COMMISSION OF THE EUROPEAN COMMUNITIES

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accompanying the

Proposals for

COUNCIL REGULATION establishing common rules for direct support schemes under the common agricultural policy for farmers and establishing certain support schemes for farmers

COUNCIL REGULATION on modifications to the common agricultural policy by amending Regulations (EC) No 320/2006, (EC) No 1234/2007, (EC) No 3/2008 and (EC) No […]/2008

COUNCIL REGULATION amending Regulation (EC) No 1698/2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD)

COUNCIL DECISION amending Decision 2006/144/EC on the Community strategic guidelines for rural development (programming period 2007 to 2013)

Impact Assessment

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A – PROCESS, OUTLINE AND METHODOLOGY

1. PROCESS AND OUTLINE

A Steering Group of 15 Commission Services contributed to the identification of the analysed options and objectives, and discussed in several meetings the preliminary results of the Impact Assessment. In parallel, public consultation with stakeholders included two public seminars which discussed the HC Communication, and invited contributions based on a questionnaire. During the seven-week period of public consultation, the Commission received a significant number of submissions (85) with wide-spread representation across Member States (MS) and stakeholders, from farm and environmental groups to industry.

The conclusions are presented in this Impact Assessment report, which together with its accompanying background material detailing the results of the various internal and external analyses, is annexed to the legal proposals. The Impact Assessment compares policy options against the baseline assumption of continuation of existing policies, including policies related to the WTO. The most recent market outlook indicates that a higher level of agricultural prices will persist for the foreseeable future. This outlook has been taken into account in the present analysis, and constitutes the baseline for market developments. Uncertainties about the prospects of a WTO agreement in the context of the Doha Development Agenda (DDA) negotiations imply that, for this analysis, the description of a reliable scenario of a DDA agreement was not feasible. However, in selective areas, the potential outcome of such an agreement is assessed based on the comparison of options to the formal EU offer in DDA.

The Impact Assessment used extensively quantitative analysis for issues related to the SPS and market measures. The impact from adjustments in SPS-related issues were analysed based on microeconomic data from the Farm Accountancy Data Network (FADN), while econometric analysis was used to estimate the impact of adjustments in market measures. On the other hand, for issues related to new challenges and cross compliance, analysis was mainly of a qualitative nature.

This Report was examined by the Impact Assessment Board and benefited from its suggestions. To take account of its opinion, several modifications were introduced with respect to previous versions. An overall introduction was added to give a better overview of the various elements of the Report, and better identify in the problem definition and objectives the inter-relation between the various issues.

The three main areas of analysis (SPS, markets, new challenges) are now addressed in separate sections. In each section, a cover page introduces problem definition and specific objectives compared to a clearly defined baseline scenario. At the end of each section, after the individual chapters, tables summarise the impacts of each option and assess each option with respect to fulfilling its objectives. Specific modifications were also introduced in individual chapters, following the Board's various suggestions. A final section was added, bringing together the main conclusions of the Assessment of the Health Check proposals, including cross-cutting impacts of all options, and their impact on stakeholders beyond the agricultural sector.

Additional analysis has been included in those areas where developments in recent months rendered altered some of the initial assumptions (such was for example the case in dairy with respect to price developments or the quota level were altered because of recent

developments), or existing analysis was added in the annexes to clarify already analysed developments (such as the impact of price increases on consumers).

A series of Annexes provide details supporting the results of the analysis. These Annexes summarise the results of the public consultation of stakeholders (A), provide information about the state and role of EU agriculture in the EU economy and EU regions and the impact of CAP support (B), analyse issues related to the SPS framework (C), include analyses on market-related measures (D), on the suitability of existing RD instruments and financial resources to face new challenges (E), and provide additional internal (microeconomic) and external studies that were also used in the analysis (F and G, respectively).

2. METHODOLOGY

To address the above issues, and analyse the impact of potential changes in the CAP, the present Impact Assessment (IA) followed these steps.

Public consultation with stakeholders included two public seminars, one on the global presentation of the HC, the other with focus on dairy issues. Stakeholders were invited to contribute to the preparation of proposals based on a questionnaire. This resulted in a significant number of submissions with wide-spread representation across Member States (MS) and stakeholders, ranging from farm and environmental groups to industry (details are provided in Annex A).

Many existing analyses and studies, both internal and external, were examined, leading to the overall assessment that the CAP reform process has already radically reformed and improved the performance of the CAP. Annex B provides information about the state of EU agriculture and its role in the EU economy and the EU regions which indicates the contribution of CAP reform towards increased market orientation, better distribution of support among the various policy pillars, more transfer and budget efficiency, and improved balance in EU and world markets. Annex B also sheds light on the impact of CAP support based on the conclusion of an extended analysis about the prospects of EU agriculture for 2020. This study provides the best proof of what support does: it contributes to regional farm income, less intensive farm practices and more territorial cohesion in a joined-up manner. It is not the overall level of EU agricultural production that would suffer from the removal of support to EU agriculture, but the location and the intensity of this production.

Annex C analyses the potential impact of changes in the SPS model towards a more flat, per area, rate of support on the distribution of farm payments, and on farm income at MS and farm level. It relies on the analysis of the distribution of support based on data concerning the most recent CAP payments, on microeconomic analysis at farm level, and on the conclusions of external studies about the impact of decoupled support on farm income and on land markets. It also looks into the impact of payment limitations on the distribution of support and on farm income.

Annex D relies on different analytical approaches (in-house and external partial equilibrium econometric models to microeconomic analysis at the farm level) to assess the outlook for agricultural markets and the potential impact of changes in CAP market instruments. This analysis also used the results of a commissioned external study on the phasing-out of dairy quotas and its potential impact on production, prices and income. Furthermore, the annex summarises the conclusions of several studies on risk management.

Annex E summarises the results of the screening of RD instruments to identify their suitability for the new challenges facing EU agriculture, and assesses the potential impact of an increase in modulated funds which shift support from the 1st to the 2nd CAP Pillar.

Finally, Annexes F and G provide a list of additional internal (microeconomic) and external studies that were also used in the analysis.

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B – INTRODUCTION

1. SCOPE AND OBJECTIVES

The basic objectives of the common agricultural policy (CAP) are set in the Treaty. Following successive reforms since the mid-1990s, they have since been adapted in the European Summits of Berlin and Göteborg. In the Communication preparing the 2003 reform, the CAP was identified as aiming to achieve:

- a competitive agricultural sector,
- production methods that support environmentally friendly, quality products that the public wants,
- a fair standard of living and income stability for the agricultural community,
- diversity in the forms of agriculture, maintaining visual amenities and supporting rural communities,
- simplicity in agricultural policy and the sharing of responsibilities among Commission and Member States,
- justification of support through the provision of services that the public expects farmers to provide.

Implementing the above broad objectives in more concrete policy terms, the 2003 reform marked a new phase in the CAP reform process by introducing changes in the CAP with three main objectives:

- enhance competitiveness with significant adjustments in market measures in the sectors of cereals, dairy, and rice;
- promote a market oriented, sustainable agriculture by decoupling direct payments in the arable crops, beef and dairy sectors via the Single Payment Scheme (SPS);
- strengthen rural development with the shift of funds from the 1st to the 2nd pillar of the CAP via modulation.

A similar path was followed by subsequent reforms in 2003 (olive oil, cotton and tobacco), sugar (2006), fruit and vegetables (2007) and wine (2007). Finally, Rural Development (RD) policy instruments were also reformed (2005).

With the reform implemented in 2005-07, it is too soon to assess its full impact. First indications are in general positive, whether measured in terms of the implementation rate of decoupling, better market outlook or strengthened rural development programmes. In most areas, initially expressed concerns about the impact of the reform did not materialise. Thus in the present context, a fundamental reform of the CAP for the remaining horizon of the present financial perspectives (until 2013) is neither necessary nor desirable.

However, other, parallel market and policy developments indicate a rapidly changing environment facing EU agriculture. These developments, together with the experience gained so far from implementation, indicate the need for CAP adjustments which could not be foreseen when the 2003 reform was carried out. The aims of the HC are therefore to:

(1) assess the experience from the implementation of the Singe Payment Scheme and to introduce adjustments that further simplify and increase the effectiveness of the policy;

(2) introduce adjustments to the CAP in order to allow it to respond to present market opportunities and face new challenges related to energy/climate change policy objectives.

2. ISSUES

Following the HC Communication, the present Impact Assessment is grouped in three main areas aiming to address the three main policy questions of the HC:

(1) How to make the Single Payment Scheme more effective, efficient and simple?

Regulation (EC) No 1782/2003 covers all issues related to the core of farm support today, the Single Payment Scheme (SPS). The analysed options are assessed based on their impact in allowing farm support to deliver the stated reform objectives of market orientation, simplicity and WTO compatibility, while in parallel being more responsive to equity and other societal considerations.

(2) How to render market support instruments still relevant in a globalised world and an enlarged EU?

Regulation (EC) No 1234/2007 covers issues related to the single common market organisation (sCMO). The impact of various options in adjusting this recently consolidated legislation is assessed based on how such adjustments would permit a better response of the CAP to the emerging opportunities in world agricultural markets and fine tune existing market management instruments to render intervention a real safety-net mechanism, and on how they would remove remaining supply constraints.

(3) How to master new challenges by adapting to the new risks and opportunities?

Regulation (EC) No 1698/2005 covers issues related to Rural Development (RD) policy. Existing policy measures and financial resources are assessed in order to examine whether a better targeting of financial priorities within the CAP would allow it to respond to the new challenges and emerging risks from climate change, bio-energy, biodiversity and water management.

The present Impact Assessment has a certain degree of autonomy within each of the above three areas. But there are also important cross-cutting linkages in the expected impacts of various options. Such linkages are more evident in:

- the removal of existing supply controls in arable crops (set aside) which are driven by market considerations, but could create risks for existing environmental side benefits;
- the risk that the expiry of dairy quotas pose for farm income and employment in certain regions, and the resulting need for adjustment in the SPS and/or RD;

- the need to combine measures across different policies (cross compliance and RD measures) in order to better respond to new challenges;
- the increasing importance for farmers of risk management information and tools;
- the need to carefully examine and balance the potential benefits form adjustments in CAP measures with the administrative costs that they could entail.

The potential impacts of the various options for CAP adjustments were assessed based on the following criteria:

Economic	**Social**	**Environmental**
Market orientation	Stability of farm income	Environmental sustainability
Competitiveness	Vitality of rural areas	Biodiversity
Budgetary cost	Employment	Expected uptake by MS
Transfer Efficiency	Distribution of payments	
Administrative burden	**Simplification**	**Others**
Cost to the farm	Implementation rules	Compatibility with WTO constraints
Cost to public administration	Better targeting	Coherence with other relevant policy objectives

C – SINGLE PAYMENT SCHEME

1. PROBLEM DEFINITION

- The current SPS framework includes a degree of rigidity, which restricts the effectiveness of the SPS and reduces its responsiveness to evolving conditions:
  - the SPS payments are based on a reference period, which, particularly under the historic model, reflects previous production structures and agricultural support;
  - there is no provision to allow MS to adjust their initial implementation decision, in terms of the SPS model chosen, partially coupled support and Article 69 options;
  - there is no instrument for addressing the uneven distribution of payments;
  - the current scope of cross compliance needs to be re-assessed in the light of new challenges facing EU agriculture.
- SPS implementation has also created a number of extra costs, which lower the efficiency of the system in attaining its declared objectives:
  - some measures of cross compliance, not linked to agricultural activities, were therefore not appropriate for this instrument;
  - the receipt of high payment levels by a few beneficiaries raises the question of whether and to which extent payments can be justified for farms of very large economic size;
  - the receipt of small payment levels of many beneficiaries raises the question of whether payments can be justified when they exceed their administration cost.
- Several aspects of the current SPS implementation, in particular measures of partially coupled support and cross compliance, could benefit from a simplification, in order to ease the administrative burden for farmers and public administrations.

2. OBJECTIVES

- Achieving improved competitiveness, better market orientation and better compliance with EU standards;
- meeting the underlying sustainability goals of the reformed CAP;
- meeting the societal expectations from the CAP in terms of the provision of public goods, the distribution of direct payments and new challenges;
- preserving the vitality of rural areas and specific types of farming, which may be low in intensity, but high in positive environmental or regional benefits;
- further simplifying the CAP.

C.a. IMPLEMENTATION OF THE SINGLE PAYMENT SCHEME

1. BACKGROUND

The objective of the 2003 CAP reform was to provide a direct payment system that allows farmers to be market oriented, is as simple as possible from an administrative point of view, and is compatible with WTO requirements for Green Box payments. This was achieved with the introduction of the Single Payment Scheme (SPS), which rendered decoupled farm support the central element of the 2003 CAP reform.

In implementing the SPS, MS could opt for a historic model (payment entitlements based on individual historic reference amounts per farmer), a regional model (flat rate payment entitlements based on amounts received by farmers in a region in the reference period) or a hybrid model (mix of the two approaches, either in a static or in a dynamic fashion)[1].

In order to receive payments, farmers have to activate their SPS entitlements by matching them with a corresponding number of eligible hectares. In the historic model the number of payment entitlements corresponds to the number of hectares that generated support payments in the reference period; thus eligible land not used to activate entitlements remains as "naked land". On the other hand, in the regional implementation the number of payment entitlements broadly matches the number of eligible hectares.

This significant shift in farm support was facilitated by the flexibility that MS had in their choice. However, whatever the choice of model, both historic and regional approaches to decoupling are similar in two fundamental aspects. Both models do not guide production choices, but allow farmers to be market oriented by reacting to market signals and price developments. Both models have a fixed reference in payments and in the area to which these payments correspond.

But the two fundamental choices in implementing the SPS, and their variants, also have a significant difference with respect to the distribution of support, whether this is fixed in one shot (static) or gradually (dynamic).

- The first approach (historic model) respects the previous level of support that farmers received, and leaves redistribution issues to be dealt with through modulation. As a result this SPS model uses the *farm as the fixed reference* for the allocation of payment rights (entitlements).
- The second approach (regional model), driven mainly by equity arguments since redistribution was significantly scaled down because of the limited extent of modulation, addresses issues of redistribution of support through the SPS. As a result, this SPS model uses the *area as the fixed reference* for the allocation of entitlements.

[1] Most of the new MS are still implementing the Single Area Payment Scheme (SAPS), a simplified area payment per hectare, introduced *before* the SPS to facilitate transition to EU.

In practice, MS choices led to an almost even split, in budgetary terms, between historically-based and regionally-based support. Both approaches achieve the objective of WTO compatibility by introducing fixed references for the payments farmers receive. And although the initial implementation of the regional model proved to be more complex, once in place both models are similar in their implementation rules.

To provide MS with additional flexibility to target specific needs, Article 69 of Regulation (EC) No 1782/2003 authorises them to take up to 10% of the component of the national ceilings of each sector to allocate additional payments to the farmers engaged in important types of agriculture for the protection or improvement of the environment or for improving the quality and marketing of agricultural products. Payments are made to farmers within the sector(s) affected by this retention. At its origin, Article 69 was intended to provide some limited flexibility to MS to deal with unintended consequences of decoupling.

2. PROBLEM DEFINITION

SPS model

As Member States prepare themselves for future adjustments in the CAP, they should be allowed to adjust their SPS model based on the experience gained so far from its implementation across the EU. However, in the current legislation there is no provision that would allow MS to make such changes.

The possibility to introduce adjustments to the SPS model is particularly relevant since the question of how equitably support is distributed among farmers, persists as an important issue, especially under the historic model.

The historic model allowed farmers to be market oriented while keeping their past support level while the regional model redistributed support to farmers in a way that the support per hectare is similar within regions. The historic model can, thus, be regarded as being less equitable since it gives aid to individual farmers based on their past support levels, which reflect the previous structure of production and of agricultural support. As the historic reference period for payments becomes more distant, these individual differences will continue to become harder to justify.

Article 69

Further decoupling and the expiry of the dairy quota could affect the income of certain producers in particular regions. This could also negatively affect the vitality of rural areas where farmers have no viable alternatives and could lead to the discontinuation of certain environmentally beneficial types of farming. Furthermore, the need for additional tools to address risk management has become apparent.

The possibility to give targeted, flexible support under Article 69 has raised interest in the applicability of this Article as a means to mitigate such problems. However, in its present form, Article 69 does not appear suitable to address these issues due to the fact that payments can only be made to farmers in the sectors affected by the retention of funds, and this rule limits the flexibility of MS in applying Article 69.

3. OBJECTIVES

SPS model

The specific objectives of adjustments to the SPS implementation in terms of the model applied are to give MS the possibility to:

- adjust their chosen model towards flatter rates of support;
- address concerns about the equity and distribution of payments among farmers;
- continue to ensure high transfer efficiency, market orientation of the farming sector and environmental sustainability of farming through compliance with EU standards;
- limit administrative burdens and simplify the system where possible.

Article 69

With respect to the revision of Article 69 the specific objectives are to:

- provide a flexible instrument to address specific problems stemming from further decoupling and the end of the dairy quota;
- address risk management needs, thus mitigating possible income problems;
- continue environmentally beneficial agricultural production in regions that could be negatively affected and the improvement of quality and marketing of the agricultural products;
- contribute to the vitality of rural areas in certain where farmers may not have viable alternatives;
- ensure that supporting measures remain in conformity with WTO commitments

4. OPTIONS SPS MODEL

The following policy options for SPS models were analysed[2], and results were assessed with a view to whether these options meet the objectives mentioned for the SPS model in section 3.

Table 1. – Policy options SPS model

Option	***SPS model***	***Description***
0	Status quo – baseline	No review possibility for MS; both historic and hybrid/regional models continue as present
1	EU-wide flat rate per eligible hectare	The same flat-rate payment entitlement per eligible hectare applies to all EU MS
2	SAPS for all MS	The Single Area Payment Scheme of new MS becomes the model for all EU MS
3	Regional flat rate per hectare	Move towards regional flat-rate entitlements applied to all eligible area
4	Regional flat rate per entitlement	Move towards regional flat-rate entitlements based

[2] Analysis on the basis of FADN simulations with the DG AGRI G3 Aids4k model, results from research projects and other DG AGRI calculations (see note 1 in Annex C for details).

		on current entitlements

5. IMPACT ANALYSIS SPS MODEL

In the public perception, the biggest difference between the two SPS models lies in their distribution impact; land value considerations are largely limited to the research community. Therefore, the starting point for understanding the impacts of a move towards a flat rate is to consider the current distribution of direct payments in the EU, and assess the impact of various SPS options on this distribution. These impacts, which lie mainly in the economic and social sphere, are discussed in some detail in this section but attention is also devoted to the environmental and administrative impacts.

The overview table in the end of this chapter provides a complete picture of the most important economic, social, environmental and administrative/simplification impacts for all options for the SPS model. See also note 1 in Annex C for more detailed analysis.

5.1. Option 0: status quo

The two broad SPS models, historic and regional, differ with respect to their equity/redistribution impact. The historic model did not redistribute support between farmers, and thus asset values (especially land) of the farms were little or not at all affected[3]. A very high transfer efficiency results from the fact that there is some "naked land", so support is better aimed at active farmers instead of landowners[4].

While the historic model gives aid to individual farmers based on their past support levels, the regional model redistributed payments in a way that the support per hectare is similar. By setting flat rates at a regional scale, payments can be adjusted to the conditions of different regions which may be justified by differing natural conditions and cost structures. However, the redistribution of support among farmers in the regional model could have an effect on asset prices, which may induce a structural response of farms. Its implementation led to increased capitalisation of aid in the value of land which may result in a somewhat lower transfer efficiency of direct support as some of it may benefit non-farming landowners.

Analysis of the current distribution of support among EU MS demonstrates a complex situation. It is often pointed out that the distribution of direct payments among farm in the EU is “uneven”: 80% of beneficiaries receive roughly 20% of payments[5]. When regarded at a per hectare basis, as can be expected, the range of direct payments per hectare tends to be wider in the MS applying the historic SPS model than in those applying regional/hybrid models.

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3 Part of direct support is captured ("capitalised") in the value of land. Therefore, any redistribution of support also affects land values. Capitalisation of support in land values should be the higher, the less "naked land" (eligible land not currently used to activate entitlements) exists.

4 See note 1 in Annex C for more details.

5 See also chapter C.d. (payment limitations) and notes 1 and 4 in Annex C for more details.

The average payments also differ widely among MS, whether the variable used as reference is the payment per area (hectare) or whether the payment is calculated per beneficiary. In Figures 1 and 2, to facilitate comparison of the analytical results, average farm payments were calculated in a simplified way based on their expected level after all MS fully implement CAP reforms and new MS fully integrate into the CAP. It is worth noting that presently the MS with the highest per hectare payments figure among those MS with the lowest rate of payment per beneficiary; on the other hand, the MS with the highest payment per beneficiary is around the EU average when area is the reference variable.

Figure 1: Average direct payment per MS (in € per hectare)

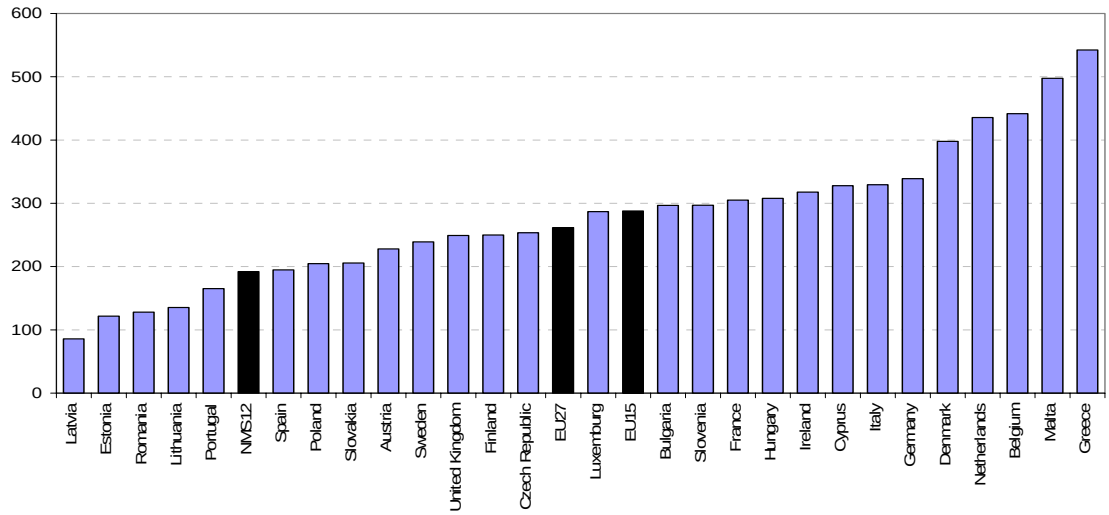
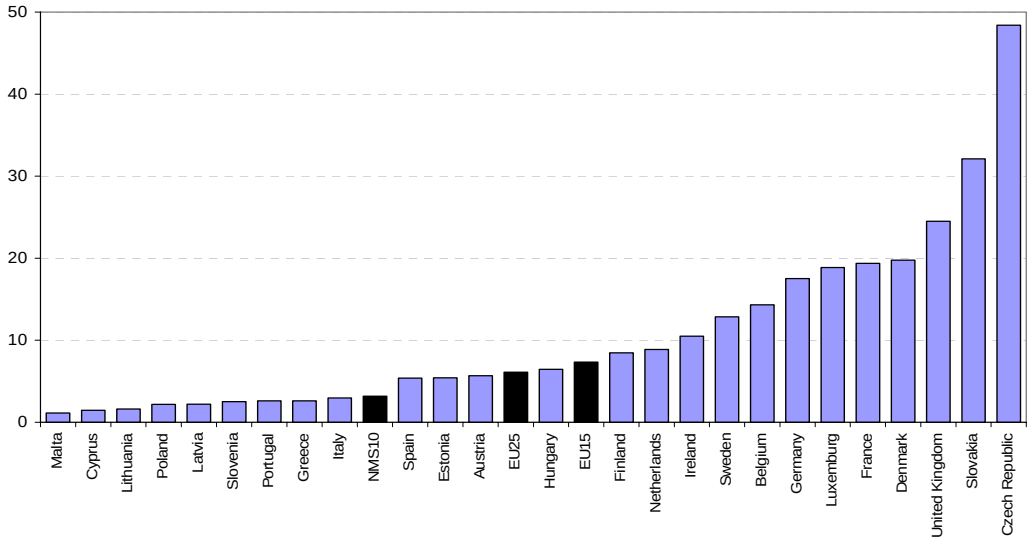


Figure 2: Average direct payment per MS (in €'000 per beneficiary)



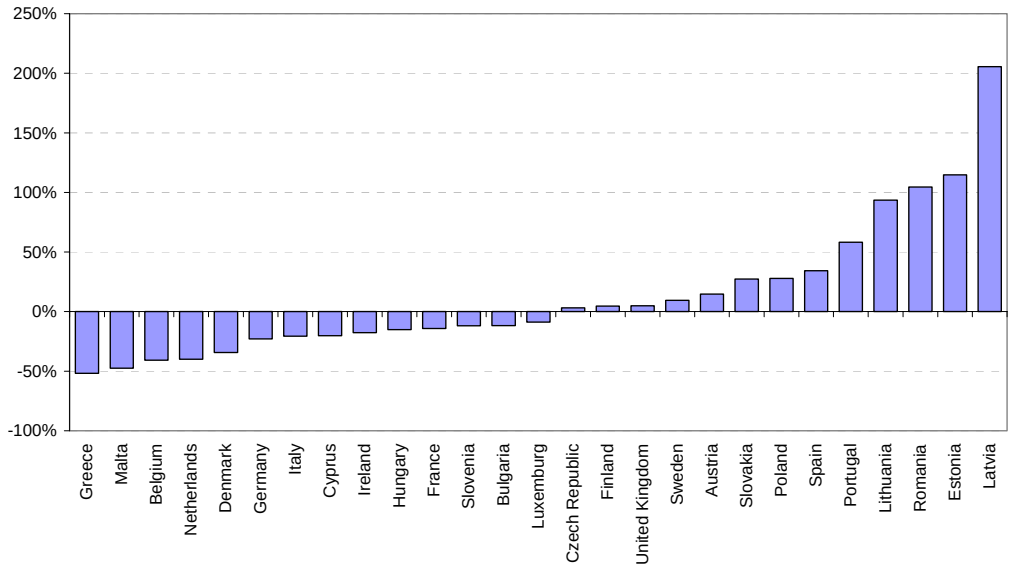
Source: DG AGRI calculations (see Annex C, note 1 for details).

Due to the "whole farm approach" of cross compliance, both historic and regional model contribute similarly to respecting cross compliance standards. They are also similar with respect to administrative burdens.

5.2. Option 1: EU-wide flat rate per eligible hectare

Figure 3 demonstrates the potential redistributive impact of a move towards an EU-wide flat rate per hectare by indicating the % change in the overall amounts each MS would receive[6].

Figure 3: Redistribution between MS with an EU-wide flat rate



Source: DG AGRI calculations (see Annex C, note 1 for details).

This option would imply a fundamental reform of the SPS, and is therefore beyond the scope of the HC Communication. However, it has found some proponents in the context of the present public debate, and was therefore analysed to better assess its potential impacts. This analysis arrives at the conclusion that it is very difficult to identify any benefits it could bring with respect to the declared objectives of adjustments to the SPS.

In summary, the implementation of this option:

- would not improve the distribution of payments within MS – some of the MS negatively affected have average payments per beneficiary that are very low, others are in the opposite situation;
- would result in adverse impacts on asset (land) values, with very significant declines in some MS and the opposite effect on others. It could affect farm structures and would decrease transfer efficiency due to higher capitalisation;
- would not change much the skewed distribution of support between farms at EU level since the distribution of land in the EU mirrors to a large extent that of production value (which is the historic reference for payments)[7];
- would have impacts on the distribution of payments between farms in terms of their economic size and in terms of type of farming;

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6 The graph compares the national ceilings currently established for MS in Regulation (EC) No 1782/2003 with the amounts they would receive if an EU-wide flat rate was applied.

