee for each RDP bringing together relevant stakeholders;
- Annual Progress Reports for each RDP to monitor programme implementation;
- Programme level ex-ante, mid-term and ex-post evaluations, conducted by independent evaluators, EU level syntheses, and a system of ongoing evaluation for each rural development programme, established by the Member States;
- capacity building, including the European Evaluation Network, to support implementation and evaluation of the rural development policy.
- The main developments compared to the current system will be to establish a clear link between operations selected for funding and policy priorities, to reinforce Local Action Groups level monitoring and evaluation, to streamline the data and reports required and to automate data provision as far as possible.