7 One counter-intuitive result of these simulations was that in some MS, a harmonised flat rate does not decrease but actually increases the unevenness in the distribution of direct payments.

- would possibly bring some new beneficiaries into the system which could increase administrative costs but could also slightly increase the land under cross compliance;
- could be combined with further simplifications to the SPS system[8].

5.3. Option 2: SAPS for all MS

The Single Area Payment Scheme was introduced in the new MS before the introduction of the SPS to facilitate their adjustment to the EU because of their specific agricultural situation[9]. As a transitional system, SAPS was designed to assist the integration of new MS in a smooth manner, given the very significant differences between the level of their general and rural economies and those in the EU-15.

As the deadline for the expiration of SAPS approaches, and new MS consider their integration into the SPS, the possibility of extending this deadline to the end of the present financial framework if they so wish seems a natural choice if, at the same time, EU-15 MS are allowed to review their SPS implementation and opt to move towards a more flat rate model.

As a transitional scheme, SAPS clearly performed its intended role. Yet at times SAPS has been considered as a system which should be applied to all MS, i.e. an inverse move from SPS to SAPS is considered as desirable. Although such suggestions are not wide spread, they tend, nevertheless, to confuse at times the policy debate because they fail to focus on the main difference between SPS and SAPS – the fixed entitlement reference of the former and the varying area reference of the latter.

The single area payment is a flat rate payment per hectare at MS level. It is calculated by dividing the annual national financial envelope of the MS by the agricultural area under SAPS in a given year. As a transitional scheme, this is fine. But as a permanent scheme, it would contradict the philosophy of decoupled support because it would not be a system based on fixed entitlements.

In terms of its distributional impact, a SAPS for all MS would lead to substantial redistribution within MS and higher capitalisation of support, resulting in strong effects on land values. The distribution of payments among farms would mirror that of land and would, thus, continue to be skewed.

The desire of farmers to maximise payments by maximising their eligible area could put pressure on land not currently in agricultural use and of high environmental value.

5.4. Option 3: regional flat rates per eligible hectare

A general flat rate could have significant redistribution impacts even within the same MS if its farm structures differ widely. However, such impacts could be mitigated

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8 This refers to simplifications that are neutral to the SPS model applied but lead to administrative simplification, e.g. reducing the number of different types of entitlements (see also note 1 in Annex C.

9 This situation was characterised by very different and much lower (where relevant) levels of support, the absence of previous payment and area references and the consequent absence of control systems.

with a targeted move towards a flat rate that takes into account such differences by harmonising payments in a regional context[10].

This can be done by dividing the total level of reference payments of the historic model in a region by the eligible area in this region.

In a move towards a regional model, the extent to which land remains “naked” becomes a crucial parameter. A regional flat rate per eligible hectare reduces the percentage of "naked land” leading to more capitalisation of support in land values[11].

The following general conclusions can be derived:

- a regional flat rate per eligible hectare does not change much with respect to the unequal distribution of support between farms in the EU (however, there are variations in results between the MS with improvements in some of them);
- there is some reallocation of direct support from larger to smaller economic size classes of farms and the impact is differentiated for different farm types (however, both of these impacts are less pronounced than for the EU-wide flat rate);
- although regional flat rates per eligible hectare increase the capitalisation of support in land prices and reallocate support between farms, the effect on land values in the MS would be moderated by the fact that the regional context can be taken into account;
- the regional flat rate per hectare could result in new beneficiaries in MS where the historic model was previously applied because of the expansion of support to all eligible area. This could increase administrative costs but also slightly increase the land under cross compliance;
- the option can be combined with further simplifications to the SPS system.

5.5. Option 4: regional flat rate per entitlement

In this option, the regional flat rate is derived by dividing the total value of payment entitlements within a region by the area corresponding to these entitlements.

At first sight, the difference with option 3 appears small, especially since a move towards a flat rate based on the existing entitlements, with respect to its overall redistributive effects, would produce largely similar results to that of regional flat rates per eligible hectare. However, there are also some notable differences between the two options when comparing their potential impact in the same region.

The regional flat rate per entitlement:

- could mitigate the undesired consequence of a redistribution of support favouring landowners while still keeping the desired impact of more even levels of payments among active farmers;

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[10] This realisation seems to reflect the choice of England, where the ratio between the highest and the lowest flat rate is 7 to 1.

[11] See more detailed discussion in note 1 in Annex C.

- would not change the degree of capitalisation of support in land values as compared to the status quo since the amount of "naked land" would remain the same;
- would not lead to new beneficiaries in the SPS system since only those already holding entitlements would be affected, thus limiting administrative costs and leading to no change in the amount of land under cross compliance.

6. OPTIONS FOR ARTICLE 69

The following policy options for Article 69 were analysed, and results were assessed with a view to whether these options meet the objectives mentioned for Article 69 in Section 3.

Table 2. – Policy options for Article 69

Option	***Article 69***	***Description***
0	Status quo – baseline	No change to the current Article 69
1	Targeted revision	The sector-specific rule by which retention and payments have to be made in the same sector would be removed. MS would be allowed to use up to x% of their national ceiling to grant targeted support to farmers in specific sectors (such as dairy, beef, sheep, goat meat and rice) and certain regions and in relation to risk management (in addition to the current use of Article 69). The share of support going to measures that do not with certainty meet the conditions of the Green Box would be limited.
2	Extended revision	Same as option 1 except that there would be no limitation on the share of support going to non Green-Box measures.

7. IMPACT ANALYSIS ARTICLE 69

This section presents a summary of the impacts of the different options for the revision of Article 69.

The overview table in the end of this chapter provides a complete evaluation of the most important economic, social, environmental and administrative/simplification impacts for the options. See also note 1 in Annex C for the analysis.

7.1. Option 0: status quo

No change to the current Article 69 implies that the flexibility for some MS to react to potential problems in the milk sector and other sectors due to the end of the quota and further decoupling, as well as to risk management issues, would be very limited[12]. This would be the case because the requirement that the 10% of SPS support that has to be retained and used within the same sector could severely constrain some MS, e.g. those with more mountainous or fragile dairy regions than others.

This could not only present income problems to certain producers but may also negatively affect the vitality of rural areas where farmers have no viable alternatives

[12] See also Chapter 3 (partial decoupling), Chapter 6 (milk) and Chapter 9 (risk and crisis management).

and could lead to the discontinuation of certain environmentally beneficial types of farming (e.g. rice cultivation in certain regions).

7.2. Option 1: targeted revision

The targeted revision would give MS increased means to address possible problems in the milk sector and other sectors arising due to the end of the quota, further decoupling or the need for additional risk management tools. It would not mean a major revision of the current Article 69 but would imply some risk of further re-coupling (however within clear limits).

To take the example of the dairy sector, such a revision could address problems in two ways – either through an increase of the decoupled payment in the regions negatively affected by the abolition of the quota system, or through a coupled payment to the sector in the form of an area or per cow payment linked to production.

The first choice would be fully compatible with the overall WTO orientation of the CAP, but would not necessarily guarantee the continuation of production.

The second choice implies an increase in the level of partially coupled (Blue Box) support. In the case of a DDA agreement, it would thus require a parallel reduction in other partially coupled support (e.g. in arable crops) to allow the EU to remain within its expected margins of Blue Box support in the future. However, an appropriate restriction on the share of coupled measures of support would resolve this problem.

7.3. Option 2: extended revision

A generalised extension of Article 69 would give MS much greater flexibility to address possible problems in specific sectors, as well as risk issues, but it would imply several risks for the consistency of CAP orientation.

Most measures currently applied by MS under Article 69 are production-linked, and this option would mean a backtracking from further decoupling as it would not limit the share of coupled measures under a revised Article 69. In the case of a DDA agreement, it would clearly risk exceeding the ceiling of Blue-Box support (unless there was a corresponding parallel reduction in other partially coupled support).

8. CONCLUSIONS

With the experience gained so far with the implementation of the SPS system, the lack of a possibility for MS to adjust their chosen model towards a more flat rate of payment is an anachronism. Possibilities to make adjustments in the implemented models seem desirable as long as they respect the stated objectives of the system. The historic model of the SPS enabled the smooth transition to decoupling in MS whose variable production structures implied that various sectors were integrated successively into the SPS. The time seems ripe to allow MS to consider if they wish an adjustment towards a more flat rate.

But there are different ways of doing so and very different impacts from each way. While all options analysed fulfil the objective of leading to more equal rates per hectare or entitlement, none does actually result in any fundamental changes to the unequal distribution of support among farms. Flat rates at a larger scale (EU-wide or MS-wide under SAPS) have strong

effects on land values with possible structural responses. The more targeted a move towards a regional flat rate is, the lower the impact on land values would be from the implied redistribution of support, and the more support would remain among active farmers.

A gradual move towards flatter rates could contribute to making the adjustment process easier for farms. With respect to environmental objectives the options have largely similar effects (apart from more negative elements of the SAPS). The same is true for administrative impacts where, after some obvious initial costs of adjustments to the system under all but the status quo, the operational costs should not differ substantially, although there may be some additional costs where there are new beneficiaries to the system. All SPS options can be combined with further simplifications to the system.

The best way to address potential problems in regions which could face a negative impact from the dairy quota phasing-out or further decoupling, or to deal with the potential need for additional policies addressing risk management, seems to be through a revision of Article 69 that would allow part of the available level of SPS support to target such regions, provided that the global amount and the proportion of coupled support in the mix of supporting measures stayed within clearly defined ceilings.

This would allow supporting particular sectors and regions, mitigating negative effects on income, vitality of rural areas and environmentally beneficial farming practices while respecting WTO commitments.

9. SUMMARY TABLES

9.1. Comparison between different options and their respective impacts – SPS flat rate

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline – historic and regional SPS model	Option 1 – EU-wide flat rate per eligible hectare	Option 2 – SAPS for all MS	Option 3 – regional flat rates per eligible hectare	Option 4 – regional flat rates per entitlement
Economic	*Both models* market orientation ☺☺ *Historic model* no redistribution between farms and no impact on asset values ☺☺ very high transfer efficiency ☺☺ *Regional model* redistribution between farms impacts on land values ☹ high transfer efficiency ☺	market orientation ☺☺ very significant redistribution across MS results in strong impact on asset values ☹☹ decreased transfer efficiency due to more capitalisation ☹☹	market orientation ☺☺ very significant redistribution within MS results in strong impact on asset values ☹ decreased transfer efficiency due to more capitalisation ☹	market orientation ☺☺ redistribution between farms has limited impact on land values 😐 decreased transfer efficiency due to more capitalisation ☹	market orientation ☺☺ more targeted redistribution between farms minimises impacts on land values ☺ transfer efficiency unchanged with respect to present models 😐
Social	*Historic model* past individual references raise equity issues ☹ more support to active farmers ☺ *Regional model* regional references respond to equity issues ☺ more support to landowners ☹	equalises payment levels per area across the EU ☺ payment distribution changes, but remains skewed (per area this time) ☹☹ more support is capitalised in land, and thus shifts more to landowners ☹	equalises payment levels per region within a MS ☺ payment distribution changes, but remains skewed ☹ more support is capitalised in land, and thus shifts more to landowners ☹	equalises payment levels per area in a targeted way ☺ payment distribution improves (to a limited extent) ☺ more support is capitalised on land, and thus shifts more to landowners ☹	equalises payment levels per entitlement in a targeted way ☺☺ payment distribution improves (to a limited extent) ☺ support to land unchanged, and neutral with respect to present capitalisation on land values 😐

IMPACTS	Option 0 – baseline – historic and regional SPS model	Option 1 – EU-wide flat rate per eligible hectare	Option 2 – SAPS for all MS	Option 3 – regional flat rates per eligible hectare	Option 4 – regional flat rates per entitlement
Environmental	Both models neutral with respect to land under cross compliance 😐 Both models are neutral with respect to production practices 😐	May slightly increase land under cross compliance ☺ No impact on production practices 😐	Could put pressure on land not currently in agricultural use but of high environmental value ☹	May slightly increase land under cross compliance ☺ No impact on production practices 😐	Neutral with respect to amount of land under cross compliance 😐 No impact on production practices 😐
Administrative	Both models similar with respect to administrative burden 😐	Initial administrative costs due to change in number and value of entitlements ☹ New beneficiaries cause additional administrative costs ☹	Initial administrative costs for SPS MS to change system ☹ No costs for MS applying SAPS 😐	Initial administrative costs due to change in number and value of entitlements ☹ New beneficiaries cause additional administrative costs ☹	Initial administrative costs due to change in value of entitlements ☹ Avoids new beneficiaries and resulting additional administrative costs ☺
Simplification	Both models are neutral with respect to further simplification 😐	Can be combined with further simplification ☺	Can be combined with further simplification ☺	Can be combined with further simplification ☺	Can be combined with further simplification ☺
Other			Contradicts aims of decoupled support because it is not based on fixed entitlements ☹☹		

9.2. Comparison between different options and their respective objectives – SPS flat rate

☺☺ fully respecting objectives; ☺ partially respecting objectives; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – baseline – historic and regional SPS model	Option 1 – EU-wide flat rate per eligible hectare	Option 2 – SAPS for all MS	Option 3 – regional flat rates per eligible hectare	Option 4 – regional flat rates per entitlement
Competitiveness	😐	☺	☺	☺	☺
Market orientation	😐	☺	☺	☺	☺
Societal expectations (Equity/distribution among farmers)	historic: ☹ regional: ☺	per ha ☺☺ between farms ☹☹	per ha ☺ between farms ☹	per ha ☺ between farms ☹	per entitlement ☺ between farms ☹
Environmental sustainability	😐	☺	😐 to ☹	☺	😐
Budget costs	😐	Total costs 😐 Distribution ☹☹	😐	😐	😐
Administrative costs	😐	☹	😐	☹	☺
Vitality of rural areas	😐	☺	☺	☺	☺
Simplification	😐	☺	☺	☺	☺
Transfer efficiency	historic: ☺ regional: 😐	☹	☹	☹	☺

9.3. Comparison between different options and their respective impacts – SPS Article 69

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – Article 69 unchanged	Option 1 – targeted revision	Option 2 – extended revision
Economic	Limited flexibility to respond to problems in specific sectors and to some needs for risk management ☹	Increased flexibility to respond to problems in specific sectors and to some needs for risk management ☺ Limited risks for backtracking in decoupling ☹	Significant flexibility to respond to a selective set of problems ☺☺ Risk for backtracking in decoupling ☹☹
Social	Flexibility for support in specific vulnerable regions limited ☹	Increased flexibility for supporting affected farmers and regions ☺	Great flexibility for supporting affected farmers and regions ☺☺
Environmental	😐	Environmentally beneficial farming supported ☺	Environmentally beneficial farming supported ☺
Administrative	😐	Initial costs of reallocating support ☹	Initial costs of reallocating support ☹
Simplification	😐	☹	☹
Other: WTO	😐	In case of DDA agreement, should allow to stay within ceiling for Blue Box support 😐	In case of DDA agreement, risks exceeding ceiling for Blue Box support ☹☹

9.4. Comparison between different options and their respective objectives – SPS Article 69

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – Article 69 unchanged	Option 1 – targeted revision	Option 2 – extended revision
Competitiveness	😐	😐 to ☺	Depends on MS implementation ☹ to ☺
Market orientation	😐	😐 to ☹	☹☹
Environmental sustainability	😐	☺	☺
Budget costs	😐	😐	😐
Administrative costs	😐	☹	☹
Simplification	😐	☹	☹
Vitality of rural areas	😐	☺	☺
Stabilisation of farmers incomes	😐	☺	☺
Transfer efficiency	😐	Depends on MS implementation ☹ to 😐	Depends on MS implementation ☹ to ☺

C.b. CROSS COMPLIANCE

1. BACKGROUND

Cross compliance creates a link between farm-relevant support and farm-relevant legislation. It aims at being an effective mechanism to promote sustainable agriculture and at the same time a tool which enhances the CAP's role in meeting the expectations of the society.

Payments under the first pillar and some rural development measures have to comply with parts of 19 existing and already implemented regulations or directives, the so-called statutory management requirements (SMR). The SMR cover rules relating to agricultural production, land and activities in the three areas of: the environment; public, animal and plant health; and animal welfare.

Payments also have to comply with good agricultural and environmental conditions (GAEC) which concern the issues of soil erosion, soil organic matter, soil structure, minimum level of maintenance and maintaining the total area of permanent pasture. In order to give technical support to farmers on the basic requirements of cross compliance MS had the obligation to introduce a Farm Advisory Systems (FAS)[13].

As a control system, which reduces payments to farmers who are found not to be in compliance with standards associated with their agricultural activity, cross compliance contributes to the greater acceptability of agricultural support by the society at large.

Furthermore, cross compliance, particularly through the systematic provision of information by MS to farmers about the requirements applying to the latter, has been evaluated as making a significant contribution to ensuring compliance with obligations and as contributing to increasing farmers' awareness about obligations with respect to SMR and GAEC[14].

Practical problems in the implementation of cross compliance led the Commission to advance a report foreseen on the application of cross compliance with the 2003 CAP reform. The March 2007 Report suggested legal modifications aiming at simplification and streamlining of the system. In June 2007 the Agricultural Council adopted conclusions which supported the Commission's report, and shortly thereafter the Commission prepared the necessary legislative changes.

The report did not however address the scope of cross compliance, since at the time of drafting the report it was considered too early to assess such changes. Instead, the Commission committed itself to address the scope within the context of the HC.

2. PROBLEM DEFINITION

The experience of implementing the cross compliance system has shown that not all requirements included in the scope are actually relevant to meeting the objectives of cross

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13 SMR and GAEC are listed in Annex III, and Article 5 and Annex IV of Regulation (EC) No 1782/2003, respectively. FAS were to be set up by 1 January 2007 in all MS cross compliance will apply from 2009/2011 following the Council agreement in January 2008.

14 The evaluation study was carried out by Alliance Environment (a consortium comprising the Institute for European Environmental Policy and Oréade-Brèche) from June 2006 to August 2007. The final evaluation report has been published on the Europa website in November 2007.

compliance[15]. Some requirements may be irrelevant, while at the same time implying an administrative burden, and hence the costs of having these requirements within the scope of cross compliance are higher than the benefits. Practical problems have been raised by MS, as well as by the Commission itself through its activities of audits for the clearance of accounts. Therefore, the current scope of requirements needs to be adjusted so that it does not pose an unnecessary administrative burden while not adding anything towards meeting the objectives of cross compliance.

Furthermore, additional legislative acts have come into force since the 2003 reform, which could be relevant to include in the scope in order to meet the objectives of cross compliance. Also, new challenges have occurred since 2003 which could not be foreseen at the time of the reform, thus it is relevant to assess whether these challenges could be better addressed through the cross compliance system. On top of this, changes which are suggested with the Health Check, such as the setting to zero of set aside, may have negative environmental implications. The cross compliance scope should therefore be assessed as to whether it could be adjusted to contribute to the retention of environmental benefits from set aside.

3. OBJECTIVES

The scope of cross compliance should be screened to examine whether the SMR and the GAEC could be better targeted or if more requirements should be added, in order to:

- enhance the contribution of cross compliance as an effective mechanism to promote sustainable agriculture[16];
- enhance cross compliance's role in meeting the expectations of the society, without increasing the administrative burden of cross compliance for MS and farmers.

The screening aims specifically at; firstly, deleting requirements which are not considered relevant in meeting the objectives of cross compliance, and thereby decreasing the administrative burden for MS. Secondly, the screening aims at adding requirements which could enhance the CAP's role in better addressing concerns regarding climate change and water management, although the requirements added should not imply higher costs than benefits[17]. The possibility of retaining environmental benefits from set aside through the cross compliance system will also be analysed.

4. POLICY OPTIONS AND ANALYSIS OF THEIR IMPACTS

4.1. Option 0: status quo

The options considered here, and their potential impact, are assessed with respect to the scope of cross compliance as defined in existing legislation (status quo). The list of SMR and GAEC standards stay as they are in Article 5, Annexes III and IV of Regulation (EC) No 1782/2003. By maintaining status quo, more time would be allowed to analyse the potential benefits and costs of the existing scope, since these may become clearer over time. However, maintaining status quo would also imply a

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15 The objectives of cross compliance are to be an effective mechanism to promote sustainable agriculture and to enhance the CAP's role in meeting the expectations of the society.

16 This is considered to be achieved through the respect by farmers of the rules relating to the relevant aspects of cross compliance.

17 The criteria outlined below will clarify this statement.

missed opportunity to address the concerns that have already been raised with the current scope, as well as to include potential new measures that can contribute to meeting the overall objectives of cross compliance.

4.2. Option 1: better targeting the current scope of cross compliance

This option concerns mainly the assessment of existing SMR based on the analysis of the legal texts, on the questions and remarks made by the Member States to the Commission based on their experience of controls, as well as on the audits done by the Commission in the framework of the clearance of accounts procedure.

Increasing the acceptance of cross compliance by farmers, by only having *relevant* legal acts within the scope of cross compliance, is considered to enhance the contribution of cross compliance as an effective mechanism to promote sustainable agriculture. Hence, this option consists of identifying the requirements whose deletion would not impact upon the current substance of the scope of cross compliance[18]. As such, the list contains SMR proposed to be deleted because they do not fulfill one or more of the following criteria:

- do not have a direct link to agricultural activities and agricultural land, and/or whose non respect cannot be attributable to an individual farmer;
- concern MS and not farm activities and as a result become difficult to control;
- induce administrative *costs* for MS that exceed the *benefits* derived from the inclusion of these legal acts[19].

4.3. Option 2: broadening the scope of cross compliance

This option consists of analysing the consequences from adding certain important legal acts relevant to farming activities in the areas of environment, public, plant and animal health and animal welfare, as well as certain standards to maintain the agricultural land in good agricultural and environmental condition. The relevant acts shall fulfill the criteria presented for the previous option, and in addition they shall help meeting, where appropriate, the new challenges mentioned in the HC communication, in particular those of climate change and water management, and contribute to the retention of environmental benefits stemming from set aside[20].

One legal act that could be, partly, considered to be included in the scope of cross compliance is the Water Framework Directive (WFD). The purpose of the WFD is to establish a framework for the protection of all community waters (groundwater, surface waters, coastal waters, etc.) with the aim of meeting "good status" for all water bodies by 2015. Article 11 of the WFD foresees the establishment of MS programmes with measures for the management of river basins by the end of 2009[21].

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18 See note 2 in Annex II for details.

19 http://ec.europa.eu/agriculture/eval/reports/cross_compliance/full_text_en.pdf.

20 Only water issues are addressed here, while issues directly or indirectly related to climate change challenges are dealt elsewhere (section VIII, and V for set aside). Certain public provisions that were examined, but considered either already covered or not justified from a cost/benefit analysis are covered in note 2 in Annex C.

21 Some measures will apply at farm level and are the ones which would be included in the scope of the cross compliance. However, they will not necessarily apply to all farms in the same river basin and will

MS then have to implement the programmes of measures (buffer strips, winter cover, input reductions, etc.) by the end of 2012 at the latest. Thus the difficulty of including the WFD as an SMR within the scope of cross compliance at this stage is that the programmes of measures are not defined yet, and hence their relevance for farming activity and farm responsibility cannot be assessed[22].

However, although the WFD can be considered not to be mature enough to be included in the scope of cross compliance at this stage, other ways of introducing water management within the scope of cross compliance could be considered. For example, the discussion about the "misuse of water resources" is mainly focused on including water as an issue and/or standard within the GAEC.

Currently, the issues and standards do not cover water specifically, since GAEC was introduced to ensure proper land management in order to handle risks associated with the decoupling of support in the 2003 CAP reform. Therefore, including water management in GAEC would imply a broadening of its scope, but it would simultaneously increase the capability of MS to deal with the water management issue.

This option also consists of analysing the possibility of retaining environmental benefits from set aside through cross compliance. Losses of environmental benefits are not the same in every Member State, but are specific to certain regions depending on the current use of set aside as well as the characteristics of its implementation. Therefore, instruments that could allow for flexibility in application should be introduced. A general GAEC solution, such as a fixed environmental area, should be avoided since this would give rise to disproportionate effects compared to the current legal obligations.. Within the GAEC, such instruments could for example include the introduction of a standard on buffer strips (without a fixed quantification on EU level), and a reinforcement of the standard on retaining landscape features. These measures could however have implications for the baseline of Rural Development programs.

5. COMPARISON OF THE OPTIONS AND THEIR IMPACTS

Assessing the costs and benefits of *new* cross compliance measures at this early stage of the implementation of the system is extremely difficult. Measures in place have already provided some indications of their effectiveness and relevance, leading to the conclusions in the discussion of option 1. But how to assess options not yet in place?

The discussion in this section is, therefore, by necessity of a qualitative nature, and needs to be considered with this caveat in mind. It lists potential advantages and disadvantages of the various options, but leaves open the assessment of the best policy choice (or combination of choices). This was considered necessary since many of the following advantages and disadvantages are part of a public debate based more on assumptions, arguments and preferences, than on concrete evidence.

differ depending on the specificities of each river basin and conditions within the river basin, depending on the location of the farms.

[22] Note 2 in Annex C discusses in more detail the practical difficulties involved.

As for impacts, the analysis does not consider economic impacts or impacts on employment for any of the option, since this is not considered to be affected by a change in the scope of cross compliance.

5.1. Option 0: status quo

Advantages:

- it grants more time for proper definition, implementation and evaluation of existing SMR instead of modifying the scope of cross compliance at this time;
- many of the potential benefits and costs of cross compliance will only become clear in the longer term and more time will be needed to properly assess them;
- some MS have yet to define obligations for farmers for some requirements in the current SMR, or clarify the definition and extent of their GAEC;
- a well developed awareness and understanding of SMR is not necessarily present yet among farmers, and the FAS that should assist them are in their early stages.

Disadvantages:

- the opportunity of further contributing to new challenges by including more requirements or standards will be missed;
- the opportunity of deleting requirements which are not relevant to meeting the objectives of cross compliance, or which are redundant, will be missed;
- the opportunity to clarify some existing requirements in order to make them better accepted by the farmers and thus better implemented will be missed.

5.2. Option 1: better targeting the current scope of cross compliance

Advantages:

- simplification to farmers since the controllability and targeting of current requirements (concerning a farmer's responsibility or farming activity) would be improved, making it easier for farmers to understand the rules and issues, and thus increasing their acceptance for the system;
- administrative costs for the Member States would be reduced;
- due to synergy in effects and the overlapping between the regulations/directives, the objectives of cross compliance may still be achieved, even if some requirements are withdrawn from the scope.

Disadvantages:

- confusion among farmers may be created about the importance of respecting legal requirements who will apply to farmers even though they are withdrawn from the scope of cross compliance.

5.3. Option 2: broadening the scope of cross compliance

Advantages:

- additional requirements or standards could contribute to better addressing and facing the new challenges (e.g. with respect to water) within the CAP, as well as to retention of environmental benefits form set aside;
- broadening the scope of cross compliance would send a clear political message of the importance attached to these requirements and the importance of these requirements being respected by farmers. Thus, broadening the scope would improve the acceptability of public support, and could therefore have positive social impacts;
- introducing new obligations into cross compliance based on pre-existing and already implemented legislation (SMRs) should in principle have no impact on production costs for farmers; as has been the case for the majority of GAEC.

Disadvantages:

- may increase the administrative burden, since additional cross compliance obligations would demand additional effort from administrations, and would stretch the ability of inspectors to carry out controls on wide ranging obligations;
- negative attitudes of farmers towards cross compliance policy could increase as they may feel overloaded or over-controlled, which might be counter-productive rather than improving the achievements of the objectives;
- including the WFD in the scope of cross compliance and introducing water management issues within GAEC generates reactions because WFD measures are not defined yet and GAEC was meant to ensure proper *land* management;
- broadening the scope of requirements under GAEC impacts upon the "baseline" for the formulation of agri-environmental rural development measures, with potentially negative impacts when income foregone for farmers is calculated.

6. CONCLUSIONS

There are advantages both from deleting some of the current requirements within the scope of cross compliance, and from adding new requirements. Better targeting is necessary in order to address some of the practical problems that have arisen during the implementation period of the system. This will ease the administrative burden while not putting at risk the objectives of cross compliance. Simultaneously, a broadening of the scope will contribute to addressing the concerns of dealing with new challenges, as well as contributing to retaining environmental benefits from set aside.

7. SUMMARY TABLES

7.1. Comparison between different options and their respective impacts – cross compliance

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – status quo	Option 1 – better targeting the scope	Option 2 – broadening the scope
Economic	😐	😐	😐
Social	😐	😐	Improves acceptability of public support ☺
Environmental	😐	Neutral with respect to environmental impacts as changes affect only irrelevant provisions 😐	Contributes to better meeting and addressing new challenges, and retain environmental benefits from set aside ☺☺
Administrative	Some existing rules have proven redundant of not relevant ☹	Eases administrative burden for MS ☺☺	Increases administrative burden for MS ☹
Simplification	😐	More pertinent, and thus simpler for farmers to grasp and implement ☺☺	Implies more requirements for farmers within cross compliance framework ☹

7.2. Comparison between different options and their respective objectives – cross compliance

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – status quo	Option 1 – better targeting the scope	Option 2 – broadening the scope
Competitiveness	😐	😐	😐
Market orientation	😐	😐	😐
Environmental sustainability	😐	😐	☺☺
Budget costs	😐	😐	😐
Administrative costs	😐	☹	☹☹
Simplification	😐	☺☺	☹
Vitality of rural areas	😐	😐	😐
Stabilisation of farmers incomes	😐	☺	😐
Transfer efficiency	😐	😐	😐

C.C. PARTIALLY COUPLED SUPPORT

1. BACKGROUND

Decoupling introduces flexibility in the choice of producers, who continue to produce where it is profitable, and adapt their output to the market or change to alternative crops where it is adequate. Thus overall, decoupling leaves the producer at least as well off as before when his/her choice is the same, and most likely better off when he/she adjusts as a result of production flexibility and market orientation.

The fact that the actual level of decoupled support after the 2003 reform exceeded the minimum required indicates that the above argument is well understood. Within this context, therefore, the continuation of partially coupled support in certain sectors begs the question of whether such support is still pertinent[23]. For an answer, one has to recall the reasons by which the 2003 and 2004 reforms retained such support:

- the need to provide stable supply to the processing industry and thus avoid negative social and economic consequences of the implied restructuring;
- the need to sustain a certain level of specific production due to lack of alternatives and consequent social problems or environmental problems.

2. PROBLEM DEFINITION

Experience with decoupling in general shows that this move did not imply dramatic changes in the production structure at the EU level, although a few sectors faced significant reduction of production at the regional level.. Furthermore, the extent of recent reforms and the integration of more sectors into the SPS render the partially coupled support less relevant and often preventing farmers to achieve further competitiveness and market orientation. Moreover, in the cases of non profitable sectors farmers are worse of than farmers in a full decoupling situation receiving lower payments[24]. Besides, farmers still receiving coupled aid are have also to face both coupled and decoupled systems running in parallel, thus adding complexity and administrative costs without any income benefits. For the reasons mentioned above, move to full decoupling would be desirable. However, adjustments in production may represent short-term challenges for the agri-food chain, and in few cases these may create more costs than benefits. In some specific cases a minimum level of agricultural production is important to sustain economic activity in regions with few economic alternatives, to ensure an adequate supply of raw materials to processing industries, or to generate environmental benefits.

Thus the potential risks and possible alternatives in the regions should be identified on a case-by-case basis before deciding to which extent and until when coupled or industry support should remain, and where these were designed to promote certain production, their effectiveness should be assessed.

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23 See note 3 in Annex C for details about the remaining partially coupled support.

24 This argument was already raised during the discussion in the Council that preceded the 2003 reform. See Council "CAP Reform: Explanatory note DS 222/03", Luxembourg, 18 June 2003.

3. OBJECTIVES

The following policy options were analysed, and results were assessed based on whether these options met the following objectives:

- fulfil the principal objectives of the 2003 CAP Reform: competitiveness, market orientation and sustainability;
- simplify the support scheme;
- contribute to vitality of rural areas, prevent land abandonment and allow smooth restructuring of downstream industries, where they are crucial for the vitality of rural areas.

4. POLICY OPTIONS

Table 3. – Analysed policy options for partially coupled support schemes[25]

Option	***SPS model***	***Description***
0	Status quo – baseline	No change in the present set of measures
1	Full decoupling	Inclusion of all partially coupled aids in the Single Payment Scheme
2	Targeted selective decoupling	Case-by-case analysis to identify if, and in which sectors, the shift of partially coupled support to full decoupling could create social, regional or environmental problems.

4.1. Timing and transition to full decoupling options

Options 1 and 2 above do not exclude the possibility of transition to full decoupling, and a gradual phasing out process could be foreseen to attenuate impacts. Specific sectors may require specific solutions, and measures under rural development or measures such as the previously mentioned Article 69 (section C.a.) could tackle the issues of providing alternatives, diversification, infrastructure development and restructuring to prevent abandonment and adverse effects on processing industries that were behind partially coupled payments and environmental impact in specific areas. However, as the analysis of other support schemes (section D.c.) will demonstrate, the issue of transition to full decoupling is more pertinent for aids to the industry than aids to farmers. For the latter's point of view and income prospects, the risk of production decline is best managed with full decoupling.

[25] The following sectors are excluded from this analysis because they have been recently reformed or are included elsewhere in the present analysis: fruit and vegetables, tobacco, sugar, cotton, payments for outermost regions.

5. IMPACT ANALYSIS

5.1. Economic impacts

The assessment of the economic impacts from a move towards full decoupling was based on two sets of interrelated analyses – those focusing on a specific sector's market and income outlook and those focussing on a farm's reaction to further decoupling[26]. It also looked into the experience of decoupling into the EU since the reforms of 2003 and afterwards.

5.1.1. Status quo

a. Market and income outlook

The potential impact of this option is essentially driven by the present medium-term outlook for EU agriculture[27]. From this outlook, it is the production and price picture that is more relevant here.

The price outlook for most EU cereals appeared particularly strong both within the EU and in world markets, but a number of risk factors particularly those related to weather and climate could result in greater price fluctuations than seen in the past decade. This outlook affects all related crop sectors, generating price increases, especially for oilseeds.

The medium-term perspectives for animal products are very positive for dairy markets, relatively positive for poultry and pig meat, but beef production is expected to continue to decline over the medium term in line with the structural reduction of the dairy herd and the impact of decoupling in certain high cost, extensive regions.

Sheep and goat meat production is projected to decline gradually in line with past long-term trends and the impact of decoupling of ewe premiums in the major producing countries.

The medium-term income projections display a rather favourable income outlook for EU-27, supported by positive price developments and by the implementation of the CAP, including the sharp rise in the subsidies granted to agricultural producers in the EU-12[28].

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26 The market and income outlook is based on the input from AGRI.G2, while analyses on farm reactions are based on FADN data analysed by AGRI.G3. The Scenar2020 stud has also been used, where appropriate, to supplement conclusions. All relevant sources are available in full detail in the site of DG AGRI.

27 See http://ec.europa.eu/agriculture/analysis/markets/index_en.htm.

28 This market outlook is based on current macroeconomic assumptions. Changes in assumptions on exchange rates and oil prices could alter this outlook, but not the conclusions of this section. The latest update is found in http://ec.europa.eu/agriculture/analysis/markets/index_en.htm.

b. Summary conclusions for coupled support[29]

The present level of coupled support in the arable crop sector, or in the much smaller hops and seeds sectors, does not seem to relate to the perceived fears about the potentially negative impact on farmers expressed before the 2003/04 reforms. It seems to be more related to developments that characterise these sectors and that are generally positive[30].

In the livestock sector, on the other hand, and especially in the extensive beef and the sheep and goats sector, especially for meat production, partially coupled support seems to have a stronger impact on farm income.

In general, the status quo raises a complex problem already identified in the context of the debate for the 2003 reform. These payments are generally considered as slowing down production losses in the sectors involved; but at the same time they imply that producers cannot reap the full benefits of SPS because in regions facing downward production trends coupled payments will keep being reduced (unlike decoupled ones, which are fixed). On the other hand, in some cases coupled premiums, by keeping a certain level of production activity could be important for some agri-food chains in certain areas and for delivering environmental benefits in cases where these are dependant on specific faming systems.

In terms of administrative impacts, the status quo keeps by design intact the existing administrative systems which run in parallel, and therefore ensuing administrative burden for both EU and MS administration and farmers. Finally with respect to trade, keeping the present level of coupled support implies the continuation of the present level of "blue box" CAP payments.

5.1.2. Full decoupling[31]

With respect to *cereals*, full decoupling could imply declines of area in some regions of the MS involved, but these should be moderate based on the recent price increases. A drop of durum wheat (more sensitive because coupled payments represent a higher share of the farm's margin) in favour of soft wheat could have implications for the processing industry, but the generally higher price levels over the medium term could partly offset some of this impact[32]. Full decoupling does not seem to change the profitability hierarchy in Spain for the cereals studied in FADN, but changes that of France. In the latter durum wheat growers could be willing to change to more profitable crops such as soft wheat or grain maize.

The following table shows the impacts no farmers' margins over variable costs resulting from a move to further decoupling.

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29 For a discussion on this point, see in particular Section 5.1.3b of note 3 in Annex C.

30 For olive oil, it is hard to see any economic reasoning for the level of coupled support (6%) retained in Spain, given the positive developments in the sector and the experience from other producing MS.

31 The conclusions of this part are common whether one looks ate the sector level or the microeconomic level of the farm.

32 The most sensitive regions to be affected appear in results of note 3 in Annex C.

Table 4. – Summary results of impact from full decoupling (production of specialist producers where margin over variable costs is affected)

	Spain		France		Portugal		Belgium	
	Coupled payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin
COP	23%	5%	39%	11%				
HOPS								
BEEF BREEDERS	42%	4%	63%	**19%**	60%	**19%**	43%	7%
BEEF BREEDERS & FATTENERS	36%	0%	56%	**15%**	43%	*	31%	0%
BEEF FATTENERS								
SHEEP MEAT	28%	5%	68%	**19%**	34%	*		
SHEEP MILK	7%	*	10%	*	18%			
GOAT MILK	10%	*	4%	*	18%			

* FADN sample to small too assess the impact of supression of coupled payments

	Austria		Sweden		Finland		Germany	
	Coupled Payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin	Coupled Payment as % of the margin	% switching to negative margin
COP								
HOPS							5%	0%
BEEF BREEDERS	102%	**35%**						
BEEF BREEDERS & FATTENERS			n.a. (average margin is already negative)	8%				
BEEF FATTENERS			average margin negative	0%	61%			
SHEEP MEAT					46%	*		
SHEEP MILK								
GOAT MILK								

* FADN sample too small to assess the impact of supression of coupled payments

Source: DG AGRI G3 – EU FADN

In *beef*, the move to full decoupling could accentuate present trends, with the most significant negative impacts expected among suckler cow producers, where the coupled premium represents a significant part of a farm's margin. The more extensive and specialised the production system is, the higher the risk especially in those regions where output is low and/or production costs are higher. Suckler cow breeders are also more exposed to price reductions due to their lower margins, and more vulnerable to potential WTO developments.

On the other hand, while for suckler cows the number of animals for which coupled support premium is claimed is close to the ceilings set with the 2003 reform, the number of animals is significantly lower for other beef premiums (except for fatteners in some MS), indicating less potential negative impacts in these sectors.

The *sheep meat* sector would be also affected by decoupling as the 50% coupled premium sheep meat production plays an important role in farms' margin (in France,

in particular, almost 20% of sheep meat farm would not cover their variable costs, against 5% in Spain). But milk sheep or goat would be less affected because their output is higher.

In summary, the analysis of a move towards full decoupling indicates that the stronger impacts will be in the sectors and regions where the coupled premiums represent an important share of farmer's margin. Analysis has identified these sectors to be those of suckler cows, and sheep (especially for meat). In the cereals sector and in other beef premiums impacts would not be significant overall (although could still affect some particular regions).

The biggest advantage from a generalised move towards full decoupling will be in *market orientation*, in *income transfer*, and in *administrative and simplification terms* for both public administrations and farmers because instead of several systems running in parallel there would be only one single SPS system for the premiums to be decoupled. The complexity and overhead of aid application controls would be reduced, specifically on the spot controls. It would also be advantageous in *WTO* terms where a full share of old direct payments would be fully "green box" payments.

5.1.3. Targeted selective decoupling

This option, which stems directly from the conclusions of the previous one, suggests that the risks of production decrease in the suckler cow and sheep meat sectors in extensive systems would be avoided by keeping the corresponding premiums in the current partially coupled support.

The budgetary impact of this (and the previous) option would not change in relation to the *status quo (baseline)* because the partially coupled part of support would be transferred to the SPS. It would be positive in administrative and simplification terms for both administration and farmers as mentioned in the full decoupling scenario except for the premiums to be kept coupled.

It would also be advantageous in WTO terms where a bigger share of old direct payments would be fully "green box" payments (just arable crops coupled premium in SP and FR accounting for 35% of the EU remaining coupled elements), although at lower extent than in the previous option.

In comparison to the full decoupling option the disadvantages related to the premiums to be kept coupled would remain.

5.2. Social impacts and environmental impacts

The potential impacts that various options of full decoupling could have in the sectors examined are summarised in the following Table 5.

Table 5. – Social/environmental impacts of alternative partially coupled support options

Option	***Social impact***	***Environmental impact***
0	Production and farmers remain in regions with risks for abandonment, mainly in extensive livestock regions. Farm income would be lower than with full decoupling where the trend for production is already downward. The processing industry would not be affected because policy factor would remain unaltered.	Minor environmental impacts where payments are in extensive farming, such as beef and sheep production. In cereals, similar production patterns as at present will continue.
1	Improved income transfer for farmers in all sectors. Decoupling could lead to reduction, abandonment or change of production in areas with low farm margins, such as in suckler cows and sheep for meat. (FADN simulations shows that 33% of specialised suckler cows holdings in Austria, 21% in France and 17% in Spain could not cover their variable costs and hence could abandon production. A similar situation would occur to 19% of French sheep meat farmers). Minor impacts in processing, except for regions that depend to a large extent on extensive livestock systems. The reduction of production in some areas can have negative repercussions for the processing industry (and consequently on local employment) which depend on a minimum quantity of supply[33]	Mixed picture, with some gains and also in certain regions some significant losses for environment. On the plus side, gains in terms of lower greenhouse gas emissions and, in certain areas, reduced pressure on limited resources. On the negative side, benefits from extensive livestock systems in fragile and normally environmentally of high value regions would be at risk (e.g. biodiversity and landscape losses, reduced forest fire protection).
2	Keeping coupled support only where it is found necessary, social impacts are minimised, namely with respect to farm impact in local processing industry.	This option minimises any potentially negative impacts by retaining support where its removal would imply high environmental costs.

6. CONCLUSIONS

The *status quo* option contradicts the 2003 CAP reform path in terms of competitiveness, market orientation and simplification of the support scheme. *Full decoupling* would have a positive impact on farm income in most regions due to higher transfer efficiency of direct support, it could put at risk production in certain sectors in specific regions where local production is vital to ensure the viability of local agri-food chain and to preserve the environment. Evidence from analysis suggests that *targeted selective decoupling* whereby coupled support is retained in sectors of extensive livestock meat production (beef and sheep) would maximise the benefits from full decoupling in the crop sector, while at the same time maintaining the overall positive social and environmental impacts of coupled support in fragile regions of high environmental value.

[33] Following industry and DG AGRI estimations in 2005 red meat and pigmeat provided for 230 000 jobs in slaughtering/cutting and 600 000 in processing activity.

7. SUMMARY TABLES

7.1. Comparison between different options and their respective impacts – partially coupled support

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – full decoupling	Option 2 – targeted selective decoupling
Economic	Continues current production trends 😐	Full market orientation ☺☺	Market orientation gains limited to sectors moving to full decoupling ☺
Social	Production and farmers remain in regions with risks for abandonment, mainly in extensive livestock regions ☺ Supply to processing industry continues 😐 Farm income declines where production trends are already downward ☹	Could lead to reduction of production in regions with low farm margins, such as with extensive beef and sheep farming ☹ Minor impact for processing industry except where extensive livestock ☹ Improved farm income transfer ☺☺	Social negative impacts for processing minimised since production support in fragile areas continues ☺☺ Improved income transfer limited to sectors where full decoupling applies ☺
Environmental	Positive environmental impact in extensive livestock farming 😐	Losses in environmentally high value regions of extensive livestock systems ☹	Production of extensive livestock systems retained 😐
Administrative	Two administrative systems continue to run in parallel ☹	Great administrative simplification ☺☺	Reduction of administrative burden only where full decoupling is implemented ☺
Simplification	😐	All direct support instruments merged ☺☺	Reduction of number of instruments in the sectors where decoupled is fully implemented ☺
Other	😐	All coupled payments shift to Green Box ☺☺	Important part of the coupled payments shifts to Green Box ☺

7.2. Comparison between different options and their respective objectives – partially coupled support

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – baseline	Option 1 – full decoupling	Option 2 – targeted selective decoupling
Competitiveness	☹	☺☺	☺
Market orientation	☹	☺☺	☺
Environmental sustainability	😐	☹	☺
Budget costs	😐	😐	😐
Administrative costs	😐	☺☺	☺
Simplification	☹	☺☺	☺
Vitality of rural areas	😐	☹	☺
Stabilisation of farmers incomes	😐	☺☺	☺
Transfer efficiency	😐	☺☺	☺

C.d. INDIVIDUAL PAYMENT LIMITATIONS

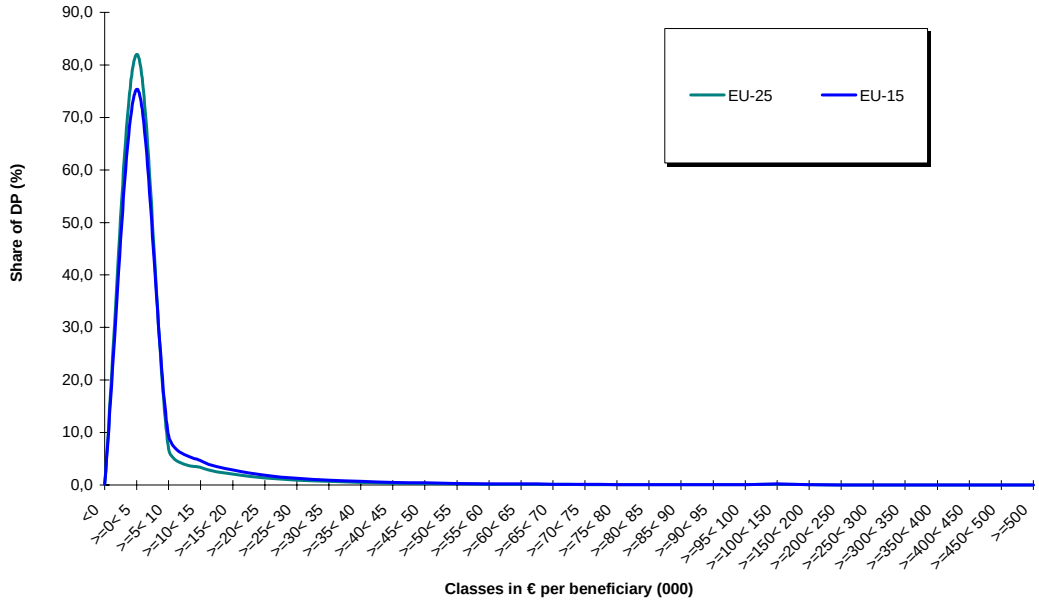
1. BACKGROUND

Whether to introduce cuts in the highest payments received by larger farms, because such payments are not considered economically or socially justified, has been an issue in the public debate on the CAP since the early 1990s. Several Commission proposals for payment redistribution mechanisms (1992, 2000, and 2003) were not retained in full by the Council.

Currently, the only method for achieving a certain redistribution of payments under the CAP is through the linear, 5% reduction of payments above €5 000 from compulsory modulation. Two provisions at the MS discretion, however, currently impact on low payments: the possibility of setting up a minimum size of agricultural parcels for which an SPS application can be introduced (0.3 ha), and the possibility not to grant any aid if the amount per application is less than €100[34].

Continued attention is being drawn to the uneven distribution of direct payments between farmers (see Figure 4 below). A minority of beneficiaries (around 20%) receives the large majority of payments (around 80%). Almost half of beneficiaries in the EU-25 receive payments that do not exceed €500.

Figure 4: Distribution of direct payments in EU-15 and EU-25



Source: DG AGRI calculation based on CATS data

34 New MS shifting from SAPS to SPS may fix a minimum size of 1 ha per holding for the establishment of payment entitlements and payments.

2. PROBLEM DEFINITION

High levels of payment per holding are exposed to the criticism that they are excessive and socially unacceptable. This criticism has grown in the context of increasing transparency of EU policy, notably of CAP payments, and the shift of support to the SPS. In removing the link between production and the direct payment through the decoupling process, the question has been raised about whether an individual beneficiary deserves such a high level of income support and whether the money could be used within the CAP in a more effective way. The situation has become more complex with enlargement to EU-27 because of the structural characteristics of farms (i.e. large or very large co-operative farms) in some MS, including new MS.

The other problem arising from the uneven distribution of direct payments relates to the large number of very small payments. This number essentially includes small farmers, but it also includes in certain MS recipients whose value of payment is below the administrative cost of managing it. While this situation has existed for some time, the problem has been exacerbated with the introduction of the regional SPS model in some MS, which extended payments to all eligible area, and brought with it new beneficiaries, some receiving very low payments.

3. OBJECTIVES

Introducing individual limits for decoupled direct payments should be assessed with respect to its impact on the following policy objectives:

- contributing to the overarching goals for the CAP (improved competitiveness, better market orientation, better compliance with EU standards),
- meeting the societal expectations (in particular, for a more even distribution of direct payments),
- preserving the vitality of rural areas,
- further simplifying the CAP.

4. POLICY OPTIONS

Against this background, and taking into account the Commission's approach to keep any savings from payment limitations within the MS, and to apply lower payment limitations only at MS discretion, the following policy options were examined:

Table 6. – Policy options for individual payment limits

Option	***Upper payment limitations***	***Description***
0	Status quo – baseline	No change in the present set of measures. Currently, reduction in payments under the CAP is made through the linear, 5% reduction of payments above € 5 000 from compulsory modulation.
1	Fixed individual limits at a certain level	Individual limits set at a certain maximum level per beneficiary (e.g. € 100 000, € 200 000 or € 300 000), beyond which no payments are granted (capping).
2	Progressive individual limits	The support level would be reduced at different rates as overall payments to the individual farm reach different thresholds (e.g. payments above € 100 000 would be reduced by 10%, payments above € 200 000 reduced by 25%, and above € 300 000 by 45%).

Option	*Lower payment limitations*	*Description*
0	Status quo – baseline	No change in the present set of measures. MS currently have the possibility of setting up a minimum size of agricultural parcels for which an SPS application can be introduced (0.3 ha), and the possibility not to grant any aid if the amount per application is less than € 100.
1	Compulsory application of current individual lower limits	The current lowest level of threshold (€ 100 or 0.3 ha) is implemented in all MS.
2	Increased individual lower limits	Increase in the value of lower payment limits in all MS to € 250 and 1 ha. The minimum size for parcels (not exceeding 0.3 ha) remains unchanged.

8. IMPACT ANALYSIS OF UPPER PAYMENT LIMITATIONS

Detailed results of the various options are presented in Annex C[35]. These main results are summarised in Table 7.

Table 7. – Summary impacts of upper payment limitations at aggregate EU level

Variable	*Payment threshold (option 1)*			*Progressive cuts (option2)*
	A € 100 000	*B € 200 000*	*C € 300 000*	*A cut = 10% B cut = 25% C cut = 45%*
Number of affected MS	*15*	*8*	*5*	*15*
Affected farms (number)	*25 480*	*7 610*	*4 380*	*25 480*
Affected farms (% of total)	*1%*	*0.2%*	*0.1%*	*1%*
Average size of affected farm	*721 ha*	*1 440 ha*	*1 898 ha*	*721 ha*
Average labour per farm	*16 AWU*	*38 AWU*	*51 AWU*	*16 AWU*
Changes in affected farms				
– in average payment (%)	*– 55%*	*– 54%*	*– 47%*	*– 14%*
– in average farm income (€)	*– 30%*	*– 28%*	*– 25%*	*– 8%*
Budgetary savings (million €)	*3 087*	*1 754*	*1 176*	*807*
Budgetary savings (% of SPS)	*8%*	*5%*	*3%*	*2%*

Source: DG AGRI calculation based on FADN
Note: The progressive cuts option is more comparable to the capping option with the threshold set at €100 000.

Summary results in Table 7 and the more detailed results of Annex A lead to the following conclusions with respect to the main economic and budgetary impacts for the three options[36].

[35] See note 4 in Annex C, and the detailed Annex tables it contains.
[36] See in particular the summary table in Annex C, note 4.

8.1. Option 0

The status quo (baseline) is neutral in terms of impacts. However it fails to address the problem of the uneven distribution of payments. The high levels of payment per holding will continue to be exposed to the criticism that they are socially unacceptable. An increase of the share of decoupled payments due to further decoupling, as analysed in other parts of this impact assessment, will make payments more transparent to the public and further increasing societal concerns on equity issues.

8.2. Option 1

Individual limit thresholds set at high levels as referred in option 1 (i.e. €300 000 and €200 000) affect a very small number of holdings (0.1-0.2% of EU total) in a limited number of MS, particularly the new ones. On the affected holdings, capping results in very significant cuts in direct payment levels (47-54%) and reductions in income levels (25-28%). The burden of such a measure in terms of the budget released by such ceilings would fall on only three MS (Germany, Czech Republic and Hungary).

Individual limit thresholds set at lower levels (i.e. €100 000) affect more farms across the EU (up to 1% of EU total of holdings) and more MS (15 in total are affected). However, even at this level, the measure would not attain its specific objective because it would not significantly change the distribution pattern of payments, due to the heavy bias towards small payments in the EU. The lower limit would need to be set far closer to the average direct payment per beneficiary in EU-25 (€6 100 in 2005 from the CATS payment database) to have any significant effect on payment distribution. Furthermore, the impact from such lower limit thresholds on the affected holdings on the level of direct payments (–55%) and income (–30%), are stronger. Since many of these farms are large employers of agricultural labour, the consequences on the employment situation in their local areas could be significant. On the other hand, the incentives for structural adjustment to avoid the limit (i.e. splitting of larger farmers into several smaller entities or transfer of entitlements) would be much stronger at this level of payment limitation.

Various legal responses to this problem of impact in large farms which are important employers of agricultural labour were addressed but found to have difficulties. Taking account of different farm structures and ownership arrangements (e.g. co-operatives) would require adjustment to the definition of the "legal person" claiming the payment, which would in itself open the door to circumvention and fraudulent splitting. Preventing any circumvention of the ceilings (by the transfer of entitlements or the splitting of holdings) would be difficult to implement, would require a definition of splitting and would lay the burden of proof on Member State administrations.

8.3. Option 2

Progressive individual limits (i.e. step-wise as from €100 000 upwards) maintain the more generalised nature of the measure across the EU (1% of EU total of holdings) but have significantly milder impacts on cuts in direct payments (–14%) and income (–8%) on the affected holdings. The total funding released by the measure is significantly less (€807 million) but more evenly spread across the 15 affected MS.

The main advantage of progressive payment limitations is that they weaken the incentives for structural adjustment to avoid the limit (e.g. farm splitting). However, the possibility of an

increase in transfer of entitlements (sale or rent) to maximise benefits in the presence of the individual limitations remains.

In terms of net budgetary effect and financial management, independently of the impacts at farmer level, the possibility that Member States could retain the funding released through this measure significantly increases the possibilities for adoption of high-level individual payment limits. However, with progressive limitations, the current system of financial control used to manage modulated funds would no longer be workable. Farmers receive a varying mixture of direct aids originating in different regimes and of different composition each year; therefore it would be problematic to anticipate the amounts released by the individual limit mechanism for each individual regime. Consequently, it would no longer be possible for the Commission to define net financial ceilings for each individual direct aid scheme, which would imply important changes to financial management.

9. IMPACT ANALYSIS OF LOWER PAYMENT LIMITATIONS

The potential impact from an increase in lower payment limitations is shown in Table 8.

Assuming that the current possibility of individual payment limits of €100 was applied, around 12.5% of all beneficiaries would be excluded from direct payments.

Table 8. – Summary impacts of lower payment limitations at aggregate EU level

	Minimum payment			*Minimum total area*		
% of total	*€ 100*	*€ 250*	*Affected*	*0.3 ha*	*1.0 ha*	*Affected*
Beneficiaries	*12.51%*	*30.84%*	*18.33%*	*1.54%*	*9.27%*	*7.74%*
Payments	*0.16%*	*0.84%*	*0.68%*	*0.01%*	*0.17%*	*0.16%*

Source: CATS 2006. For minimum payment, all direct payments in EU-25; for area, 10 MS applying SPS.

The percentage of beneficiaries affected varies greatly between MS (see Table 9 below).

Table 9. – Impacts of lower payment limitations at MS level

% of beneficiaries affected													
Payment range	BE	CZ	DK	DE	EE	GR	ES	FR	IE	IT	CY	LV	LT
0 and < EUR 100	*3%*	*1%*	*5%*	*1%*	*18%*	*11%*	*10%*	*3%*	*2%*	*19%*	*40%*	*23%*	*22%*
>=EUR 100 and < 250	*2%*	*7%*	*7%*	*5%*	*25%*	*15%*	*11%*	*2%*	*1%*	*19%*	*31%*	*38%*	*44%*
0 and < EUR 250	*5%*	*8%*	*12%*	*6%*	*43%*	*25%*	*22%*	*5%*	*3%*	*38%*	*71%*	*61%*	*66%*

Payment range	LU	HU	MT	NL	AT	PL	PT	SI	SK	FI	SE	UK	EU-25
0 and < EUR 100	*1%*	*14%*	*85%*	*14%*	*2%*	*15%*	*14%*	*16%*	*18%*	*0%*	*0%*	*7%*	*13%*
>=EUR 100 and < 250	*2%*	*26%*	*7%*	*16%*	*4%*	*32%*	*22%*	*26%*	*28%*	*1%*	*5%*	*7%*	*18%*
0 and < EUR 250	*3%*	*40%*	*93%*	*31%*	*6%*	*46%*	*36%*	*42%*	*46%*	*1%*	*5%*	*14%*	*31%*

Increasing the minimum level to €250 would affect close to 31% of all direct payment beneficiaries and the amount saved would represent around 0.84% of the payments.

The currently possible minimum individual area limit of 0.3 ha involves around 1.5% of all beneficiaries, which may be excluded from the SPS. The percentage affected again varies greatly, from 0.32% in Ireland to 9.2% in Portugal, but the amounts affected are even smaller than the rounded figure in the table (0.005% of the payments).

Increasing the minimum individual area limit to 1.0 ha would affect around 9.3% of all beneficiaries of the SPS, representing around 0.17% of the payments.

The very large number of small beneficiaries of CAP direct payments reflects more general structural aspects of EU agriculture. For many of these small beneficiaries, agriculture may be only one of several economic activities. These activities may be related more or less directly to agriculture. Consequently, any change in the payment rules would be unlikely to have significant agricultural employment impacts but could remove an alternative income source in rural areas with many small and part-time farmers.

While data on the administrative costs to MS of the management of direct payments is not yet available, studies on the transaction costs of the CAP on farmers have indicated that, in the range of MS studied, the average farmer in those MS imply total costs of applying for SPS payments above €250[37]. Only in one MS was the average farmer administrative cost below €250 (i.e. €107), largely a reflection of the small farm size, since costs per ha were more similar between most MS, ranging between €9 and €14 per ha.

10. CONCLUSIONS

10.1. Upper limitations

In relation to the attainment of the objectives pertaining to the SPS, the status quo (baseline), though neutral in terms of many impacts, fails to address the problem of the uneven distribution of payments.

The introduction of fixed individual limits, however, moves away from the general objectives of the SPS by having very severe impacts on large farms with high employment levels, and could jeopardise the rural fabric of the relatively few regions such payment ceilings would affect.

The progressive individual limits option, though contrary to the simplification objective, becomes globally the most positive option, since it addresses the problem of uneven payment distribution in a manner which attenuates the negative impacts on farms in regions with productive structures based on large farms.

10.2. Lower limitations

By excluding an estimated 30% of all beneficiaries from the SPS, increasing the individual limits to a minimum of EUR 250 would significantly affect the distribution of direct payments. However, it should be recalled that public perception of the uneven CAP payment distribution is focused more on the high payment level of a relatively small number of beneficiaries, and not on the other less widely recognised feature of CAP payments, the very high number of small beneficiaries.

From the point of view of simplification of the SPS, increasing the individual limits would have the advantage of reducing the number of small dossiers to be handled. Furthermore, raising the minimum size for SPS to 1 ha would mean that rules for EU-15 and EU-12 would no longer diverge, which would increase the degree of equal treatment between EU farmers.

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[37] See "The administrative burden on farms arising from the CAP, 2007", available in the following site: http://ec.europa.eu/agriculture/analysis/external/burden/index_en.htm

However, owing to the great difference in the percentage of beneficiaries affected by such a measure, lower limits could be criticised in some MS as an unfair treatment of small farmers.

In relation to the attainment of the objectives pertaining to the SPS, the compulsory application of the current optional rules on minimum payment size would address the need for simplification but have some negative social impacts in some MS. Raising higher the minimum payments intensifies the gains in simplification and the negative impacts on regions with farms structures based on small farms. For that reason, leaving the choice of setting either a minimum size or a minimum amount to MS competence would allow better adjustment to their specific situation.

11. SUMMARY TABLES

11.1. Comparison between different options and their respective impacts – upper payment limitations

☺☺ strong positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ strong negative

IMPACTS	Option 0 Status Quo	Option 1a Fixed individual limits at EUR 100 000	Option 1b Fixed individual limits at EUR 200 000	Option 1c Fixed individual limits at EUR 300 000	Option 2 Progressive individual limits
Economic	😐	Cuts direct payments by 55% in 1% of farms in many MS ☹☹ releases €3 billion ☺☺	Cuts direct payments by 54% in 0.2% of farms in a few MS ☹ releases €1.8 billion ☺	Cuts direct payments by 47% in 0.1% of farms in a few MS ☹ releases €1.2 billion ☺	Cuts direct payments by 14% in 1% of farms in many MS 😐 releases € 0.8 billion ☺
Social	Perceptions of uneven payment distribution in some MS persist ☹	Net income drops 30% in affected farms (avg. labour levels 16 AWU) ☹☹ modest impact on payment distribution ☹	Net income drops 28% in affected farms (avg. labour levels 38 AWU) ☹☹ minor impact on payment distribution ☹	Net income drops 25% in affected farms (avg. labour levels 51 AWU) ☹☹ insignificant impact on payment distribution ☹	Net income drops 14% in affected farms (avg. labour levels 16 AWU) ☹ small impact on payment distribution ☹
Environmental	😐	Cross compliance still applicable 😐	Cross compliance still applicable 😐	Cross compliance still applicable 😐	Cross compliance still applicable 😐

Comparison between different options and their respective impacts – upper payment limitations (cont'd)

IMPACTS	Option 0 Status Quo	Option 1a Fixed individual limits at EUR 100 000	Option 1b Fixed individual limits at EUR 200 000	Option 1c Fixed individual limits at EUR 300 000	Option 2 Progressive individual limits
Administrative	😐	Significant risk of circumvention, increase in controls required ☹☹ affects only some MS ☹	Significant risk of circumvention, increase in controls required ☹☹ disproportionate effect on very few MS ☹☹	Some risk of circumvention, increase in controls required ☹ disproportionate effect on very few MS ☹☹	Low risk of circumvention, increase in controls required ☺ moderate effect on some MS ☹☹
Simplification	😐	Clear, simple and easily communicated rule ☺	Clear, simple and easily communicated rule ☺	Clear, simple and easily communicated rule ☺	Introduces complexity in payment rules ☹

11.2. Comparison between different options and their respective objectives – upper payment limits

☺☺ fully respecting objectives; ☺ partially respecting objectives; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – baseline	Option 1a Fixed individual limits at EUR 100 000	Option 1b Fixed individual limits at EUR 200 000	Option 1c Fixed individual limits at EUR 300 000	Option 2 Progressive individual limits
Competitiveness	😐	☺	☺	☺	☺
Market orientation	😐	😐 to ☹	😐 to ☹	😐 to ☹	😐 to ☹
(Equity/distribution among farmers	☹	☺	☺	☺	☺
Environmental sustainability	😐	😐	😐	😐	😐
Budget costs	😐	😐	😐	😐	😐
Administrative costs	😐	☹	☹	☹	😐 to ☹
Vitality of rural areas	😐	😐	😐	😐	😐
Simplification	😐	☹	☹	☹	☹
Transfer efficiency	😐	☺	☺	☺	☺

11.3. Comparison between different options and their respective impacts – Lower payment limits

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

IMPACTS	Option 0 – baseline	Option 1 – Compulsory application of current individual lower limits	Option 2 – Increased individual lower limits
Economic	😐	Exclusion from payments of 13% of beneficiaries, but minimal impact on total payments (0.2% of total) ☹	Exclusion from payments of 31% of beneficiaries, with small impact on total payments (0.8% of total) ☹☹
Social	Large number of small beneficiaries in some MS applying regional model ☹	13% of total beneficiaries (and higher percentage in some MS) affected ☹ Net income loss to few beneficiaries 😐 to ☹	13% of total beneficiaries (and higher percentage in some MS) affected ☹☹ Net income loss to many beneficiaries in some MS ☹
Environmental	😐	😐	😐
Administrative	Administrative cost higher than payments in some cases ☹	Reduction in MS administrative burden ☺	Significant reduction in MS administrative burden ☺☺
Simplification	😐	Extent depends on level of limits ☺	Significant simplification across MS ☺☺

11.4. Comparison between different options and their respective objectives – Lower payment limits

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – baseline	Option 1 – Compulsory application of current individual lower limits	Option 2 – Increased individual lower limits
Competitiveness	😐	☺	☺
Market orientation	😐	😐	☺
Environmental sustainability	😐	😐	😐
Budget costs	😐	😐	😐
Administrative costs	😐	☺	☺☺
Simplification	☹	☺	☺☺
Vitality of rural areas	😐	☹	☹☹
Stabilisation of farmers incomes	😐	☹	☹
Transfer efficiency	😐	☺	☺

D – MARKETS

1. PROBLEM DEFINITION

The changed policy environment and the favourable market situation currently facing EU agriculture have raised questions as to the pertinence of CAP market instruments in their present form:

– supply control measures of the CAP in the sectors of milk (quotas) and cereals (set aside) restrict the ability of EU farmers to respond to market signals and to grasp market opportunities, and contradict the objective of market orientation;

– in several small sectors which retain policies of supply control and/or coupled aid adjustments are need to make adapt them to the overall orientation of the CAP;

– the intervention system for cereals has been adjusted to better fulfil its safety-net function. However, further modifications are necessary in order for it to function more efficiently in the case of strong market disruptions, without reliance upon subsidised sales (both internally and externally);

– differences among sectors in current intervention rules make their application more complex than necessary. Harmonising provisions for intervention across all sectors would further simplify the CAP;

– increased market orientation of EU agriculture and concerns for increased impacts from climate change, turn production and price risks into a heavier burden for farmers to bear, and bring calls for more risk management tools that need to be examined.

2. OBJECTIVES

- Improve competitiveness and market orientation, while preserving the environmental benefits of current policy tools,
- provide a safety net for farmers in case of strong market disruptions, which does not lead to unsustainable public stocks,
- assure that application of the measures will not lead to excessive budgetary cost and complexity,
- contribute to the vitality of rural areas,
- contribute to the stability of farm income.

D.A. CEREAL INTERVENTION AND SET ASIDE

1. BACKGROUND

The current EU intervention system for cereals is a single floor price of 101.31 €/t, with monthly increments, applicable to all major cereals across the EU[38]. Through buying at this price level, CMO ensures that internal market prices do not drop far below the safety-net intervention price. In the most recent reform of the cereal intervention system it was agreed that intervention quantities for maize will be gradually phased-out, but left open for the HC any further changes in the system[39].

Set aside was introduced with the 1992 reform to limit the cultivated area and thus complement the role of intervention and border measures in balancing the markets. The importance of set aside has been significant in the past, but the recent increase in cereal prices and most importantly the transition to the SPS have raised questions about its consistency with the overall objectives of the reformed CAP[40].

2. PROBLEM DEFINITION

The specificity of agriculture production[41] has been at the basis of the policy makers' decision to provide for a safety-net to farmers in case of markets disruptions. The dismantling of the maize intervention was necessary to remedy possible risks of high regional intervention stocks; but may lead to a relative loss of competitiveness for barley and possibly soft wheat, which under normal market conditions (i.e. lower cereals prices) may also trigger the risk of increasing public stocks for these cereals. In the current outlook context, the probability for such outcome looks remote. Since price variations are a feature of agricultural production, the intervention system has to be redesigned in a way that it still fulfils its safety-net role in case of strong market disruptions, but efficiently, without reliance upon subsidised sales (both internally and externally).

In addition, set aside needs to be reviewed because it still restricts the ability of EU farmers to respond to market signals and to grasp market opportunities thus contradict the objective of market orientation. In the context of expected high prices and decoupled support, further questions have been raised about the need of set aside as a supply control mechanism. The question has become more pertinent with the temporary setting of set aside at 0% for 2007/2008 due to low stocks and the current market outlook.

Yet, since mandatory set aside also delivers clear environmental benefits, concerns have been expressed about the environmental impact with its removal. This raises the question of where

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38 At present, intervention is available for bread making wheat, durum wheat, barley, maize, and sorghum; not available for feed wheat, rye and oats. It is being phased out for maize.

39 The June 2007 agreement set an upper ceiling on quantities going to intervention of 1.5 million tonnes in 2007/08, 700 000 tonnes in 2008/09, and 0 in 2009/10. It leaves the possibility to re-open intervention in case of changing market conditions.

40 See Figure 5 of note 5 in Annex B, for the strong inverse relationship between lower set aside and higher intervention stocks in the past. In the same note, Figure 1 indicates why this relationship is weaker recently; SPS allows set-aside entitlements to be transferred to less productive areas, thus limiting the supply control effectiveness of set aside.

41 Production decisions have to be taken long in advance with limited knowledge of the final outcome, large number of producers, relatively homogeneous products, inelasticity of demand, etc.

and to which extent loss of environmental benefits would take place, and of what type of measures would be appropriate to mitigate such impacts.

3. OBJECTIVES

The proposed options for adjustments in cereal intervention and set aside were assessed with respect to their capacity to meet the following objectives:

- provide a safety net for farmers in case of strong market disruptions, which does not lead to unsustainable public stocks
- ensure competitiveness and market orientation for the sector, while preserving the environmental benefits of set aside
- facilitate farmers' response to market conditions, especially prospects for high prices by eliminating mandatory set aside as well as simplifying the SPS implementation

4. POLICY OPTIONS FOR CEREAL INTERVENTION

Table 10. – Analysed option for cereal intervention

	Option	***Description***
0	Status quo – no further changes to the intervention system	The quantity of maize intervention is set at zero from 2009/10, with the possibility to re-open intervention in case of adverse market conditions
1	Reduction of the intervention price to a safety-net level	The buying-in price could be reduced to a sufficiently lower level allowing the system to act as a genuine safety net (this scenario corresponds to a hypothetical low world price situation)
2	Restrict intervention quantities to zero for all feed grains	Similar to maize, zero ceilings are applied to coarse grains going into intervention, with the possibility to re-open intervention in case of adverse market conditions. No quantity intervention ceiling is introduced for soft wheat.
3	Tendering system	A combination with option 2. Examines the possibility to introduce a tendering scheme for intervention from the first offered quantity. From the 2009/10 marketing year intervention would take place exclusively in the context of the activation of the special intervention measures, standard intervention for grain would only concern soft wheat and rice.

5. IMPACT ANALYSIS OF CEREAL INTERVENTION OPTIONS

5.1. Economic impact

The analysis of the EU market situation under alternative intervention assumptions on production, consumption, public and private stocks, prices and trade was done using the ESIM model. Three of the four options were simulated for the 2007–13

period based on the updated DG AGRI baseline which takes into account the latest market developments in the EU and world markets[42].

A particular difficulty in this analysis proved to be the current very high level of world market prices for cereals. Since intervention is a safety-net mechanism, it makes sense to analyse its potential impact when prices fall below their intervention level, not when they are almost twice as high as the latter. Thus sensitivity analysis focused on the potential impact of the various options under lower price levels (such as those witnessed in the recent past).

Table 11. – Impact of intervention options on the cereal sector

	Production (mio t)	*Consumption (mio t)*	*Imports (mio t)*	*Exports (mio t)*	*Area (ha)*
Option 0: Status quo					
Level	307.1	284	9.0	32.5	60.2
change from baseline	*1%*	*0*	*–13%*	*15%*	*2%*
Option 1: Safety net					
Level (million t)	307.1	284.8	9.0	27.7	60.2
change from baseline	*1%*	*1%*	*–13%*	*–2%*	*2%*
Option 2: Intervention only for wheat					
Level (million t)	306.8	284.1	9.0	32.9	60.1
change from baseline	*1%*	*0*	*–13%*	*17%*	*2%*

Source: DG AGRI based on ESIM model. Change is measured from baseline in 2013

5.1.1. Option 0: status quo – no further changes to the intervention system

The impact of this option could be felt when prices are at levels that were (until recently) considered "normal". Then, some of the previous pressure on maize intervention shifts to barley and soft wheat, and some build-up of intervention stocks for both would be inevitable (especially if export subsidies are abolished). In such a case budgetary costs will increase.

5.1.2. Option 1: reduction of the intervention price to a safety net

Under current high price levels the definition of a safety-net level appears very difficult. For demonstrative purposes a decrease of the intervention price to €95/t was chosen (based on minimum prices resulting from simulations with the ESIM model under a low price scenario). This option could bring benefits of international competitiveness and market orientations, including to the EU meat sector and its competitiveness, only in a lower price environment in world markets. Currently, this looks a very remote possibility.

5.1.3. Option 2: extension of maize intervention model to all feed grains

This option has the advantage to allow the support of all cereals under low prices, without the disadvantage of hampering barleys' competitiveness. Such a case would

[42] See http://ec.europa.eu/agriculture/publi/caprep/prospects2007a/index_en.htm and note 5 in Annex A for details.

lead to lower budget costs with respect to status quo. Previous analysis indicates that setting the support price only for one cereal would be enough to allow all cereal prices to find their natural balance around it[43]. Wheat seems the natural choice for such a price based on its destination for food and the fact that its price formation is more transparent with more competitors in world markets than in other cereals.

5.1.4. Option 3: tendering

This option was not evaluated quantitatively because it is not possible to model unknown future behaviour of cereal market participants. Two strong arguments favour it. The first is the simplification it will bring by harmonising cereal intervention rules to those of other CMOs. And although for some it would be seen as a drop in the effective intervention buying-in price of those quantities that enter intervention, in reality it helps the *average* market price to find its natural equilibrium level in a smoother manner when prices are low. In this case budgetary costs would be lower with respect to the other options.

5.2. Environmental impact

Conclusions of a DG AGRI evaluation study[44] indicate that in the past, even when EU intervention prices were higher than world prices, a direct link between the price support and the change in production techniques was difficult to establish and cannot be quantified. Only when support prices were increased significantly above world market prices did the relevant profitability of cereals change, and resulted in environmental risks (notably water and soil pollution, fall in biodiversity, and a degradation of soil structures). For instance, risks on water quality, soil erosion, soil pollution, and biodiversity could be greater in regions where greater intensification is associated with higher specialisation, monoculture, and the elimination of existing landscape features. On the other side, cross compliance applies equally to all land, regardless of the crop produced.

Since world market prices are significantly above support prices in the EU, none of the above holds in the current context. This high level of prices could create risks of intensification, but these risks have no evident link with the current support policy. On the contrary, under low price conditions the maintenance of the current intervention system may hamper the profitability of feed grains (barley) and could lead to environmental implications analogous to those described previously. Risks will be higher in case of substitution with maize, and to a lesser extent with oilseed rape, with respect to other cereals given their relative higher negative impacts on water quality, soil erosion, biodiversity and landscape[45].

None of the other options (1, 2 and 3) is supposed to have strong incidence over the relative profitability of cereals. If the production of any cereal would increase with respect to others, considerations over its impact on the environment should take into account not only the differences in intensity with respect to other cereals, but also market and technical developments.

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43 The idea was already proposed by the consultants in the DG AGRI "Evaluation of the cereals CMO" carried out by LMC International in 2005.

44 "Evaluation de l'impact sur l'environnement des OCM et des mesures de soutien direct de la PAC relatives aux cultures arables", 2007.

45 Idem as note 44.

5.3. Social impact

The only option to have an impact on farmers' income is option 2. On average the reduction of the intervention price to a safety-net level would not affect significantly the income per annual work unit of the farms producing cereals. If compared with the baseline (option 0), the increase of income by 2013 would be 2% lower, e.g. there will be an increase of income of 2% against a 4% in the baseline.

There would nevertheless differences with respect to the average income between the safety-net scenario and the baseline at Member State level, which would go from –6% (Slovakia) to +2% (Denmark), and by region from –8% (*Marche*, Italy) to +6% (*Asturias*, Spain). The main explanatory factors are the degree of specialisation in cereals (the lower the specialisation in cereals, the lower the decrease of income (or the higher the increase); the extent of the feed costs (the higher the feed costs, the lower the decrease of income (or the higher the increase), because of the high decrease of feed costs); the share of durum wheat in cereals (the higher the share of durum wheat in the cereals area, the higher the decrease of income, because of the high price drop applied in comparison to the baseline, i.e. –25%)[46].

5.4. Other

In all cases, given that the EU has become a net importer of cereals, there will be no impact on third countries.

Options 2, 3 and 4 could require deconsolidation of import duties[47], while for option 5 a pure tendering system would no longer operate on the basis of a fixed intervention price.

6. IMPACT ANALYSIS OF SET ASIDE ABOLITION

6.1. Policy options for set aside

Table 12. – Analysed options for set aside

[46] For more details see Annex F, in particular note 5.

[47] At present the maximum duty is calculated on the basis of the fixed cereals intervention price of € 101.31 per tonne (Headnote 6 of the WTO schedules).

	Option	*Description*
0	Status quo – no further changes to the current system	Set-aside obligation and entitlements are kept
1	Removal of set-aside obligation	Withdrawal of the obligation to set aside. The set-aside entitlements become regular entitlements.
2	Mandatory environmental set aside, 5% of total farm area	Obligation for all farmers to keep a fixed percentage of total area (5% reflects some such ideas) as an "environmental compensation/priority" area, with existing landscape features (e.g. hedges, ponds, fields margins) supplemented by strips along water courses.
3	New GAEC environmental features	One variant of option 2 is to replace the fixed percentage of set aside for all farmers with new standards that would expand the present list in GAEC to reflect the above landscape features.
4	Strengthening of environmental set aside within Pillar II	Agri-environmental measures within Pillar II already include programmes with many features that are similar with those advocated under cross compliance (GAEC), and provided additional funding were available they could be used to target the expected impact from the abolition of set aside.

The two distinct aspects of mandatory set aside (a supply control mechanism with environmental side benefits) were examined in parallel in the various options of its abolition. Initially, supply control was the dominant set-aside feature, but as it became less effective and society started to realise the environmental benefits of set aside, more focus turned on its environmental aspects. Analysed options reflect this evolution of concerns about set aside. The first two options looked at the impact of set-aside abolition on cereal area, production, prices, and farm income, and the impact from the potential loss on environmental benefits. The last two focus on ways to mitigate potentially negative environmental effects.

6.2. Economic impacts

The table blow summarises the economic impact of first two set-aside options.

Table 13. – Set-aside options of cereal area, production and prices

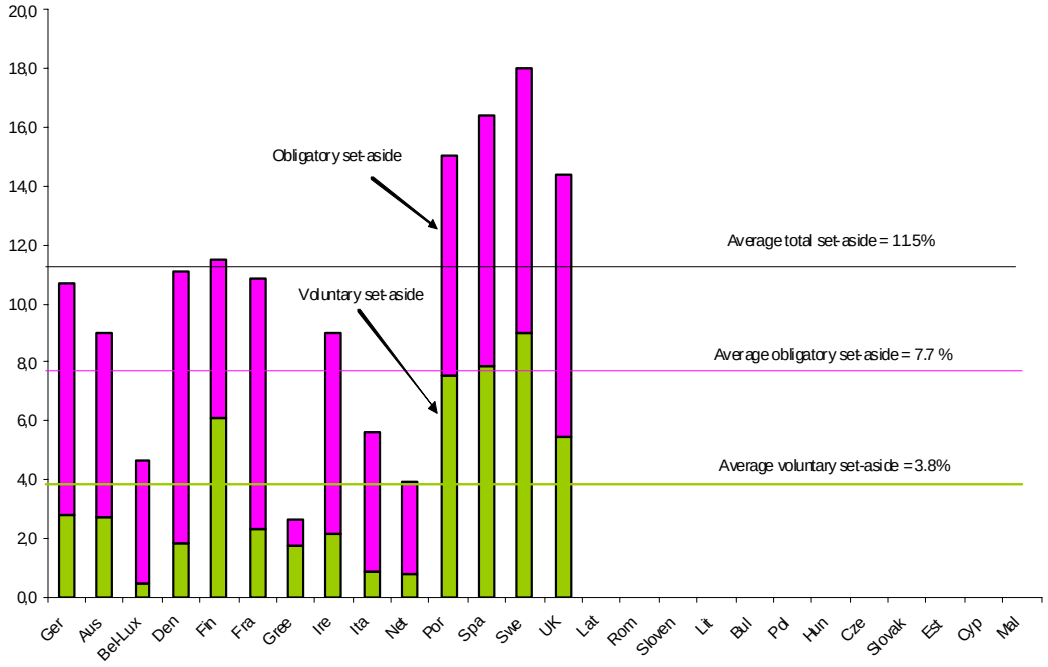
	Area (mio ha)	*Production (mio mt)*	*Prices (€/mt)*
Option 1: no set aside			
Level	*60.2*	*307.1*	*150*
Change from status quo	*+ 2%*	*+ 1%*	*–4%*
Option 2: 5% mandatory set aside on all land			
Level	*58.7*	*297.7*	*165*
Change from status quo	*–1%*	*–2%*	*+ 5%*

Source: DG AGRI based on ESIM model. Change is measured from status-quo value in 2013.

In 2007, around 3.7 million ha of EU arable land was under compulsory set aside, including 0.8 million ha used for non-food production. All this area is in EU-15 (most of it in Germany and France); new MS have no set-aside obligation.

An additional 3.0 million ha of agricultural land eligible for direct payments are non-cultivated land, mainly under permanent set aside[48].

Baseline – Set-aside distribution in 2007 – % of COP area



The impact from the abolition of mandatory set aside (option 1) will be to bring back to production an area corresponding to roughly half of the area that is currently under mandatory set aside. It is expected that the total area under set aside (including voluntary set aside) will remain in average at around 5% even with no mandatory set aside in place. By 2013, production would increase by 1% and prices drop by 4% compared to the baseline.

Under option 2, production would decrease by 2% and prices increase by 5%, again from the baseline. Thus this option still limits production response in the EU, but adds 0.4 million hectares to set aside. But the flat rate imposed across all MS is significantly different than the one of today, since option 2 leads to a drastic change in the allocation of set aside across MS and farmers by imposing an across the board percentage, while the potential environmental impacts from the abolition of set aside are limited to a few regions. The administrative burden, both at EU and MS, is expected to grow significantly due to the need to settle a brand new payment system, and also because of more controls at MS level. Moreover, the merging of entitlements is rendered more complicated and the raises the baseline for other RD environmental measures.

Option 3 allows for a more targeted approach, since it does not impose a fixed percentage of area under environmental set aside, but allows MS to choose the most appropriate feature from an expanded list of GAEC. On the negative side, the expansion of the scope of cross compliance with this option risks affecting the baseline, and thus relevant provisions of existing RD programmes in different MS.

48 With the implementation of the SPS in all MS, no distinction is made between voluntary set aside and non-cultivated land. The latter is significant in Spain, Portugal, Finland, Sweden and the UK.

However, if on one side, the administrative burden in most MS and farms increases, on the other, the merging of set-aside entitlements implies a simplification of the system.

Finally option 4 allows MS to target environmental benefits where they are mostly needed, building upon existing RD provisions. Although at MS level reprogramming will be needed at the beginning, the whole set-aside system will become simpler following the merging of entitlements. The prospects for success of this option would depend on the debate on modulation and on MS priorities. More funds would be needed, but also more focus by MS on retaining the environmental benefits from set aside in the regions that could be most affected[49].

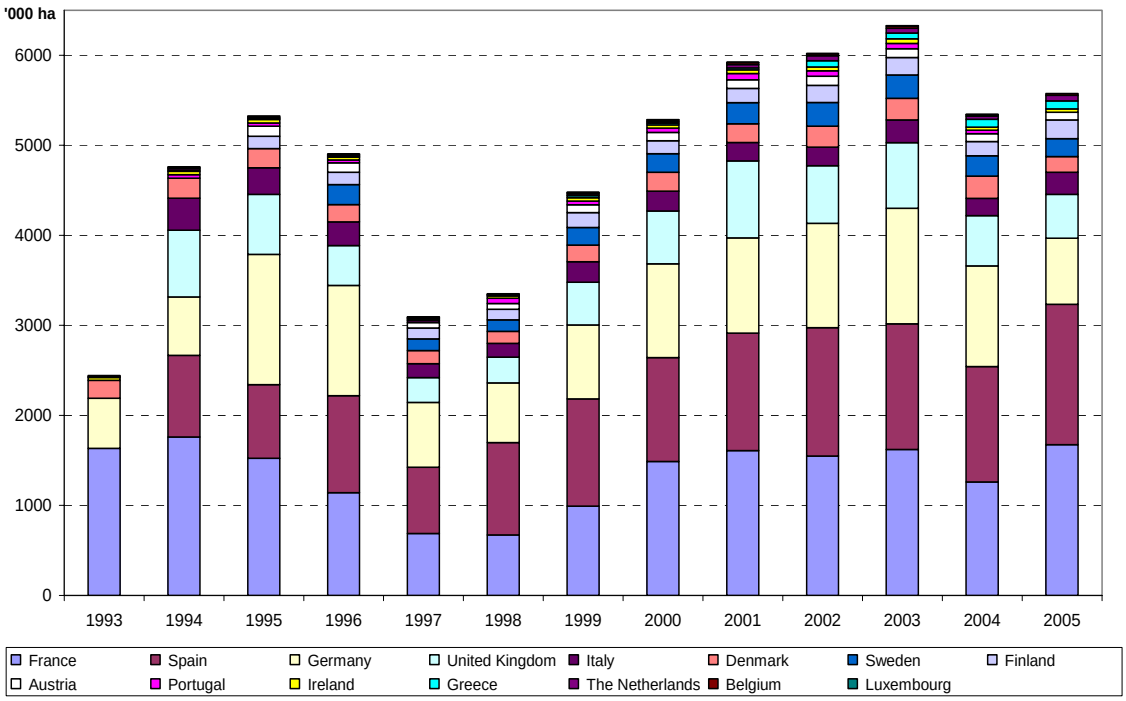
6.3. Environmental impacts

Quantifying the exact environmental benefits of set aside remains difficult; however, qualitative conclusions can be drawn based on the literature and on the expected market results.

The environmental impacts of option 1 (removing set aside) are expected to apply to all MS, thought there would be quite a strong regional component, since the extent of set aside varies significantly across EU, with its area increasing in some MS and decreasing in others (see Figure 5). The magnitude of impacts will depend on the characteristics of these regions. Some movement of set aside out of very productive regions to less productive ones would appear to have already happened where MS rules have allowed this. It is also to be noticed that 25% of the set-aside area is currently cultivated with non-food crops, 80% of which is oilseed rape.

[49] The criticism of environmental NGOs often focuses on the very different emphasis that MS place on agri-environmental measures, whether within GAEC or within RD.

Figure 5: Evolution of set-aside area in EU-15 since 1993, based on FADN data



Under current market perspectives for the medium term, production of cereals, and to a certain extent oilseeds, are expected to expand in the main producing regions, where set aside is mostly concentrated (e.g. some parts of UK, France and Germany). In these areas greater risks of losing benefits are associated to a greater intensity if set-aside land is converted to arable crops under monoculture (loss of biodiversity, landscape features, nutrient leaching, soil erosion and soil and water pollution). On the other side, if land conversion takes place in a context of diversification and rotation with the introduction of oilseeds and protein crops within the rotation, the negative risks on environment would be much smaller[50].

In the less productive areas obligatory set aside assumes particular relevance in the farm rotation scheme. It is likely that in these areas set-aside land will remain broadly as it is with perhaps some return into break crops such as temporary grass land, with minor impact on the environment.

In some parts of southern EU areas, such as in Spain, there is already a requirement for mandatory rotation within the national legislation, but in other regions how the benefits of set aside are retained would depend on managing practices, the risks are very variable depending on agricultural practises and local conditions[51].

As for option 2, the retention of environmental benefits should be ensured over an area which is expected to be higher and distributed among 27 MS.

Under option 3 the environmental benefits of set aside are expected to be retained, but the exact extent is difficult to assess since it will depend on how MS implement

50 See reference in note 6.

51 Idem.

GAEC standards. In several Member States GAEC standards with clear benefits to biodiversity are already in place. They include mandatory buffer strips, e.g. 2 meters buffer trips along hedges and watercourses in UK, and 5 meters buffer strips in France. Other standards with benefits to biodiversity include the ban of converting grassland in certain areas in Austria, minimum stocking densities and requirements for buffer strips in England and Finland.

Although the environmental impacts of the strengthening of environmental set aside foreseen in option 4 are expected to be positive, they are also difficult to quantify. They will depend on the uptake of measures and the implementing modalities that MS will put in place, and on the funding available.

6.4. Social impact

If the obligation of set aside would continue (baseline scenario) in an environment of high prices farmers would be penalised since they could not increase their income, taking advantage of favourable market conditions. On the contrary, under option 1, farmers could benefit from a higher income under the present market outlook. Under option 2, the area under production would be reduced and also farmers income, although its extent depends on the extent of the obligation and on the amount of the payments. Under option 3 and 4, the extent of the impact would depend on the extent of the area under set aside. Both options imply a higher acceptability of the SPS to the wider public.

7. CONCLUSIONS

The intervention system being a safety-net mechanism, analysing the impact of alternative intervention systems under current very high world market prices appeared difficult. Thus, considerations of the potential impacts of the various options focused on a sensitivity analysis under lower price levels.

In brief, although the reduction of the intervention price (option 1) would imply a real increase of competitiveness and market orientation, an effective reduction of the intervention price appears difficult. Restricting intervention to zero for all feed grains (option 2) would allow a safety–net support to all grains without impacting on their competitiveness, but a combination with a tendering system (option 3) would better reflect needs for intervention when prices are low as well as imply lower budget costs. This option has the further advantage of harmonising the intervention system to that of the other market sectors.

As regards to set aside, under the current price environment the impact of the baseline scenario would be negative in economic and social terms due to the lost opportunities for EU farmers. The withdrawal of the set-aside obligation (option 1) will allow a better response to market opportunities and will lead to a higher income for farmers and a simplification of the system, but there are potential risks of losing the environmental side benefits of set aside.

The three alternative systems that were analysed, i.e. setting an environmental set-aside area (option 2), introduction of new GAEC features (option 3) and the strengthening of RD environmental set aside (option 4) will bring environmental benefits, although to different extents. Option 2 will imply a lower response to markets, lower income to farmers and a significant increase in administrative burden and complexity, but higher environmental benefits. In the case of option 3 and 4, the economic impacts will depend on MS absorption of the relevant measures, as well as the extent of the environmental impact, which in any case

will be positive. In both cases the overall acceptability of the SPS to the wider public will increase.

All proposed options for cereal intervention and set aside are not expected to have a significant impact on consumers because the transmission from producer to retail prices is very limited. This is due to the very low share (4%) of agricultural raw materials on the final value of transformed products (bread, flour and other related products).

8. SUMMARY TABLES

8.1. Comparison between different options and their respective impacts – Cereal intervention

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – Reduction of the intervention price	Option 2 – Restrict intervention to zero for all feed grains	Option 3 – Combination of option 2 and tendering system
Economic	With present outlook 😐 If price were to drop, stocks of barley and possibly wheat could lead to budgetary costs ☹	Presently remote chances 😐 Competitiveness and market orientation only in an environment of lower prices ☺	Allows safety-net support to all grains without impacting on their competitiveness ☺☺	Would better reflect needs for intervention when prices are low, and lower budget costs ☺☺
Social	😐	😐 or ☹ depending on MS, and their relative degree of specialisation in cereals	😐	😐
Environmental	😐	😐	😐	😐
Administrative burden	😐	😐	Small initially, but not under present high prices ☹ to 😐	😐
Simplification	😐	😐	😐	Harmonisation in all sectors ☺☺
Other	😐	Import duties to be changed ☹	Import duties to be changed ☹	Import duties to be changed ☹

8.2. Comparison between different options and their respective objectives – Cereal intervention

☺☺ respecting objective; ☺ possibly respecting objective; 😐 neutral; ☹ objective possibly at risk; ☹☹ objective at risk

OBJECTIVES	Option 0 – baseline	Option 1 – Reduction of the intervention price	Option 2 – Restrict intervention to zero for all feed grains	Option 3 – Combination of option 2 and tendering system
Competitiveness	😐	😐 / ☺☺ under low international prices	😐	😐
Market orientation	😐	☺☺	😐	☺
Environmental sustainability	😐 / ☹ under low prices	😐	😐	😐
Budget costs	😐 / ☹ under low prices	😐	☺☺	☺☺
Administrative costs	😐	😐	initially ☹☹ / then 😐	😐
Simplification	😐	😐	initially ☹☹ / then 😐	☺☺
Vitality of rural areas	😐	😐	😐	😐
Stabilisation of farmers incomes	😐	😐 / ☹ only under persistent low prices	😐	😐
Transfer efficiency	😐	😐	😐	☺

8.3. Comparison between different options and their respective impacts – set aside

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – Baseline	Option 1 – Withdrawal of set-aside obligation	Option 2 – obligatory environmental set-aside area	Option 3 – New GAEC environmental features	Option 4 – strengthen RD environmental set aside
Economic	If high prices persist, loss of opportunities for EU farmers ☹	Better response to markets; increased competitiveness ☺☺	Lower response to markets; lower competitiveness ☹☹	Impact depends on MS absorption of relevant measures 😐	Impact depends on MS absorption of relevant measures 😐
Social	If high prices persist, loss of farm income ☹	Higher income with present market outlook ☺☺	Impact on lowering farm income depends on extend of obligation 😐 to ☹	Increases acceptability of SPS to wider public ☺	Increases acceptability of SPS to wider public ☺
Environmental	If high prices persist, set-aside entitlements could shift away from intensive farming ☹	Potential risks of losing environmental side benefits of set aside in some areas ☹	Environmental benefits increased (wider set-aside area) ☺☺	Environmental benefits from GAEC standards depend on MS implementation ☺	Environmental benefits from RD measures depend on MS implementation 😐 to ☺
Administrative burden	😐	Significantly reduces administrative burden ☺☺	Significantly increases administrative burden, including of controls ☹☹	Increases burden for most MS and farms ☹	Increases burden at MS level (reprogramming) ☹
Simplification	😐	Entitlements merged ☺	Complicates merging of entitlements and increases RD baseline ☹	Entitlements merged ☺ Increases RD baseline ☹	Entitlements merged ☺ Extent depends on implementation by MS

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – Baseline	Option 1 – Withdrawal of set-aside obligation	Option 2 – obligatory environmental set-aside area	Option 3 – New GAEC environmental features	Option 4 – strengthen RD environmental set aside
					😐 to ☺

8.4. Comparison between different options and their respective objectives – set aside

☺☺ respecting objective; ☺ possibly respecting objective; 😐 neutral; ☹ objective possibly at risk; ☹☹ objective at risk

OBJECTIVES	Option 0 – Baseline	Option 1 – Withdrawal of set-aside obligation	Option 2 – obligatory environmental set-aside area	Option 3 – New GAEC environmental features	Option 4 – strengthen RD environmental set aside
Competitiveness	☹	☺☺	☹☹	😐	😐
Market orientation	☹	☺☺	☹☹	😐	😐
Environmental sustainability	😐 to ☹	☹	☺☺	☺☺	☺
Budget costs	😐	😐 ☹ under low prices	😐 ☺ under low prices	😐	😐
Administrative costs	😐	☺☺	☹☹	☹ to 😐	☹
Simplification	😐	☺☺	☹☹	☹ to 😐	😐
Vitality of rural areas	😐	😐 to ☺	☺☺	😐 to ☺	😐 to ☺
Stabilisation of farmers incomes	😐	☺☺	☹	😐	😐
Transfer efficiency	😐	😐	😐	😐	depends on MS implementation

D.B. THE PHASING-OUT OF MILK QUOTAS

1. BACKGROUND

With the introduction of milk quotas in 1984, market support for the dairy sector remained essentially unchanged in the EU since the late 1990s. Reforms in 1999 and in 2003 decreased support prices with the aim of enhancing the competitiveness of the sector, and resulted in a better balance between internal and world market prices. But supply control through the milk quota system remains to date the defining feature of EU dairy policies, prolonged with the 2003 reform until 2014/15.

At the same time with the restricted supply environment in the EU, world markets are experiencing significant demand growth, driven not only by stronger demand but also by a shift in demand towards higher value added dairy products[52]. Part of this growth is reflected in the improvement of the EU market balance, and the recent strength in EU prices. But any additional EU supply response is not possible with the present system.

2. PROBLEM DEFINITION

In the light of buoyant internal and external demand, the remaining quota system is now restricting production expansion, as opposed to the situation in 1984, when quotas were introduced as a response to overproduction. Quotas hold back the sector from achieving the objectives of CAP reform since they still reflect concerns of two decades back, instead of responding to present opportunities. They reduce market orientation because they distort farmers' response to price signals, and prevent efficiency gains in the sector by slowing down restructuring.

In the absence of a decision to extend the national reference quantities beyond 31 March 2015 the quota regime would effectively expire because the levy on excess production and the national reference quantities would cease to exist. Since dairy production is relatively capital intensive and investment decisions have to be taken in a longer time frame than most other sectors, an early strategy would allow the sector to gradually adjust to a quota-free policy environment.

3. OBJECTIVES

The analysis of alternative policy options of the phasing-out of dairy quotas was assessed with respect to the fulfilment of the following CAP reform policy objectives:

- promoting competitiveness, market-orientation and sustainability;
- contributing to the vitality of rural areas and preventing land abandonment;
- preserving types of farming which are important for the protection or enhancement of the environment or for improving the quality and marketing of agricultural products.

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[52] An in-depth analysis of market situation has been presented by the Commission in a report "Market Outlook for the Dairy Sector" COM(2007) 800.

4. POLICY OPTIONS

The policy options analysed here were all based on the assumption that the logic of the present system has run its course and is no longer sustainable beyond its expiration. This assumption is supported by all previous major analyses on the outlook of EU and world dairy markets, which demonstrate two things: that the abolition of the quota will result in significant gains for the EU dairy sector, but also that certain regions in the EU will face significant adjustment costs and environmental risks[53].

4.1. Option 1: quota extension

This option envisages the continuation of the quota beyond to provide a reference scenario for comparison with the other options. In a sense, it corresponds to the extension of the quota system for analytical purposes.

4.2. Option 2: quota expiry in 2015

This option, which envisages no change to the current policy framework, enables the assessment of any adjustments in the system to make it less restrictive. It corresponds to a "hard landing" for the sector, which will face abrupt adjustments.

4.3. Option 3: phasing-out of quotas

This option envisages the gradual phasing-out of the quota regime ("soft landing") through annual increases of the quotas, in order to reduce the restrictiveness of the quota regime by 2015. Two sub-options with different rates of phasing out are foreseen through the introduction of two annual rates of quota increase:

4.3.1. Annual increases of national quotas by 1% from 2009/10 to 2014/15

4.3.2. Annual increases of national quotas by 2% from 2009/10 to 2014/15

Results of the above sub-options provide information that indicates whether there is also need for technical adjustments that would enhance the smoothness of the transition (such as the reduction of the super levy, the transferability of quotas, the distribution of additional quotas, etc.).

5. IMPACT ANALYSIS

The quota system restricts the level of production and consequently affects the price of milk and the market situation for milk products. The consequences of different options have been estimated using a quantitative econometric model on the basis of a Commission funded study 'Economic analysis of the effects of the expiry of the EU milk quota system'[54].

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53 The recent Scenar2020 is the latest in a series of analyses supporting this conclusion.

54 The study was done independently from the Commission's estimation of the medium-term outlook for dairy. General trends regarding markets are similar balance in both forecasts, but there are also

5.1. Economic impacts

5.1.1. Extension of quotas

In this scenario, since production is restricted at the quota level, demand trends for fat and protein shape milk prices, leading to a slight production response in those MS currently producing below their quota level. This restriction in production results in a price increase of 7.2% in the period 2008–2015, or about 1% per year (see table below).

Table 14. – The impact of quota extension in the EU dairy market

	Situation in 2015/16 (compared to 2008/09)				
EU-27	*Price*	*Supply*	*Demand*	*Exports*	*Imports*
Milk	+7.2%	+0.7%			
Cheese	+7.3%	+5.5%	+5.8%	+0.4%	0.0%
SMP	+12.0%	–14.8%	–5.2%	–37.6%	0.0%
Butter	–3.9%	–4.3%	–2.8%	–20.4%	0.0%
Fresh	+3.4%	+7.1%	+7.2%		

Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

Demand in cheese and fresh milk products show the strongest increases in the medium-term, while demand for bulk commodities such as butter and skimmed milk powder declines further. SMP price increases, but the price of butter falls (yet both stay above their intervention level). This situation strongly influences EU exports of milk products. Despite strong demand growth on world markets, cheese exports stagnate and the exports of SMP and butter decrease strongly.

For producers, rising prices lead to higher quota rent and income, but the same higher prices are capitalised in the value of quota, thus rendering quota expansion more difficult[55]. This slows down efficiency gains and most of the investment would be spent on additional quotas, eroding much of the advantage of high prices. The less efficient remain locked in the production, quota system would have little incentive to orient towards more competitive markets.

some differences in particular values due to different assumptions used in the models (such as different product definitions).

55 A quota rent is defined as the difference between the price under quota (higher than market price when quotas are binding) and marginal costs of production.

The quota system is also identified as one of the main obstacles to increased competitiveness of the dairy processing industry because of limited access to raw materials, increased costs of production and lost opportunities to supply growing international markets[56]. It is also administratively burdensome in terms of management and control. Finally, high prices represent a loss to the consumer, but analysis shows this impact to be smaller than often thought because of the very low price transmission of farm prices to consumer prices.

5.1.2. Expiry of quotas in 2015 ("hard landing")

In this scenario, the market developments are similar to those presented in the extension scenario until the point of quota expiry in 2015/16. When quotas are lifted in 2015, EU production increases by 3.8% (compared to the baseline) in order to match demand. The result is a strong price decrease of 8.2% with respect to the baseline in the first year after quota expiry (see table below).

Table 15. – The impact of quota expiry in the EU dairy market

	Situation in 2015/16 (compared to baseline)				
EU-27	*Price*	*Supply*	*Demand*	*Exports*	*Imports*
Milk	–8.2%	+3.8%			
Cheese	–6.4%	+1.4%	+0.7%	+12%	0.0%
SMP	–7.5%	+20%	+3.8%	+79%	0.0%
Butter	–4.5%	+8.5%	+1.4%	+106%	0.0%
Fresh	–2.7%	+0.5%	+0.5%		

Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

The impact from the sudden removal of quota restrictions is very different on the milk sector of MS, and depends mostly on prices and production costs in a given MS.[57] Similar changes with milk production and milk prices are also observed in dairy products (see table above). For higher value added products, changes are small, but are more pronounced for the commodity products, where production increases in both butter and especially SMP (compared to 2008). But while for SMP exports also increase since the world price is above the EU price, the price of butter quickly reaches the intervention level and is sustained only through export subsidies (this scenario assumes present WTO policies); this also explains the export surge compared to baseline[58].

For producers, the moment of expiry creates a great uncertainty. In the period until 2014/15, the quota system would become increasingly restrictive and the quota rent would considerably increase until the moment of abolition, making it difficult to formulate a clear perspective and reasonable expectations about the

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56 "Competitiveness of the European Food Industry: An economic and legal assessment", J.H.M. Wijnands, B.M.J. van der Meulen,K.J. Poppe (eds), Reference no ENTR 05/75

57 See Graph A5 in Annex B, note 7 for details.

58 With a DDA agreement and the abolition of export subsidies, the current price for butter intervention is unsustainable.

future of the sector. Restructuring could slow down before the quota expiry due to high prices, but this would evoke a strong supply response at the end of the regime. Such a situation would be disruptive for processors, who depend on a steady supply of raw materials and have limited capacity to accommodate large production increase. For the consumers, on the other hand, this represents a loss due to high prices until abolition, but also relatively inelastic demand for dairy products, means that a sudden drop in prices is of limited benefit.

5.1.3. Gradual phasing-out of dairy quotas ("soft landing")

By contrast to the previous scenario, the phasing-out of dairy quotas supposes gradual annual increases of the quota level to allow for production to respond to growing demand, and thus avoid the drastic production increase and price drop at the moment of lifting quotas. The impact on EU market developments was simulated with two scenarios: six annual increases in the quota level by 1% (scenario Q1) and by 2% (scenario Q2). Results on price and production are summarised in the following table.

Table 16. – The impact of quota increases on EU milk production and milk prices

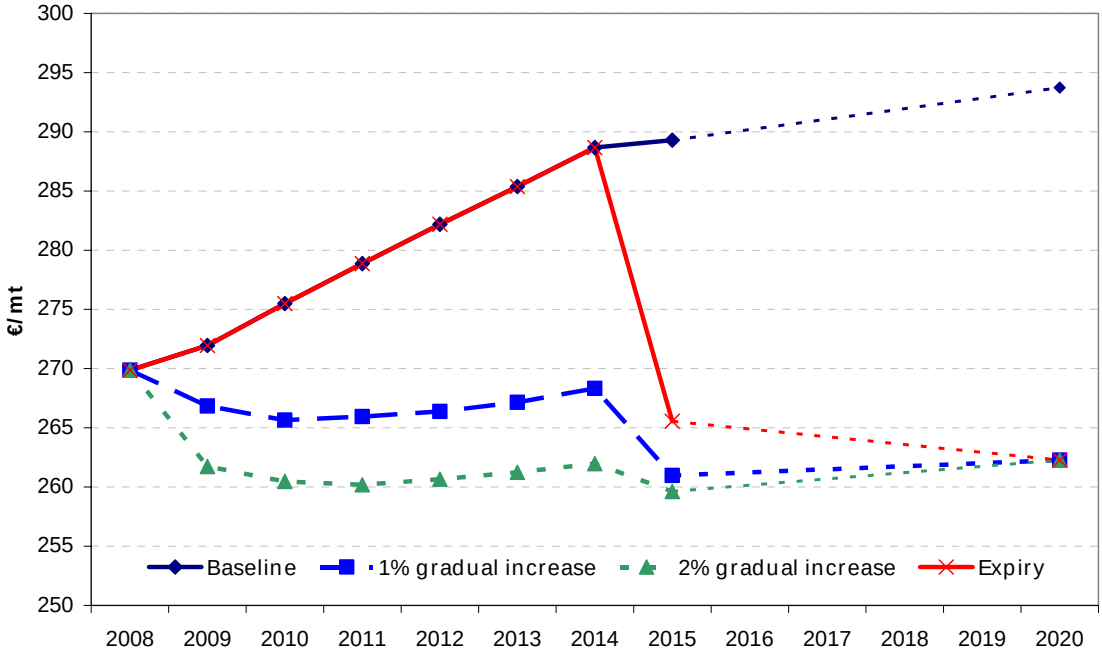
	2014/15 (compared to 2008)		2015/16 (compared to 2014/15)	
Milk	*Q1*	*Q2*	*Q1*	*Q2*
Price	–0.6%	–2.9%	–2.7%	–0.9%
Production	+3.9%	+4.9%	+1.3%	+0.6%

Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

EU-27 production is projected to increase annually by 0.7% in scenario Q1 and 0.8% in scenario Q2, which attenuates to some extent the expected price increases. Figure 6 shows the expected path of milk prices and Figure 7 the corresponding path of milk production under all four analysed scenarios[59].

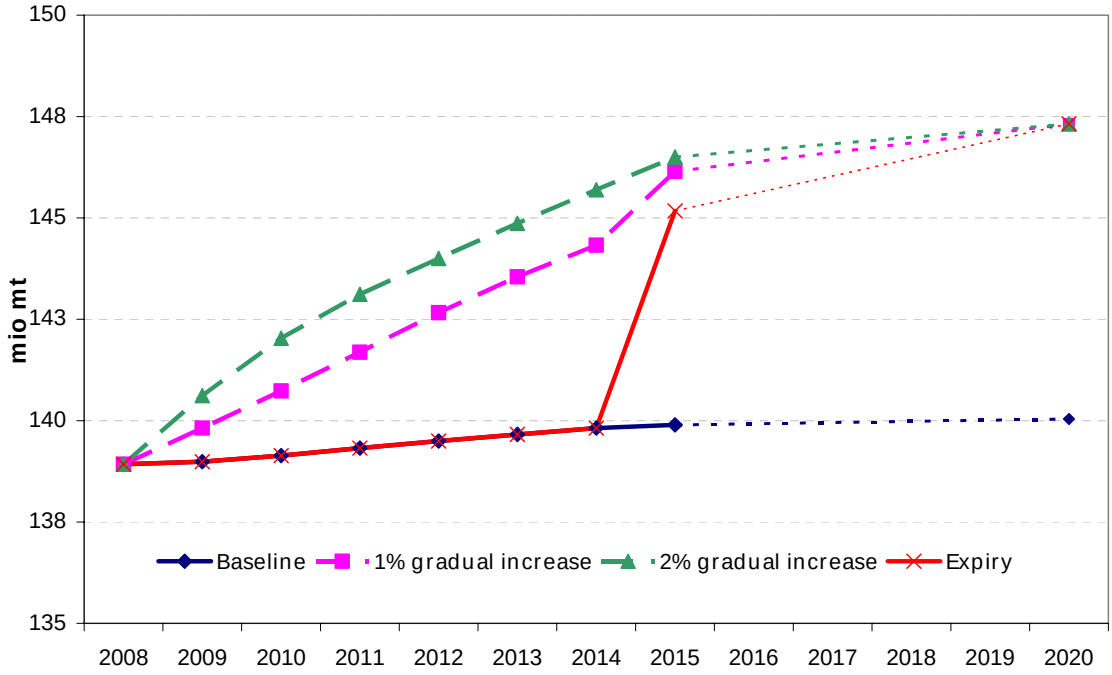
Figure 6: Comparison of milk prices under the four scenarios

[59] MS responses vary depending on their competitiveness. Detailed results for production and price responses are shown in Annex B, note 7.



Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

Figure 7: Comparison of milk production under the four scenarios



Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

Milk prices remain relatively stable under scenario Q1, with some increase towards the end of the quota, and a decline when quotas expire. In scenario Q2 the initial milk price decrease is bigger but, at the end of the quota period in 2014/15, price adjustment is also smoother. In both scenarios, milk prices are

partly sustained by butter intervention and subsidised sales; in their absence, milk prices would be around 1.5% lower[60].

The impact of both scenarios on dairy products is shown in the tables below. Market developments follow similar paths with the baseline scenario, indicating once more the potential problem that may exist with butter intervention in the absence of subsidised supply disposal. The problem is more acute with the higher quota increase scenario (Q2).

Table 17. – The impact of quota extension on EU dairy products (Q1)

	Situation in 2015/16 (compared to baseline)				
EU-27	*Price*	*Supply*	*Demand*	*Exports*	*Imports*
Cheese	–5.4%	+1.2%	+0.6%	+9.7%	0.0%
SMP	–6.2%	+17.6%	+3.2%	+69.1%	0.0%
Butter	–4.6%	+7.1%	+1.5%	+86%	0.0%
Fresh	–2.3%	+0.4%	+0.4%		

Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

Table 18. The impact of quota extension on EU dairy products (Q2)

	Situation in 2015/16 (compared to baseline)				
EU-27	*Price*	*Supply*	*Demand*	*Exports*	*Imports*
Cheese	–7.4%	+1.5%	+0.7%	+11.4%	0.0%
SMP	–9.0%	+20.7%	+4.6%	+77.8%	0.0%
Butter	–4.6%	+9.2%	+1.5%	+116.7%	0.0%
Fresh	–3.5%	+0.6%	+0.6%		

Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

For the processing industry and consumers, both scenarios of phasing-out present clear advantages with respect to the abrupt quota expiry. Their difference is in the price path, which is clearly more stable with scenario Q2; but the same scenario puts more pressure on the existing market support mechanism for butter.

5.1.4. Other dairy policy instruments

In both expiry and phasing out scenarios, the SMP price remains above the intervention level. However, in each scenario the butter price reaches the intervention level, triggering market mechanisms to prevent any further fall in

[60] During the phasing out of quotas, the quota value decreases at the end of the quota period by about 60% in Q1 scenario and 90% in Q2 scenario.

the butter price[61]; in 2015 in the 'expiry' scenario, in 2011 with 1% quota increase and in 2010 with 2% quota increase.

5.1.5. Impact on international markets

As milk is a perishable product, the principal dairy products traded on world markets are milk powders, butter and cheese. In the quota continuation option, the net exports are reduced as production moves to higher value products and domestic demand increases, which results in higher world prices. The expiry of quotas results in relatively high increase of exports and a significant decrease of world prices. The phasing out scenario forecasts gradual increase of exports as milk production increases which attenuates the world price developments and reduces the effect at the moment of expiry. Notably, as EU butter price reaches intervention level during the phasing out period, export refunds are used, which result in lower world price (at the same time increasing the value of refunds required).

5.2. Social impacts

The evolution of income between 1998 and 2005 in EU-15 shows that on average milk specialised farms have a higher than average farm income, with an increasing trend (a similar situation is observed in EU-10). But quotas have not stopped the number of small farms from declining; only resulted in larger farms stagnating over the same period (with their average size still being considered small with international standards).

The expiry of quotas will lead to expansion of the dairy sector, allowing producers and the processing industry to benefit, with associated positive impacts on rural economies, for example on employment. However, since the quota system has been ring-fenced at national (and often regional) level, quota expiry leads to restructuring of the milk production sector with potential implications for selected regions.

In most dairy producing regions, more than 90% of milk specialised farms will retain positive margins over variable costs with the price drop expected with the sudden expiry of quotas. But in a number of regions (around 15%), over half of the farms with negative margins were in that situation even before simulated price decrease, which is indicative of more general trends in the dairy sector in those regions (see table below). In some regions, this may lead to restructuring of diaries, which are localised close to production sources. (Section C indicates potential ways of addressing this issue in the discussion on a possible revision of Article 69).

Table 19. – Regions most affected with costs with a price decrease

[61] In the standard model simulations, butter (and SMP) prices are prevented by falling below the IP level by the means of export refunds and/or domestic disposal aids.

Regions/MS where farms with positive margins are between 80-90%	*Regions where farms with positive margins are below 80%*
Estonia, Latvia, Sweden, England-East (UK)	Czech Republic, Malta, Slovakia, Brandenburg (DE), Sachsen (DE), Sachsen-Anhalt (DE), Thueringen (DE), Aquitaine (FR)

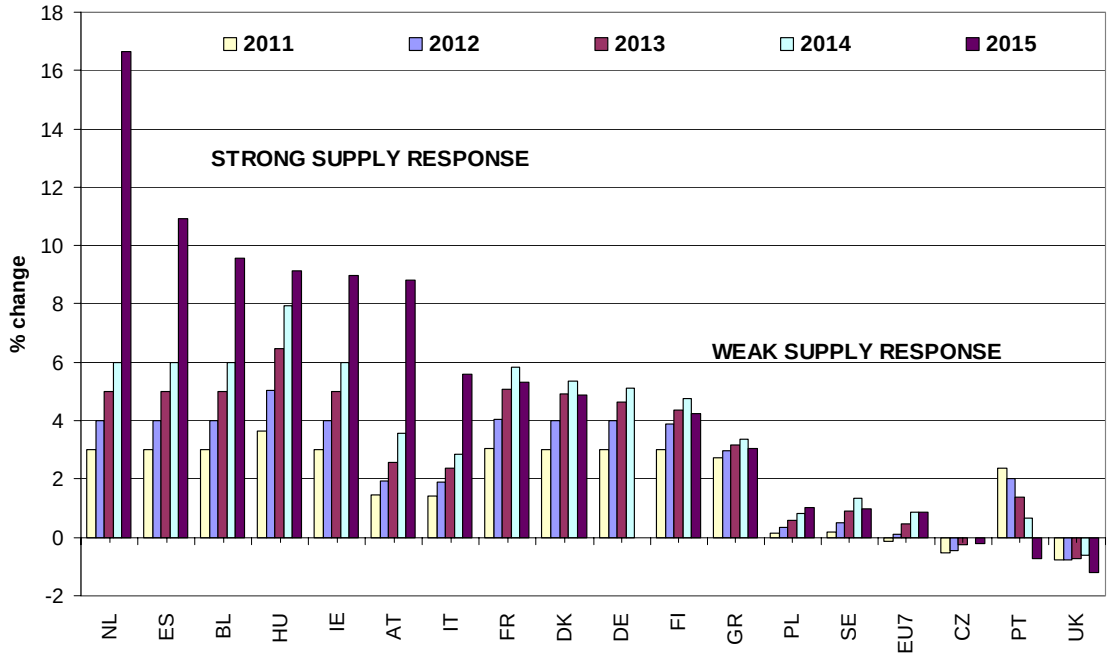
Source: DG AGRI analysis based on FADN data.

The FADN analysis shows that on average milk farms in mountainous regions in the EU15 receive higher prices, which compensate higher variable costs that they incur and allow for a higher margin per t of milk than in other areas, however on average their production is lower. On the other hand, in EU10 the margin in mountainous regions is on average lower[62]. An analysis of the impact of price drop indicates that results for mountainous regions would not differ strongly from overall results in EU15. The percentage of farms remaining with positive margins would be 95% in LFA mountainous areas, compared with 96% overall. In EU10, the decrease would be greater, however still 89% of farms would retain positive margins (as compared to 97% overall).

The phasing out of quotas would smooth out the price developments and allows for production increase, providing a stable framework for farmers and development opportunities for processors. The transformation period given by phasing out allows less competitive farmers to adapt to a gradually changing situation rather than face an abrupt price decrease. Rather than reinforcing the tendency to exploit short term benefits of market constraints before the expiry, it would encourage moving towards more remunerative product mix and adjusting the relationship with processing industry. Gradual phasing out provides for production that is less uneven between member states than a sudden abolition and at the same time prevents the effect of increasing of the quota value before 2015 due to rising prices. Moreover, a transitional period allows for more time and flexibility in adjustment of the sector and the regime to better prepare for a no-quota situation.

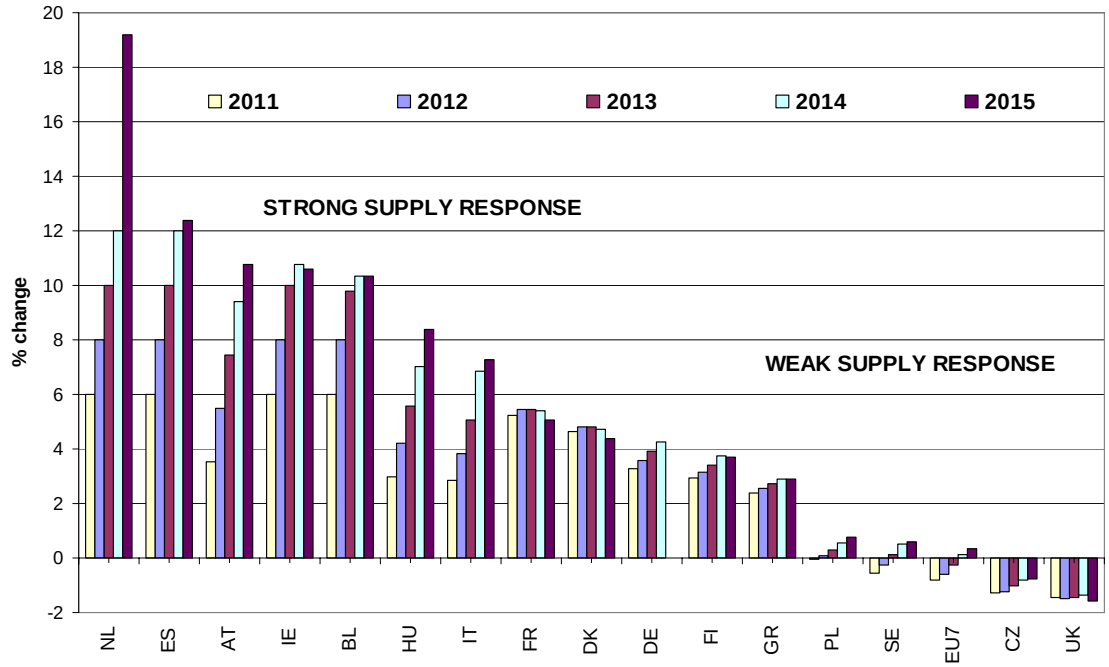
[62] Impact on milk margins of a price reduction – Complement on mountainous areas, Agri-G3, D(2008) D3926.

Figure 8: Cumulative production growth under 1% scenario (compared to 2008)



Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI

Figure 9: Cumulative production growth under 2% scenario (compared to 2008)



Source: "Economic analysis of the effects of the expiry of the EU milk quota system", IDEI.

The price impact from the phasing-out of the dairy quotas should normally benefit consumers, as more supply leads to lower prices. Results from the study 'Economic analysis of the effects of the expiry of the EU milk quota system' show that such a consumer gain at the EU-25 level would amount to about €3.7 billion in the year of quota removal (2015/16). However, while this benefit would certainly pass to the industry as a user of milk, the transmission of such price changes to the final consumer should be expected to be rather small.

As DG AGRI analysis has shown, the share of the agricultural product to the final food product is generally low, and so is on the average the share of food to total consumption. The same analysis indicates that the EU average masks significant differences not only among MS, but also among different social groups, with lower income consumers being much more vulnerable to price changes. In this case, the latter group would be more prone to reap the benefits from lower milk prices)[63].

5.3. Environmental impacts

Two recent studies have looked into the two main processes that influence the environmental impacts of dairy production[64]. Their conclusions indicate that policy in itself may not always be the main factor.

These studies identified the following linkages between environmental indicators and policy-related factors that could be influenced from the phasing-out of dairy quotas: *water quality* (from overstocking), *soil protection* (from increased area under forage crops), *biodiversity* (from intensive production methods), and *emissions* of ammonia and greenhouse gases (from herd size and production methods). In addition, the loss of dairy production in more marginal areas can be expected to lead to a loss of related biodiversity.

The *continuation* of the quota regime constrains production, increases specialisation and yields, and results in decreasing number of dairy cows by about 6.7% between 2008 and 2015 (or 1.6 million dairy cows). This leads to lower ammonia emissions of the dairy herd (to a level of 652 Kt NH3 and lower GHG emissions (to a level of 58 Mt CO2 equivalent) in the last year of current quota arrangements[65].

The *expiry* of quotas results in rapid production growth with strong concentration and intensification, as prices decrease and cost efficiency is crucial. There are areas where marginalisation is a threat, while in others production responds and specialisation increases. At the moment of abolition the number of dairy cows increases by about 2% (about 0.5 million cows), but still remain by 3.3% below 2008 level. This would also cause a strong one-off

63 See "The impact of developments in agricultural prices for consumers".

64 Environmental impacts are evaluated mainly on the basis of the study "Evaluation of the environmental impacts of CAP measures related to the beef and veal sector and the milk sector" and a supplementary study "Evaluation of the environmental impacts of milk quota".

65 These estimates are based on Commission calculations using data on emission factors in the GAINS model (http://www.iiasa.ac.at/web-apps/apd/gains/EU/index.login).

increase in ammonia and GHG emissions and the concentration effect could also lead to more nitrogen pressure. After the expiry, the number of cows is then gradually reduced as production stabilises and yield grows. By 2020, in all expiry and phasing out scenarios the number of cows is reduced by 6.2% as compared to 2008 (1.5 million cows) and ammonia and methane emissions would reach respectively 674 Kt and 57 MtCO2 equivalent. The increase of GHG (methane) emissions compared to baseline represents roughly 0.2% of the reduction needed to meet the 20% GHG reduction target in 2020 for the overall EU. It would also represent in 2020 an increase of less than 1% of total NH3 emissions (from all NH3 sources), which is well below the uncertainty surrounding the ammonia estimates.

The *phasing out* scenario results in a smoother process of adjustment thus limiting the extreme concentration and marginalisation effects. Relocation of production is less dramatic in this case and the number of cows continues to decrease, albeit at a lower rate than under the status quo, but by 2015 the herd size equals that of the expiry scenario. The number of cows falls between 2008 and 2015 by 3% in Q1 scenario (0.7 million cows) and 2.7% in Q2 scenario (0.6 million cows). This would lead to ammonia emissions of a level of 673 Kt in Q1 and 679 Kt in Q2. As for GHG emissions, in the last year of quota they decrease more in Q1 scenario (2.3%), while in Q2 they slightly increase in the first years with overall decline by 1.5% over the period. The gradual increases prevent the strong uneven production growth throughout the EU by allowing for a more gradual transition and reduce the very strong intensification pressure of the expiry option, thus easing the associated nitrogen pressure.

Table 20. – Impact on ammonia and GHG emissions

	Ammonia emissions (Kt)			GHG emissions (MtCO2 equivalent)		
Option	*2010/11*	*2014/15*	*2020/21*	*2010/11*	*2014/15*	*2020/21*
Continuation	657	652	643	60	58	55
1% increase	665	673	674	60	59	57
2% increase	671	679	674	61	60	57
Expiry	657	652	674	60	58	57

Source: Commission.

6. SUPPLEMENTARY ANALYSIS

The study, on which the quantitative analysis was based, was initiated before the most recent EU and world market price developments and the Commission proposal to increase for a 2% quota increase in 2008. A complementary analysis was carried out by DG AGRI with the OECD/AGLINK model, incorporating those factors in the baseline.

The most recent DG AGRI baseline was used as the reference scenario, and the following adjustments to the above scenarios were introduced: no quota increase in 2009/10, followed by annual increases of 1% between 2010/11 and 2013/14, no increase in

2014/15 and no quotas thereafter. As such, the cumulated quota increase (including the 2% increase in 2008/09) approaches that of scenario Q1.

Results in table 21 indicate that by the end of the phasing-out period (2014) milk production would increase by 2.2% and the price decline by 4.9% below the baseline level. With respect to present price levels, however, the milk price remains fairly stable during the phasing-out period, declining by only 1% from its 2008 level. Quota expiry in 2015 would lead to a further production increase of 1.1% and a price drop of 2% compared to the respective 2014 levels.

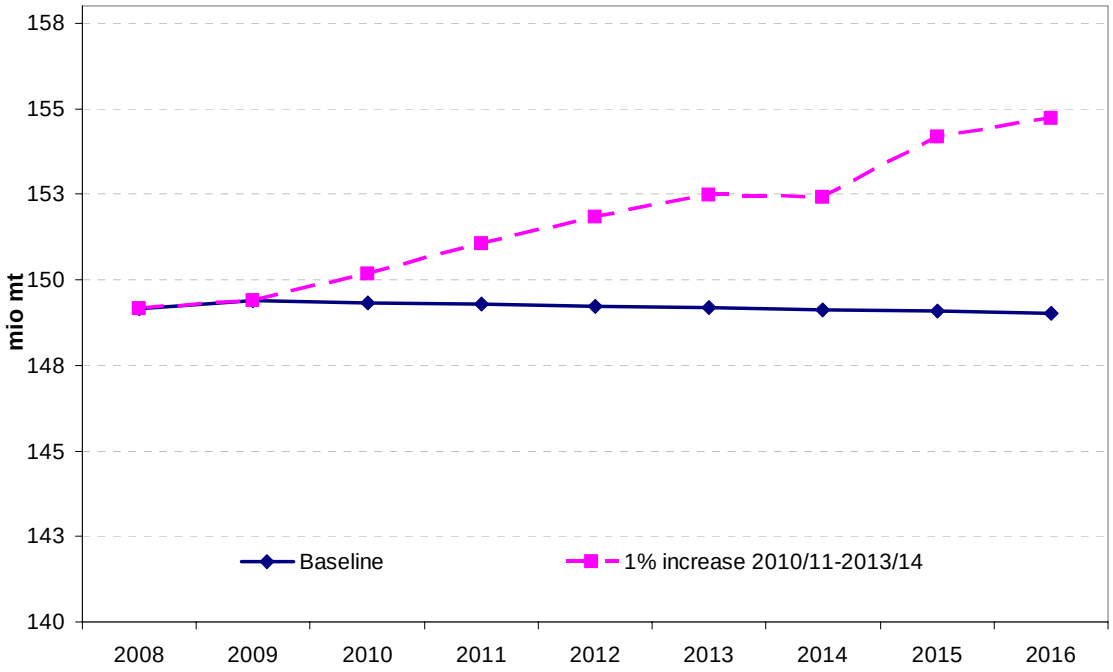
Regarding processed commodities, the production of higher value added products exceeds baseline levels, responding to both domestic as well as external demand growth. SMP production increases by almost 6%, but butter production grows only slightly above its baseline level (0.5%) by 2014. For both products EU prices remain above intervention level throughout the phasing-out period.

Table 21. – The impact on the EU dairy market in the phasing-out period

Situation in 2014 compared to the baseline					
	Price	Production	Consumption	Exports	Imports
Milk	–4.9%	+2.2%			
Cheese	–3.3%	+2.8%	+2.1%	+14.1%	0.0%
SMP	–6.7%	+5.8%	+4.5%	+27.2%	0.0%
Butter	–0.7%	+0.5%	+0.1%	+13%	0.0%
Fresh		+1.7%			

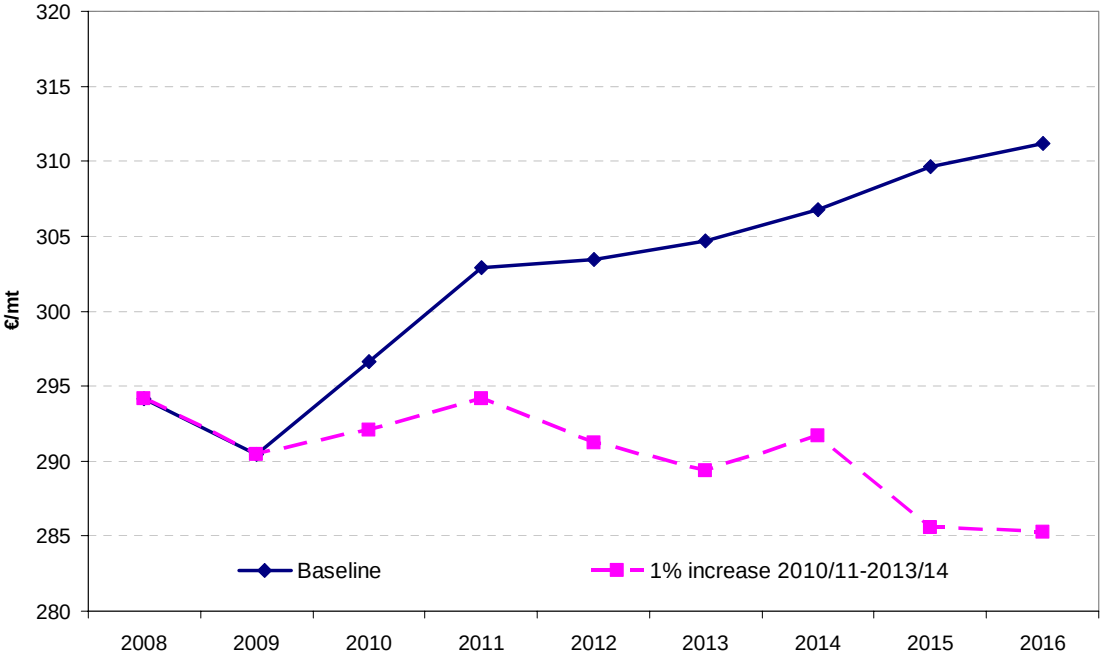
Source: DG AGRI simulation based on OECD/AGLINK model.

Figure 10: Milk production compared to baseline



Source: DG AGRI simulation based on OECD/AGLINK model.

Figure 11: Milk price compared to baseline



Source: DG AGRI simulation based on OECD/AGLINK model.

7. CONCLUSIONS

In the extension option, constrained production with growing demand increases milk price by 7% between 2008 and 2015 period. Market orientation and competitiveness of producers and processors is hampered.

In the expiry option, when quotas are lifted in 2015/16, production jumps by 3.8% to match demand, causing a strong price decrease of 8.2% in the first two years after the quota expiry.

Price declines and production responses are smoother under both *phasing out options*, but the extent of adjustment differs.

– *When the quota increases by 1% annually*, production increases by 1.3% after the quota expiry while price decreases by 2.7%.

– *When the quota increases by 2% annually*, production increases by 0.6% and a price decreases by 0.9%.

In both phasing out scenarios, the butter price falls to its intervention price level (in 2011/12 with the 1% scenario, in 2009/10 with the 2% scenario, immediately after the quota expiry). Model simulations assumed that exports refunds would be needed to sustain butter at the intervention price level. A sensitivity analysis indicates that the effect of the assumption of no export refunds would be to reduce the average milk price by an additional 1.5%.

The end result for the expiry and phasing out options in terms of market balance is the same. However the transitional process affects the social and environmental aspects. A smooth transition in the phasing out scenarios prevents rapid restructuring and allows preparing and adjusting accompanying measures to the potential problems as they become apparent.

Consumers would benefit only partially from the price decrease that would follow the implementation of options 2 and 3, although option 2 should bring the greatest benefits since prices are expected to decrease at a higher rate.

The decrease in prices foreseen in the various options is expected to be only partially transmitted to retail prices, given that the share of agricultural raw materials on the processed dairy products is 39%. The extent of price transmission will also depend on other factors (food consumption structure in each MS, concentration and segmentation of supply chain, marketing strategies of the retails sector).

A complementary analysis was conducted, incorporating more recent world market developments and the recent 2% quota increase in the baseline, with a scenario of annual 1% quota increases between 2010/11 and 2012/13. In the last year of quota, production would increase by 2.2% and price would fall by 0.8% compared to 2008 (2.2% and 4.9% respectively, compared to baseline). When quotas expire, production is anticipated to increase by further 1.1% with an additional price decrease by 2.1%. Both EU butter and SMP prices would remain above the intervention level.

8. SUMMARY TABLES

8.1. Comparison between different options and their respective impacts – milk quotas

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – Quota continuation	Option 1 – Quota expiry in 2015	Option 2 – Quota phasing out
Economic	Higher prices, but increased costs and reduced market opportunities ☹☹	Strong restructuring post-2015, but disadvantages of quotas until 2015 delay benefits from markets ☺	Smooth adaptation of sector with "soft landing" allows increased benefits from markets ☺☺
Social	Continued production in less competitive areas ☺	Strong production increase and price decline ☹☹	Transition allows less competitive areas to adjust more smoothly ☺
Environmental	Continuation of decline in milk cows herd ☺ some pressure from concentration ☹	Strong restructuring of sector with concentration in regions and marginalisation in other ☹☹	Smoother restructuring of sector with gradual decline in herd, less concentration and marginalisation ☺/😐
Administrative	Heavy administrative and control costs of the system continue ☹☹	Administrative burden goes with expiry of quotas ☺☺	Administrative burden goes with phasing-out of quotas ☺☺
Simplification	Complex system ☹☹	Lifting of constraints with expiry of quotas ☺☺	Lifting of constraints with phasing-out of quotas ☺☺

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – Quota continuation	Option 1 – Quota expiry in 2015	Option 2 – Quota phasing out
Other	😐	😐	😐

8.2. Comparison between different options and their respective objectives – milk quotas

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – Quota continuation	Option 1 – Quota expiry in 2015	Option 2 – Quota phasing out
Competitiveness	☹☹	☺	☺☺
Market orientation	☹☹	☺	☺☺
Environmental sustainability	☺	☹	☺/😐
Budget costs	☺	😐 to ☹	😐 to ☹
Administrative costs	☹☹	☺☺	☺☺
Simplification	☹☹	☺☺	☺☺
Vitality of rural areas	☺	☹	☺
Stabilisation of farmers incomes	☺	☹	☺
Transfer efficiency	😐	😐	😐

D.c. OTHER SUPPORT SCHEMES

1. BACKGROUND

Products covered in this note benefit from direct support, industry aid or both. Although of different origin and justification, all these measures have a common feature that support is granted to sectors of limited contribution to the total value added of EU agriculture, but equally they represent sectors whose regional importance could be significant.

Table 22. – Examined sectors[66]

	Direct aid	Industry aid
Nuts	Yes	–
Rice	Yes	–
Energy crops	Yes	–
Protein crops	Yes	–
Flax and hemp	optional partial coupling	Yes
Potato starch	Yes	Yes
Dried fodder	–	Yes

2. PROBLEM DEFINITION

The 2003 Reform continued the shift from product to producer support through the introduction of the decoupled Single Payment Scheme. This was done in order to encourage competitiveness and market orientation and at the same time increase the efficiency of income payments.

Decoupling introduces flexibility in the choice of producers. Farmers will continue to produce where it is profitable, and adapt their production to the market or change to alternative products where it is adequate, while they are still obliged to keep the land in good agricultural and environmental conditions in line with cross-compliance rules. Overall, decoupling leaves the producer at least as well off as before, and most likely better off as a result of production flexibility and market orientation. With 90% of aids decoupled, farmers receiving coupled aid are less oriented to markets and more limited in their production choices.

However, the continuation of coupled support in certain sectors is explained by:

- the need to ensure steady supply to the processing industry and thus avoid negative social and economic consequences of the implied restructuring in cases where production is no longer profitable;
- the need to sustain a certain minimum level of specific production to avoid consequent social problems or environmental problems;

66 The durum wheat quality premium is analysed together with partial support.

- the need to develop a particular production type considered desirable for economic, environmental or social reasons.

The Health Check review poses the question of whether coupled support in those sectors, despite the overall orientation towards full decoupling, is still pertinent. Are they fulfilling their role or are there other more targeted policy instruments, which may take on this role, as payments are decoupled.

3. OBJECTIVES

The following policy options were analysed, and results were assessed based on whether these options met the following objectives:

- fulfilling the principal objectives of the 2003 CAP Reform: competitiveness, market orientation and sustainability,
- simplification of support scheme,
- contributing to vitality of rural areas and preventing land abandonment,
- preserving specific types of farming which are important for the protection or enhancement of the environment or of social importance to rural regions and allowing smooth restructuring of downstream industries, where they are crucial for the vitality of rural areas.

4. POLICY OPTIONS

Table 23. – Analysed policy options for support schemes[67]

Option	***Degree of decoupling***	***Description***
0	Status quo	No change in the present set of measures
1	Full decoupling	Inclusion of all support in the Single Payment Scheme (except for energy crops premium which would be abolished).
2	Targeted selective decoupling	Case-by-case analysis to identify if, and in which sectors, the shift of partially coupled support to full decoupling could create social, regional or environmental problems.

[67] The following sectors are excluded from this analysis because they have been recently reformed or are included elsewhere in the present analysis: fruit and vegetables, tobacco, sugar, cotton, payments for outermost regions.

4.1. Timing and transition to full decoupling options

Options 1 and 2 above do not exclude the possibility of transition to full decoupling, and a gradual phasing out process could be foreseen to attenuate impacts. Specific sectors may require specific solutions, and measures under rural development or measures such as the previously mentioned Article 69 (section C) could tackle the issues of providing alternatives, diversification, infrastructure development and restructuring to prevent abandonment and adverse effects on processing industries that were behind partially coupled payments and environmental impact in specific areas.

The issue of transition to full decoupling is more pertinent for aids to the industry than aids to farmers. For the latter's point of view and income prospects, the risk of production decline is best managed with full decoupling.

5. IMPACT ANALYSIS

5.1. Economic impacts

The assessment of the economic impacts from a move towards full decoupling was based on interrelated analyses on a specific sector's market and income outlook and on a farm's reaction to further decoupling.

5.1.1. Status quo

The coupled payments are an income support instrument, but being linked to particular products, they influence production decisions. In fact, the principal justification for retaining them regardless of an overall policy move to decoupled Single Payment Scheme has been to increase or maintain a certain level of production for particular economic, social or environmental reasons. This implies that they have to provide incentive for farmers to grow particular crops, although within the restrictions imposed by maximum guaranteed areas or quantities (e.g. quotas).

To what extent they can or need to provide such an incentive depends on market and policy developments regarding those sectors. Where market prospects are positive or other policy instruments are used, the role of a coupled payment in production decisions diminishes. Where the prospects are negative, the role of coupled payment increases, although it is very unlikely to solve the underlying problems which remain.

In the feed market, both *protein crops* and *dried fodder* are already of limited significance as plant protein sources, and the developments of the feed market with increasing feed efficiency, slower increase in meat production and availability of cheap protein-rich residuals of biofuel production would further contribute to marginalisation of both products.

Recent policy developments have in turn overshadowed the role of the aid in production of *energy crops*. Most of the confidence in the sector stems from

political targets and various other instruments, but also market developments and improvements of the supply chain and related infrastructures.

The recent developments on *rice* markets are positive as well. Since the 2003 reform, the competitiveness of the sector increased, with stable production and falling stocks in the view of increasing demand, due partly to enlargement of the EU. The *nuts* production has also been stable.

The future of industrial crops (flax and hemp for fibre, starch), where links with the processing industry are crucial, also has a positive outlook. The demand for *flax* for long fibre has been rising and production of hemp shows an upward trend. Also, the demand for *starch* has grown over time, at an annual rate of slightly over 5%. However, since the starch potatoes can only be grown within the quota limits, it prevents the potato starch sector to participate in the growth of the starch sector.

5.1.2. Full decoupling[68]

While the producers' income does not change with the inclusion of the payment into the SPS, the main effect of decoupling is that the payment no longer is part of calculating the profitability of particular production. This choice is guided by market demand and so it benefits consumers. At the same time, it influences the production decisions and so affects the level of the specific.

The analysis of comparison between margin over variable costs with and without the coupled payment allows examining this effect. There is a high probability of abandoning production when margins do not cover costs, but even if they do there is a chance of switching to more profitable crops with higher margins. For the farmer it signifies the possibility to adapt better to the market requirements and benefit from most profitable production and so higher market receipts.

In the nuts and starch potato sectors the margins without coupled payment remain high[69]. The decoupling of aid will also have small impact on profitability of *hemp* production.

In the case of aid for the *energy crops* the examination of existing studies shows that the premium has been effective as promoting energy crops only in very limited circumstances. Similarly in case of protein crops, the aid has not been an incentive for production.

There is a high possibility of switching to other crops in the case of *flax and rice*. The decoupling would have the strongest effect on the dried fodder sector, as the profitability of production is strongly relying on aid. The value added of

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68 The conclusions of this part are common whether one looks ate the sector level, or the microeconomic level of the farm.

69 However, the stakeholders' view has stressed that the margin will not be high enough to sustain production.

the *dried fodder* sector is estimated at 25–30% of the revenues (about 550 million EUR), which roughly equals the budget of the aid.

5.1.3. Targeted selective decoupling

Where production pattern changes will have a greater social or environmental consequence, a targeted support could be granted to sustain a certain production level, such as in the case of flax or rice. Its success depends on good understanding of needs and targeting of assistance. Notably in the case of dried fodder a continuation of aid will not allow the restructuring of the sector and will subsidise a production that is not viable economically and of little relevance to the feed market.

5.1.4. Other

In terms of administrative impact, the decoupling reduces administrative and control burden, that is excessive compared to the benefits of the scheme. It also allows to treat the payments as WTO "green box".

5.2. Social and environmental impacts

The decoupling of direct aid would have no effect on the level of income for producers, as they would continue to receive the Single Payment. However, in specific cases a minimum level of production could be crucial in regions with few economic alternatives or to ensure a steady supply to the processing industries. This may have important social consequences, especially in areas highly dependant on a given production in terms of employment, but also growth potential of the region.

Indications about the impact of the 2003 CAP reform on employment have been explored in an ongoing project "The Impact of CAP Reform on the Employment Levels in Rural Areas" within the sixth RTD framework programme[70]. Significant diversity of regions throughout the EU means that the same measures can cause different impacts in different regions, while it is difficult to identify the exact causality of such measures. There is some indication, however, that decoupling and support price cuts induce a profit maximising behaviour in the farming sector and increase technical efficiency.

Notwithstanding the above, growth in a particular sector may still lead to reduced employment, albeit promoting more efficient, often younger, farmers and thus increasing the quality of labour. Rural development measures reduce employment outflows, support structural changes and create new job opportunities by supporting farm diversification and aiding small business to exploit rural location by using new technology.

The potential social impacts described above could be reduced if the decoupling is introduced gradually with a certain transitional period that would allow the processing industry to adjust to new market conditions.

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[70] The Impact of CAP Reform on the Employment Levels in Rural Areas, CARERA (con # 022563), coordinated by Aristotle University of Thessaloniki.

Table 24. – Main social and environmental impacts

Option	***Social impact***	***Environmental impact***
0	In sectors with good economic prospects, the aid has limited social impact. In the less profitable sectors, the aid forces farmers to maintain less remunerated production but it sustains the downstream industry. In the short term it benefits employment, but in the longer terms prevents restructuring and long term viability.	Generally, minor environmental impacts as most crops concerned are planted in rotation regardless of the premia. Of particular significance are the sectors of rice (water management and as substitute wetlands) and, to a lesser degree, nuts (may have some impact on erosion and desertification) sectors.
1	Improved income support transfer for farmers in all sectors and possibility of more market oriented production decisions and higher market receipts. The analysis of margins indicates that abandonment of production is not likely. Decoupling will have an impact on processing industries, especially for flax (currently about 4000 jobs) and dried fodder (currently about 3500 jobs) and potato starch (currently about 4000 jobs) that will require rationalisation of production.	For most of the sectors overall environmental effects will be marginal, as farmers continue to produce crops or switch to alternatives. Where production would be abandoned, cross compliance rules have to be respected. The particular benefits of rice cultivation in some areas may be lost. The reduction of industrially dried fodder will have a positive impact.
2	Keeping coupled support only where it is found necessary and beneficial, social impacts are minimised, especially with respect to farm impact.	This option minimises any potentially negative impacts by retaining support where its removal would imply high environmental costs.

6. CONCLUSIONS

The *status quo* option contradicts the 2003 CAP reform path in terms of competitiveness, market orientation and simplification of the support scheme. *Full decoupling* would have a positive impact on farm income in most regions due to higher transfer efficiency of direct support, it could put at risk production in certain sectors in specific regions where local production is vital to ensure the viability of local agri-food chain and to preserve the environment. The application of Article 69 and allowing transitional periods would maximise the benefits from full decoupling, while at the same time maintaining the overall positive social and environmental impacts of coupled support in fragile regions of high environmental value (better than retaining coupled payments in certain sectors).

7. SUMMARY TABLES

7.1. Comparison between different options and their respective impacts – other support schemes

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – full decoupling	Option 2 – targeted selective decoupling
Economic	Farmers depend on production to receive support ☹☹	Farmers benefit from stable income support and have freedom in production decisions ☺☺	Where coupled support remains, farmers still face constraints ☹
Social	Positive for regions, where a large role of production and processing dependant on aids ☺ Neutral where support does not influence the sector 😐	Short term employment impacts in regions with significant share of processing depending on production-linked support ☹ Permits long term adjustment to more profitable production ☺	Could reduce employment risks in regions with significant share of processing depending on production-linked support ☺ Prevents long term adjustment to more profitable production ☹
Environmental	Rice ☺ Dried fodder ☹☹ Other sectors 😐	Rice ☹ Dried fodder ☺☺ Other sectors 😐	Could prevent potential negative effects in rice areas ☺
Administrative	Complex administrative and control system ☹☹	Inclusion in the SPS ☺☺	Complex administrative and control system ☹☹
Simplification	Detailed and complex systems run in parallel with main CAP ☹☹	Better transfer efficiency of support to farmers ☺☺	Where applied, different systems would continue running in parallel ☹
Other	😐😐	All coupled support transferred to Green Box ☺☺	Part of the coupled payments transferred to Green Box ☺

7.2. Comparison between different options and their respective objectives – other support schemes

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – status quo	Option 1 – full decoupling	Option 2 – targeted selective decoupling.
Competitiveness	☹☹	☺☺	☹
Market orientation	☹☹	☺☺	☹
Environmental sustainability	Rice ☺ Dried fodder ☹☹ Other sectors 😐	Rice ☹ (unless remedied by Art. 69) Dried fodder ☺☺ Other sectors 😐	Could prevent potentially negative impacts only in some rice areas ☺
Budget costs	😐	😐	😐
Administrative costs	☹☹	☺☺	☺
Simplification	☹☹	☺☺	☺
Vitality of rural areas	☺ to 😐 (varies by sector)	☺ to ☹ (varies by sector)	☺ to 😐 (varies by sector)
Stabilisation of farmers incomes	☺	☺☺	☺
Transfer efficiency	☹☹	☺☺	☺

D.d. RISK AND CRISIS MANAGEMENT

1. BACKGROUND

While business risk is inherent in all economic activity, certain characteristics of agricultural production make it particularly fraught with uncertainty. Firstly, the amount and quality of output in agriculture that will result from a given set of inputs are typically not known with certainty, due to uncontrollable elements, especially weather. Moreover, there are long production lags, due to the biological processes on which agricultural production is based. Production decisions have to be taken long in advance with limited knowledge of final outcome and changing market situation due to high price volatility (due to typical features of agricultural markets: large number of competitive producers, relatively homogenous output and inelastic demand).

Price risks, stemming from variation in output or input prices, and production risks, mainly from variation in yields but also from animal diseases, are considered the main sources of risks that farmers face. Some of these risks are easier to identify and predict, and therefore can be managed better by *ex-ante* actions of farmers (on-farm strategies). Others are less predictable and require *ex-post* reactions.

Within the CAP, several measures are available to deal with risks. The CAP now mainly relies on the SPS as an income stabilisation tool, by providing farmers with fixed regular payments. Price support at safety net levels exists for the main sectors when farmers face situations of low prices. Limited climatic risks are usually addressed by insurances which are available to most EU farmers. MS also have the possibility of giving state aid to respond to crises[71]. Measures to manage sanitary crises are harmonised at EU level by animal health and feed/food strategy legislation and the EU Veterinary Fund. Rural Development measures also offer risk management tools, for example measures aiming at mitigating natural disasters and climate risk, measures for training farmers in risk-reduction strategies, measures for supporting diversification, or the possibility of using advisory services for risk management[72].

The 2003 CAP reform provided for a modified system of farm income support to farmers, decoupled from production. On that occasion, the Council gave mandate to the Commission *"to examine specific measures to address risks, crises and natural disasters in agriculture."* In March 2005 the Commission issued a Communication on risk and crisis management in agriculture, in which three options were put forward for discussion: a) subsidies on insurance premiums, b) assistance in setting up mutual funds, c) the provision of basic coverage against income crises. In the subsequent discussion the Council did not indicate a preference for any of the options. However, a broad consensus emerged with regard to the conditions essential for the implementation of any new instrument:

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71 The *de minimis* level was recently increased from €3 000 to €7 500 over a 3 year period per farm.

72 A list of possible measures available under the current Rural Development policy is provided in note 9 of Annex D.

- the introduction of new tools, and the related financing rules, must not undermine the operation of the instruments already existing at national level, e.g. insurance against natural disasters;
- the new measures must comply fully with the "green box" criteria as defined by the WTO;
- although public financing may be essential, especially for the establishment and smooth start-up of new tools, joint responsibility and therefore a financial contribution from agricultural producers is also essential.

Furthermore, the provision in the proposal for a Regulation on support for rural development, allowing financing of ongoing training measures with a view to improving farmers' grasp of individual risk management strategies, was considered by the delegations to be very useful.

2. PROBLEM DEFINITION

Both production and price risks cause variability in farmers' income and, as such, are relevant to agricultural policy in the view of the CAP objective to aim at a fair standard of living and income stability for the agricultural community.

The decoupling of aid in the 2003 reform implied more freedom to farmers with respect to their production decisions, and allowed them to be more market-oriented. One result of the increased market orientation though, is that farmers are in a new situation where they individually have to manage risks more actively and make use of tools and practices which reduce their risk.

Moreover, the negative outcomes of risks that farmers are exposed to are increasing in intensity due to the effects of climate change. Hence, access to information and tools that dampen negative consequences of climatic and price risks, without creating disincentives to follow market signals, are therefore more and more important to farmers.

Public support is often instrumental in assuring the availability and encouraging the use of risk management tools by farmers. At the same time, given the heterogeneous nature of risks, the scope of the EU role should be clearly defined. Current CAP market and income support contribute to the stability of income, but they do not explicitly target the variability, but rather the level of income. While state aids are permitted for risk management measures and are in place in several MS, there are shortcomings to the current, fragmented solution, such as the lack of transparency between MS, the complexity of the systems applied and differences in accessibility for farmers throughout Europe.

3. OBJECTIVES

The objective of assessing the possible inclusion of additional risk management tools in the CAP within the scope of the HC is to identify the best approach to deal with risk and crisis management. Such an approach should contribute to the stability of farm income and should not lead to excessive budgetary costs. Furthermore, the administrative burden that any instrument implies must be weighted against the additional benefits that such an instrument could provide.

4. POLICY OPTIONS

The following list of options for risk management were examined to assess their effectiveness to deal with three different types of risk: price risks, production risks and animal disease risks.

4.1. Option 0: status quo

This option is used as the baseline, considering that maintaining the current policy framework relating to risk and crisis management reflects the fact that the 2003 CAP reform provides sufficient tools to manage risk.

7.3. Option 1: EU-wide framework

This option envisages introducing a new EU-wide scheme, using one or several of the methods described in the 2005 Communication (insurance premium subsidies, mutual funds and basic coverage against income crisis). This option has to take into account the conditions set by the Council: not interfering with existing instruments at national level, compliance with WTO green box criteria and joint financial responsibility for producers.

7.4. Option 2: enhanced role of risk management in existing CAP instruments

This option envisages encouraging and strengthening risk management techniques within the current CAP instruments, which can be targeted to match the diverse conditions throughout the EU. This could be done through allocation of modulated funds (section E.b) to Rural Development measures aimed at risk management, and/or through introducing more flexibility in Article 69 (as described in section C.a).

5. IMPACT ANALYSIS

When considering the policy options for risk management, and bearing in mind the objective of contributing to income stability for the agricultural community, it is important to be aware of the main features of the evolution of farm income variability in the EU. Firstly, farm incomes vary widely both between MS and within MS. Farm incomes are also quite unstable. On average, each year between 1998 and 2003, more than half of all EU-15 farms (54%) experienced a drop in income; each year over a quarter (about 28% of farms in EU) incur losses greater than –30%[73]. However, in most MS (except, notably, the UK and Ireland) the share of farms with negative income variations has fallen compared with the early 1990s, even if an increase occurred in 2002 and 2003. This would indicate that, as direct payments have increased, income stability has improved.

[73] See note 9 in Annex D for details.

7.5. Option 1: EU-wide scheme

7.5.1. Subsidies of insurance premiums

Insurance provides an alternative to public *ex-post* compensation payments for losses caused by natural disasters at EU and national or regional level. Certain MS have already established national schemes to encourage farmers to obtain insurances.

Budgetary costs

An external study looked into four types of insurance: income insurance, yield insurance for arable crops, area index insurance for cereals and yield insurance on fruit and vegetables and the costs subsidising 50% of premiums through an EU-wide scheme. The results are summarised in the following table, with varying assumptions on the premium rate and the uptake (penetration level) revealing that the budget costs for subsidising insurance premiums for an EU-wide scheme would be substantial[74].

Table 25. – Budget costs for subsidising premiums for some insurance programmes options at EU level

	Premium rate		**Penetration level**		**Total premium value (€ bn)**		**Subsidies (€ bn) if 50% of premiums**	
Type	***lower***	***upper***	***lower***	***upper***	***lower***	***upper***	***lower***	***upper***
1. Income insurance			40%	60%	2,0	3,0	1,0	1,5
2. Yield insurance on arable crops	3.5%	5%	40%	40%	0,95	1,35	0,47	0,67
3. Area index insurance for cereals	3.0%	5%	40%	40%	0,45	0,75	0,23	0,37
4. Yield insurance on fruit & vegetables	9.0%	15%	15% (veg.) 50% (fruit)		0,5 0,5	0,9 0,8	0,25 0,25	0,45 0,40

Source: Agricultural Insurance Schemes study, DG JRC

Transfer efficiency and income stability

The welfare effect from subsidising insurance premiums depends greatly on the insurance market structure. A subsidy to the premium paid by buyers might have the effect of raising the prevailing premium while only having a limited effect on the wider market penetration, and therefore little benefit in terms of farmers' reduced exposure to risk. A further problem is that mostly farmers with a high risk level will buy the insurance. This will push the insurer to raise the premium and the insurance will become less attractive for most farmers. This danger can be reduced with a *bonus-malus* system, but it takes a long time to fine-tune such

[74] http://ec.europa.eu/agriculture/analysis/external/insurance/index_en.htm.

system. Hence, the impact on the agricultural communities' income stability from this option is not clear.

Administrative burden

The administrative burden depends greatly on the type of insurance scheme chosen. An area based index insurance which determines eligibility based on the regional yield would imply fewer problems than an individual insurance scheme. An individual insurance scheme in fact requires the availability of accurate information at farm level (i.e. claims for damages should be assessed for each insured farmer). This option requires a common definition of natural disasters, which could prove burdensome given the heterogeneous character of the disasters that occur throughout the Union.

5.1.1. Supporting mutual funds

Mutual funds are a means of sharing risks among groups of producers who want to take on their own responsibility for risk management. The fund's capital can be called on by members in the event of severe income losses to be specified by predefined rules.

Budget costs, transfer efficiency and income stability

If the Community participation under this option would be limited to support for the administrative operation, it implies a low financial cost for the EU budget. The transfer efficiency of any financial support would be relatively high because it would entail making transfers directly to the farmers, without involvement of intermediaries who could capture some of the benefits. However participation in mutual funds requires trust among the farmers and high level of social capital. Also, the systemic nature of risks could put a mutual fund measure under strong pressure, especially if a crisis occurs during the first years of having the instrument in place.

Administrative burden

Clear rules on when and how the fund's capital could be used would need to be predefined. The administrative burden of this option would be limited for the Commission, but could prove burdensome for MS and farmers. Schemes would be based on farmers' organisation that would have to be officially recognised by the MS.

5.1.2. Providing basic coverage against income crises

The third alternative of an EU-wide scheme consists of a generalised approach to manage income crises in agriculture, as an alternative to other possible sector specific intervention. Under this option, general income coverage would be provided to all farmers, helping them to overcome temporary liquidity problems caused by whatever reason. Farmers would be compensated for a serious fall in income, specified as a negative variation of more than 30%[75].

Budget costs

To assess the potential cost payable with this alternative, DG AGRI has carried out an internal study analysing the compensation for income losses higher than –30%. The analysis was carried out on the basis of FADN data for the EU-15 for the period 1989 to 2003, by using the FNVA (Farm Net Value Added) as income indicator[76].

The level of estimated compensation for farms represented in FADN if such a scheme was in place is presented in figure 7, which simulates the impact of a scheme based on data of the 1989–2003 period. The loss was defined as the difference between the income for a given year (e.g. 1998) compared with the average income for the three previous years (e.g. 1995/96/97).

Over the last six years (1998–2003) compensation would have amounted, on average, to nearly €9.3 billion per year for the EU-15, varying between a minimum of €8 billion to a maximum of 12 billion The percentage of farms affected by income losses greater than –30% varies between 22 and 32% in this period. Hence, a great weakness with introducing an EU-wide scheme for providing basic coverage against income crises would be the high budgetary variation and uncertainty, which is difficult to conciliate with a policy of budget stabilisation and the likely need of some tool to limit the expenditure.

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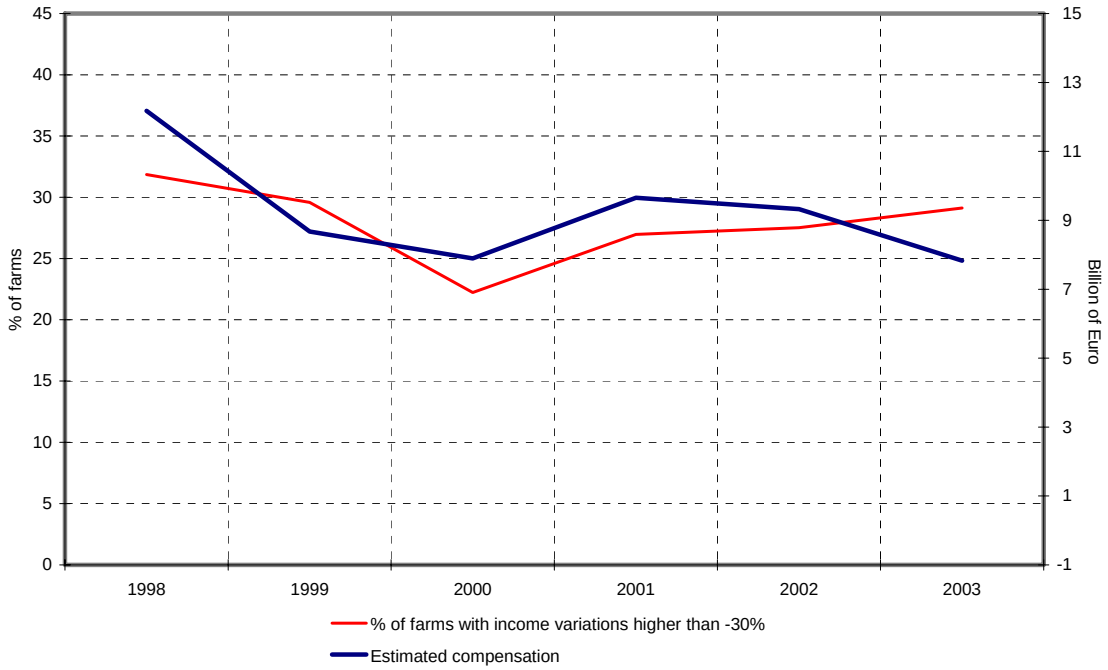
75 According to WTO rules the amount of such payments should not exceed 70% of the producer's income loss in the year, defined as the difference between the income for the last year (e.g. 1992) and the average income of the three previous years (e.g. 1989/90/91).

76 Lack of suitable data for the new MS – FADN income data for at least 4 years – has implied their exclusion from the analysis. The analysis corresponds to WTO Green Box criteria, and its methodology is explained in note 9 of Annex D.

Figure 12. – Costs for EU-15 farms with income losses exceeding 30%



Source: DG AGRI calculations based on FADN.

Transfer efficiency and income stability

Such a payment, made directly to the farmers, should in theory imply high transfer efficiency, and thus the contribution to income stability for the agricultural community is high. However, rent seeking behaviours on the part of the potential beneficiary might dissipate some of the transfer. To avoid questions of "moral hazard" (a farmer with an income loss of 29% would get no compensation, while one with 31% would), would also require some solution (such as progressive levels of compensation).

Administrative burden

The implementation of an income stabilisation instrument as described would present certain practical difficulties. Compensation would depend on farm accounts, which are not available for all farms. Different types of accounting system could produce different results, which in turn could result in inequities in the compensation paid; thus harmonised and precise definition of agricultural income holding across EU-27 would be needed.

The implementation of this tool would also require a decision on the type of system used to calculate it.

5.1.3. Environmental impacts, and impacts in terms of international constraints

All of the options outlined above may have environmental impacts. The availability of risk management tools, partly publicly funded, may cause farmers to take unnecessary risks and increase production intensity in sensitive regions. Introducing new risk management tools may therefore have a negative

environmental impact in some cases, especially those involving issues of moral hazard.

The compatibility of the options outlined above with the WTO green box rules depends on the actual design of the scheme. Schemes can be designed in order to fully comply with WTO green box rules, but the closer one gets to the objective of stabilising farmers' incomes, the more difficult it becomes to comply with WTO green box rules.

5.2. Option 2: enhancing the role of risk management in existing CAP instruments

Given the heterogeneity of the risks and crises that the EU faces (with respect both to the type of risk/crisis and the type of production) heterogeneous measures seem to provide the most suitable solution to help farmers deal with crisis situations (*ex ante* as well as *ex post*). But the form that such measures may take could differ. It is not a single measure, but a well chosen combination of instruments that would allow MS to better address local risks, with respect to markets, animal diseases and climatic risks, and with the necessary degree of flexibility.

5.2.1. Rural Development measures

Under the current Rural Development Programmes (2007–13) two measures are directly related to risk management for agriculture and forestry:

- restoring agricultural production potential damaged by natural disasters and introducing appropriate prevention measures (Axis I)
- restoring forestry potential and introducing prevention actions (Axis II)

In addition to these two measures there are several other measures, both under Axis I and II, which may be used to provide support for risk management for agriculture and forestry. These measures provide complementary support for preventive action in the areas of physical investment or human capital formation. Concerning the up-take of the different measures, the measure "Restoring forestry potential and introducing prevention actions (Axis II)" is more popular than the analogous measure for restoring agricultural production potential and prevention action related to agriculture. In fact, the uptake of measures related to risk management for agriculture (both with respect to prevention and restoring) in the rural development programmes is on average relatively weak, compared to the uptake of other measures in the strategies[77]. By providing more means for Pillar II, the measures to address risk management within the rural development programmes could be reinforced and strengthened (see section E.b).

[77] The screening of rural development strategies carried out by DG AGRI in November 2007 shows that the average up-take for "Introduction of (flood) prevention actions against natural disasters related to agriculture" and "Restoring agricultural production potential damaged by natural disasters" is 2,5 and 2,4 respectively, on a scale where 1 is equal to very high up-take and 3 is equal to no up-take.

5.2.2. Single Payment Scheme

Additional tools addressing risk management could be allowed through a targeted revision of Article 69 that would allow part of the available level of SPS support to focus on such issues, provided that the global amount and the proportion of coupled support in the mix of supporting measures stays within clearly defined ceilings. The instruments could include those that were proposed in 2005 Communication who, while not feasible at an EU-level, could correspond to the needs of particular MS at MS or regional levels.

Budget costs

Introducing additional risk management tools within the current scope of CAP would be budget neutral overall, since the new funding that these measures would require would have to be transferred from other measures. Thus, it would require a re-prioritisation of existing budgetary means.

Transfer efficiency and income stability

The transfer efficiency of this option would depend on how the particular solutions that could be implemented are designed. Given that MS would be allowed to implement and design their individual risk management tools, within the framework provided by the Community legislation, MS could be expected to design the solutions that have the highest possible transfer efficiency for their particular situations. Thus, the higher the transfer efficiency, the higher is the possibility to contribute to income stability for the agricultural community.

Administrative burden

By introducing new tools to address risk management within the existing CAP instrument, the additional administrative burden will be kept at minimum. Overall though, the administrative burden stemming from this option could increase compared to status quo, if the risk management tools that are introduced within the CAP framework are not already in place in MS within the framework for state aids. In that case, the impact on the administrative burden is neutral.

Environmental impacts, and impacts in terms of international constrains

As noted for the option of the EU-wide scheme, introduction of new risk management instruments may have environmental impacts. Furthermore, also for this option, the compatibility with the WTO green box rules depends on the actual design of the scheme. Schemes can be designed in order to fully comply with WTO green box rules.

6. CONCLUSIONS

In brief, price risks appear to be sufficiently addressed with safety-net intervention and with the flexibility that decoupling provides, hence there is no need for additional risk management tools to deal with price risks. The extension of SPS to sectors which are

currently not included could also provide a positive contribution in mitigating price variability for the agricultural community.

For dealing with the potentially growing needs for production risks, an EU-wide scheme cannot be considered feasible at this stage. Introducing an EU-wide scheme would be immensely expensive, and would imply an increased administrative burden for farmers and MS.

Given the heterogeneity of the risks and crises that the EU faces (with respect both to the type of risk/crisis and the type of production) heterogeneous measures seem to provide the most suitable solution to help farmers deal with crisis situations (*ex ante* as well as *ex post*). A harmonisation at EU level of the aid schemes currently supported with state aids could contribute to increased transparency between MS, while at the same time allowing the CAP to better meet the objective of contributing to the income stability for the agricultural community. An introduction of new risk management tools within existing CAP instruments would be budget neutral with respect to the overall EU budget. National contributions would depend on MS preference, but introducing the measure would in any case be optional. On top of this, Rural Development programmes contain measures which are directly related to risk management for agriculture and forestry, and that provide complementary support for preventive action in the areas of physical investment or human capital formation.

Table 26. – Summary comparison of options

DRAFT		Advantages	Disadvantages
EU-wide framework	Insurance against natural disasters	Provide farmers with the means to manage their own risk	Would depend on the type of framework agreed. Studies indicate that the cost of subsiding premiums would inevitably be high, entailing need for relatively expensive reinsurance Low transfer efficiency A common definition of disaster would be required
	Supporting mutual funds	Low cost Social control reducing problems of moral hazard and adverse selection	Given the "systemic" nature of risk, setting up a mutual fund is very difficult without public support. Requires a considerable level of social capital.
	Providing basic coverage against income crisis	High transfer efficiency Provide solid safety net for farmers	High cost Administratively complex and burdensome Require common definition of agricultural income across EU-27 Risk of moral hazard
MS Specific solutions:		Provide farmers with the means to manage their own	Absorption capacity

	risk (adaptation strategy to the changes) High degree of flexibility which allows MS better to address local risks with respect to markets; animal diseases and climatic risks	

7. SUMMARY TABLES

7.1. Comparison between different options and their respective impacts – risk management

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – EU-wide framework for addressing production or revenue risks	Option 2 – Introducing risk management as option within current CAP instruments
Economic	Current instruments not sufficient to cover increasing production risks ☹	Low target efficiency spreads benefits even to those not in need ☹ Significant budgetary costs needed for revenue scheme ☹☹	Depends on scheme, but better targeting links benefits closer to needs 😐 to ☺
Social	😐	Unclear transfer efficiency for production risks; better transfer efficiency for revenue schemes ☺ to ☺☺	Contributes to stabilising farm income and could respond to specific risks ☺☺
Environmental	😐	Affects farm risk behaviour and could increase intensity ☹☹	Better targeting minimises risks for intensification ☹ to 😐
Administrative	😐	Very high administrative costs to establish and control ☹☹	Administrative costs to establish and control depend on uptake ☹
Simplification	😐	☹☹	Adds to existing legislation ☹
Other	😐	Depends on scheme, but shall respect EU WTO commitments	Depends on scheme, but shall respect EU WTO commitments

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – EU-wide framework for addressing production or revenue risks	Option 2 – Introducing risk management as option within current CAP instruments
		😐	😐

7.2. Comparison between different options and their respective objective – risk management

☺☺ fully respecting objective; ☺ partially respecting objective; 😐 neutral; ☹ moving away from objective; ☹☹ putting at risk objective

OBJECTIVES	Option 0 – baseline	Option 1 – EU-wide framework	Option 2 – Enhanced role of risk management in current CAP instruments
Competitiveness	😐	😐	😐
Market orientation	😐	😐	😐
Environmental sustainability	😐	☹☹	😐 to ☹
Budget costs	😐	☹☹	😐
Administrative costs	😐	☹☹	😐 to ☹
Simplification	😐	☹☹	😐 to☹
Vitality of rural areas	☹ to 😐	😐	😐
Stabilisation of farmers incomes	☹ to 😐	☺ to ☺☺	☺☺
Transfer efficiency	😐	☺ to ☹	☺ to ☹

E – NEW CHALLENGES

1. PROBLEM DEFINITION

- The CAP is facing a rapidly changing environment where a number of new (and ongoing) challenges have intensified:
  - short- and long-term climate change creates growing concerns about its impacts on agriculture;
  - the EU renewable energy road map has set ambitious binding targets that imply the contribution of the sector.;
  - water scarcity and increased risks for droughts render water management a priority for the EU, which is more pertinent following the removal of set aside;
  - the objective to stop biodiversity decline by 2020 requires an enhanced contribution of agriculture in protecting biodiversity. The removal of set aside reinforces this requirement;
- the present set of policy instruments under RD appears to be sufficient, and new challenges have already been addressed to a large extent by the Strategic Guidelines for Rural Development that set EU priorities for the RDP in the period 2007–2013. However, the uptake of RD funds by MS suggests additional budget needs;
- the 2005 decision on the Financial Perspectives resulted in lower RD support than initially expected.

2. OBJECTIVES

- Improve the MS uptake of second pillar measures linked to new challenges, following the Strategic Guidelines for Rural Development;
- reinforce Rural Development funding, in order to address the shortfall in the current budgetary period and meet the extra budgetary resources necessary to respond to new challenges;
- respect the agreement on the exemption of new Member States from basic modulation until they reach the same level of payments with the EU-15;
- find an appropriate balance for allocating funds from additional modulation to the MS.

E.a RESPONDING TO NEW CHALLENGES

1. BACKGROUND

The HC Communication identifies a number of new, and ongoing, challenges facing the CAP (such as climate change, risk management, bio-energy, water management and biodiversity) and considers the Rural Development Policy as one of the possibilities to deal with these challenges.

2. PROBLEM DEFINITION

EU agriculture is highly exposed to climate change. A wide range of short term concerns (precipitation patterns, extreme weather events, temperature levels, water availability, and soil conditions) and longer term impacts (increased frequency and severity of extreme weather events, and projected climatic changes) will affect crop yields, livestock management, or location of production. These risks would, in turn, impact upon water availability, and pose renewed risks on biodiversity.

In addition, the new and ambitious EU renewable energy roadmap has set binding targets that imply the contribution of the agricultural sector and which is closely linked to climate change mitigation objectives.

Most new challenges have been addressed to a large extent by the Strategic Guidelines for Rural Development, that set EU priorities for the RDP in the period 2007–2013. In total, more than 25 sub-measures directly or indirectly related to climate change, renewable energies, risk and water management have been included in the programmes. However, uptake and mix of these measures varies substantially in the 89 national and/or regional rural development programs for the new funding period. The number of sub-measures related to biodiversity is similarly high as several of the measures under axis 2 are related to this objective[78].

The present tool kit of measures available under RD appears to be sufficient, but the uptake of RD funds in 2007 suggests that MS have budget needs beyond their possibilities, which hamper their responsiveness to new challenges. In fact, because of the decisions on the Financial Perspectives a number of Member States have been confronted with significant reductions of their rural development budget for 2007–13.

3. OBJECTIVES

A screening exercise of RD programmes indicates that existing measures are already providing various alternatives to address the new challenges and that MS have included related measures already in their RD programmes for the period 2007–13[79].

Thus, the analysis of the impact of the proposed options for facing "new challenges" via rural development measures focused on the impact of such proposals on improving the EU responsiveness to new challenges, as outlined in the Strategic Guidelines for Rural Development, via greater MS uptake of second pillar measures.

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78 See Annex E note 8, and especially its Annex, for details.

79 idem.

4. POLICY OPTIONS

Table 27. – Analysed options for new challenges

	Option	*Description*
0	Status quo	
1	Transfer of funds to Pillar II without any further requirements	Simply modulation of funds without specific requirements.
2	Earmarking	a) Targeting of funds to pre-determined but existing sub-measures with a reporting obligation for the new funding. MS will have to implement a system that allows a separate reporting and management identifying funds from the original funding and new funds from modulation a) Targeting of funds to existing measures with a reporting obligation concerning the new funding (financial planning and reporting) and indicators of measures in areas of "new challenges", both financed by old and new funds. MS will be asked to report on results/impacts of the totality of new challenges, combined for old and new funding.
3	Higher co-financing rates	Increase the rate of EU funds in relation to the eligible public expenditure (co-financing rate) for individual sub-measures or groups of measures that positively contribute to any of the identified new challenges.
4	Higher aid-intensities	Offer a higher percentage of the eligible total expenditure to be financed by public budget (aid intensities).
5	Obligation to use modulation funds for challenges	Member States are requested to direct the total amount of additional resources from compulsory modulation to the new challenge related actions by enlarging their number and/or scope whenever necessary. Aid intensity rates for new challenge related actions will be increased by [10] percentage points.

5. ANALYSIS OF IMPACTS

5.1. Impact on the programming process

5.1.1. Option 0: status quo

A qualitative assessment of the programming of new challenge related measures in the RD programmes 2007–13 has indicated that the uptake of measures related to New Challenges is often weaker than the extent to which they have been discussed by the Member States in the strategy and in the SWOT analysis in their RD programmes. Nevertheless, several measures related to the new challenges are already included in the RD programmes[80].

5.1.2. Option 1: transfer of additional funds to Pillar II

The Member States may have to adjust their National Strategy Plan. In any case, they will have to adjust the financial plans of the Rural Development Programs to amend

[80] See Annex E note 8, and especially its Annex, for details.

the amounts of expenditure per axis and measure. The Member States will also have to amend the projected output that should result from the programmes. Under this option the administrative burden at MS level will be higher due to re-programming. The uptake of measures/actions will possibly increase, although is difficult to quantify.

5.1.3. Option 2: ear-marking

(a) Targeting of additional funds coming from modulation to pre-determined but existing sub-measures[81] with a specific reporting obligation only for the new funding. For national strategy and projected output, as in option 1 MS would be obliged to report separately on "additional" modulation funds. This would necessitate a revision of the financial planning and a separate reporting by the MS administrations

(b) Targeting of additional funds coming from modulation to existing measures related to "new challenges" with a reporting obligation concerning:

– the new funding (financial planning and reporting);

– indicators of measures in areas of "new challenges" financed both by old and new funds

An adaptation of existing indicators could be necessary with this option. Apart from the additional reporting concerning the exact allocation of the additional spending, this sub-option would oblige the MS to have a separate reporting on the results of the support measures in the area of the new challenges.

Under both sub-options the uptake measures/actions will surely increase, although it is difficult to quantify. The administrative burden at MS level will be higher due both to reprogramming and the introduction of new reporting procedures.

5.1.4. Option 3: higher co-financing rates

In the programming period 2007–2013, for the sake of simplification, co-financing rates are defined at the level of each axis. Increasing co-financing rates for new challenges related actions would address the level of (sub)measures and would destroy one of the new elements of simplification in the new period. The system of financial programming would have to be changed, programming to be re-done, and the financial system would fall back into the approach of the old period, with the consequent increase in the administrative burden for MS.

Higher co-financing rates for individual sub-measures or groups of measures that positively contribute to any of the dimensions of the new or on-going challenges should not be envisaged because it would involve a turn back to a more complicated financing mechanism and it could also entail the re-opening of the discussion in the Council on this issue which should be absolutely avoided. The uptake of measures/actions will increase, but it is difficult to quantify.

[81] The measures have a wide scope. Therefore, it may be necessary to have targeted sub-measures to address the new challenge issues.

5.1.5. Option 4: higher aid intensities

If additional budgetary resources are injected into the system, higher aid-intensity rates may constitute a simple but efficient tool to provide additional incentives for those sub-measures which are expected to contribute positively to the new challenges. This will imply reprogramming of RD Plans for MS with its consequent burden.

Due to the limited budget available for RD plans Member States in many cases kept aid intensity rates distinctly below the maximum rates possible. Before increasing the aid intensity, it should be carefully analysed whether such incentives are really needed to make the new challenge related sub-measures attractive. There is a risk that such increase leads to dead-weight losses. The uptake of measures/actions will increase possibly more than under the other options depending on the aid-intensity rates implemented by MS. Again, the uptake is difficult to quantify.

5.1.6. Option 5: obligation to use modulation funds for new challenges

MS will need to modify their programmes in order to include the additional amounts coming form compulsory modulation. In the context of this modification MS should clearly identify in the revised program the choice of specific actions targeting the new challenges[82] and the additional amounts from modulation to be allocated to each action. Member States will be invited, on the basis of an assessment of their respective situation and needs related to the new challenges, to make use of actions included in an indicative list of action types to be inserted as an annex in the Council Regulation.

In the annual reports of each program, a specific chapter should be dedicated to reporting on the progress made in implementing the actions targeting the new challenges (climate change, renewable energies, water management, biodiversity). This would include the obligation to report on expenditure and any other relevant information.

This option is the most effective since it guarantees a higher uptake of measures/actions, although it implies higher administrative burden and complexity both at MS and EU level.

5.2. Legislative and administrative consequences

A first step to initiate a targeted re-programming of RDPs 2007–13 would be to update and revise the Community Strategic Guidelines on RD by highlighting the increased importance of the new challenges and by focusing the EU priorities more on the new challenges related to all three main objectives of the EU's RD policy.

A Council decision will be needed on the up-date of the Community Guidelines on RD and possibly a modification of the Council Regulation to oblige Member States to take up the reinforced EU priorities related to the new challenges in their strategies and to define specific actions in their revised RDPs 2007–13. In the case of option 5 a new Article of the Council Regulation should indicate the obligation of Member

[82] See the complete list in the Annex to this chapter

States to channel all funds available from increased modulation to new challenge related actions in the context of re-programming. The indicative list of new challenge related action-types should be also inserted as an Annex.

Depending on the option chosen a revised Commission Regulation would be necessary to update the Common Monitoring and Evaluation Framework. The latter would need to be up-dated by adding more indicators to facilitate the follow-up on the impact of the revised objectives addressing the new challenges. In the case of option 5 a new Article should be inserted in the Commission Regulation specifying the additional reporting obligations related to the new challenges.

5.3. Social/environmental impacts of alternative options for new challenges

	Social impact	Environmental impact
Option 0 – baseline	Neutral	Difficult to assess, depends on MS implementation
Option 1 – Simply transfer of fund to Pillar II	Response to public concerns	Possible improvement following higher uptake primarily of Axis 2, and specific Axis 1 & 3 measures[83]
Option 2 – Earmarking	Response to public concerns	Possible improvement following higher uptake primarily of Axis 2, and specific Axis 1 & 3 measures
Option 3 – Higher co-financing rates	Response to public concerns	Possible improvement following higher uptake primarily of Axis 2, and specific Axis 1 & 3 measures
Option 4 – Higher aid intensities	Response to public concerns	Possible Improvement following higher uptake primarily of Axis 2, and specific Axis 1 & 3 measures
Option 5 – Obligation to implement new challenges measures	Response to public concerns	Improvement following higher uptake primarily of Axis 2, and specific Axis 1 & 3 measures ensured by obligation

6. CONCLUSIONS

Continuing present policies would significantly limit the responsiveness of CAP to new challenges and its contribution to the key agendas of climate change, renewable energy, water management and biodiversity. Extra RD funding would, in itself, lead to a greater responsiveness and uptake of measures, but the reprogramming effort of RD measures required would not be compensated for by a better targeting or take-up of measures. Earmarking funds, higher co-financing rates or higher aid intensities would imply further administrative burden through the need for major revisions of financial planning and separate reporting by MS administrations. Targeting the use of additional modulation funds for new challenges would be the most effective in guaranteeing a higher uptake of measures/actions, although it implies higher administrative burden and complexity both at MS and EU level.

[83] See note 5.

7. ANNEX TO CHAPTER VIII – LIST OF INDICATIVE ACTION TYPES

Priority: Climate change		
Types of operations	**Articles and measures**	**Potential effects**
Improve efficiency of nitrogen fertiliser use (for ex. reduced use, equipment, precision agriculture), improvement of manure storage	Article 26: Modernisation of agricultural holdings Article 39: Agri-environment payments	Reduction of methane (CH_4) and nitrous oxide (N_2O) emissions.
Improvement of energy efficiency	Article 26: Modernisation of agricultural holdings	Reduction of carbon dioxide (CO_2) emissions by saving energy.
Soil management practices (for ex. tillage methods, catch crops, diversified crop rotations)	Article 39: Agri-environment payments	Reduction of nitrous oxide (N_2O); carbon sequestration.
Land use change (for ex. conversion of arable land to pastures, permanent set aside, reduced use / restoration of organic soils)	Article 39: Agri-environment payments	Reduction nitrous oxide (N_2O); carbon sequestration.
Extensification of livestock (for ex. reduction stocking density, increase grazing)	Article 39: Agri-environment payments	Reduction of methane (CH_4).
Afforestation	Articles 43 and 45: First afforestation of agricultural and non-agricultural land	Reduction of nitrous oxide (N_2O); carbon sequestration.
Forest fire prevention	Article 48: Restoring forestry potential and introducing prevention actions	Carbon sequestration in forests and avoid carbon dioxide (CO_2) emissions.
Priority: Renewable energies		
Biogas production – anaerobic digestion plants using animal waste (on farm and local production)	Article 26: Modernisation of agricultural holdings Article 53: Diversification into non-agricultural activities	Substitution of fossil fuel; reduction of methane (CH_4)
Perennial energy crops (short rotation coppice and herbaceous grasses)	Article 26: Modernisation of agricultural holdings	Substitution of fossil fuels; carbon sequestration; reduction of nitrous oxide (N_2O).
Processing of agricultural/forest biomass for renewable energy	Article 28: Adding value to agricultural and forestry products	Substitution of fossil fuels.
Installations/infrastructure for renewable energy using biomass	Article 53: Diversification into non-agricultural activities Article 54: Support for business creation and development Article 56: Basic services for the economy and rural population	Substitution of fossil fuels.

Priority: Water Management		
Types of operations	**Articles and measures**	**Potential effects**
Water saving technologies, water storage Water saving production techniques	Article 26: Modernisation of agricultural holdings Article 30: Infrastructure	Improve the capacity to use water more efficiently.
Wetland restoration Conversion of agricultural land into forest/agro-forestry systems	Article 39: Agri-environment payments Article 41: Non-productive investments Article 43 and 45: First afforestation of agricultural and non-agricultural land	Conservation of high-value water bodies; protection of quality water.
Development of semi-natural water bodies	Article 57: Conservation and upgrading of the rural heritage	Conservation of high-value water bodies; protection of quality water.
Priority: Biodiversity		
Types of operations	**Articles and measures**	**Potential effects**
No application of fertiliser and pesticides on high nature value agricultural land Integrated and organic production	Article 39: Agri-environment payments	Conserved-species rich vegetation types, protection and maintenance of grasslands.
Perennial field and riparian boundary strips Construction/management of biotopes/habitats within and outside Natura 2000 sites Land Use Change (extensive grassland management, conversion of cropland to pasture, long-term set aside) Management of high nature value perennials	Articles 38 and 46: Natura 2000 payments Article 39: Agri-environment payments Article 41: Non-productive investments Article 47: Forest-environment payments Article 57: Conservation and upgrading of the rural heritage	Protected birds and other wildlife and improved biotope network; reduced entry of harmful substances in bordering habitats.
Conservation of genetic diversity	Article 39: agri-environment payments	Conserved genetic diversity.

8. SUMMARY TABLES

8.1. Comparison between different options and their respective impacts – New challenges

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – Simply transfer funds to Pillar II	Option 2 – Earmarking of transferred funds	Option 3 – Higher co-financing rates	Option 4 – Higher aid intensities	Option 5 – Obligation to implement New Challenges measures
Economic	Sectors lags in adaptation ☹	😐	😐	😐	😐	😐
Social	😐	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺☺
Environmental	Increased risks from climate change ☹	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake and better targeting ☺☺
Administrative burden	😐	Reprogramming of RD required ☹	Reprogramming of RD and separate reporting required ☹	Reprogramming of RD and separate reporting required ☹☹	Reprogramming of RD and separate reporting required ☹	Reprogramming of RD and separate reporting required ☹☹
Simplification	😐	😐	☹	☹	☹	☹☹
Other	😐	😐	Increased uptake due to incentives ☺	Increased uptake due to incentives ☺	Increased uptake due to incentives ☺	Obligation helps higher uptake ☺☺

8.2. Comparison between different options and their respective objectives – New Challenges

☺☺ respecting objective; ☺ possibly respecting objective; 😐 neutral; ☹ objective possibly at risk; ☹☹ objective at risk

OBJECTIVES	Option 0 – baseline	Option 1 – Simply transfer of fund to Pillar II	Option 2 – Earmarking	Option 3 – Higher co-financing rates	Option 4 – Higher aid intensities	Option 5 – Obligation to implement new challenges measures
Responsiveness to new challenges	☹☹	☺	☺	☺☺	☺	☺☺
Greater uptake of RD measures	😐	☺	☺	☺	☺	☺☺
Simplification	😐	😐	☹	☹	☹	☹☹

E.b. MODULATION

1. BACKGROUND

Modulation is a means of budgetary transfer by which a percentage reduction is applied to farmer direct payments (Pillar I) and the budgetary resources released are reassigned to rural development (Pillar II) measures. At present, compulsory modulation for all EU-15 Member states is 5% for all payments above €5 000.

In budget terms, in 2006 it was initially calculated that compulsory modulation of 5% would release EUR 1 228 billion for re-distribution, as shown in the table below. Although in pure static terms, the estimated impact on farm income is –1.7% for the farms affected, this estimate excludes the benefits for farms from the impact of increased modulated funds on RD.

DG AGRI has carried out a preliminary exercise to assess the associated indirect effects on farmers' income of rural development measures, which indicates that the income effectiveness of Rural Development measures for the period 2000–2006 could have been somewhat less than 100% over the short/medium term, and higher over the long term. The methodology developed relied on the calculation of the leverage effect of each €1 of EU funding on other national or regional fund (proportional to the EU co-financing rate) and, more critically, to an estimate of a coefficient of income effectiveness of each RD measure. The analysis represented a first contribution on the issue and will have to be complemented and strengthened by in-depth quantitative analysis.

Table 28. – The impact from the initial modulation on MS in budget year 2013

EU-15 Distribution of modulation savings in 2013								
mio EUR	Net mod'n of 5%*	Distribution				Net loss/gain	Percentage 'return'	Allocation key
		20% direct	Additional direct	Key	Total			
	A	B	C	D	E	G=E-A	H=F/A	2003 data
Belgium	22,6	4,5	4,2	9,3	18,0	**-4,5**	*79,9%*	1,1%
Denmark	39,4	7,9	8,8	14,9	31,6	**-7,8**	*80,1%*	1,7%
Germany	224,1	44,8	42,3	114,6	201,7	**-22,4**	*90,0%*	13,0%
Greece	41,1	8,2	0,0	48,0	56,2	**15,1**	*136,8%*	5,4%
Spain	153,1	30,6	0,0	170,0	200,6	**47,5**	*131,0%*	19,4%
France	336,0	67,2	32,3	169,3	268,8	**-67,2**	*80,0%*	19,3%
Ireland	41,4	8,3	1,1	23,8	33,2	**-8,2**	*80,2%*	2,7%
Italy	96,2	19,2	0,0	105,8	125,0	**28,8**	*130,0%*	12,1%
Luxembourg	1,5	0,3	0,4	0,5	1,2	**-0,3**	*80,0%*	0,1%
Netherlands	32,4	6,5	0,0	20,3	26,8	**-5,6**	*82,7%*	2,3%
Austria	16,2	3,2	0,0	36,3	39,5	**23,3**	*244,1%*	4,1%
Portugal	11,5	2,3	0,0	44,6	46,9	**35,4**	*407,8%*	5,1%
Finland	14,7	2,9	0,0	15,5	18,4	**3,7**	*125,4%*	1,8%
Sweden	27,5	5,5	0,0	18,3	23,8	**-3,7**	*86,5%*	2,1%
United Kingdom	170,3	34,1	15,2	86,9	136,1	**-34,2**	*79,9%*	9,9%
EU-15	**1228,0**	**245,6**	**104,3**	**878,1**	**1228,0**	**0,0**		***100,0%***

Source: DG AGRI Working Document of 3 August 2006

The released funds are re-distributed among EU-15 according to a common key, based on certain criteria[84].

In two MS, UK and Portugal, voluntary modulation also applies[85]. The new MS, on the other hand, were exempted from modulation until the transition to the full level of direct payments is achieved[86].

2. PROBLEM DEFINITION

The constraints that MS are facing, due to the cut in the expected Rural Development support following the 2005 decision on the Financial Perspectives, present an obstacle to the realisation of Pillar II objectives in the current budgetary period.

In addition to the restrictions posed by this tight budgetary framework, reinforcement of the budgetary resources is necessary in order to:

- address the new challenges identified in the HC Communication (climate change, water management and risk management);
- respond to the need for increased efforts to address new productivity and environmental challenges (biofuels; improved competitiveness in market sectors).

3. OBJECTIVES

In the context of the objective to improve the MS uptake of second pillar measures linked to new challenges, the specific objectives of modulation options examined should be to:

- reinforce Rural Development funding, in order to address the shortfall in the current budgetary period and meet the extra budgetary resources necessary to respond to new challenges;
- respect the agreement on the exemption of new Member States from basic modulation until they reach the same level of payments with the EU-15;
- find an appropriate balance for allocating funds generated through additional to MS

4. POLICY OPTIONS

Four options are analysed in comparison to status quo. The first three assumed the same overall level of increase in modulation, 8%, achieved with annual 2% steps from 2009 onwards, but took into account different assumptions for new MS and re-distribution of the fund released.

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84 The allocation criteria safeguard 1 percentage point of modulation to be distributed directly back to the MS where it was generated, the rest being distributed between the Member States according to agricultural area, agricultural employment and GDP. However, it is also guaranteed that any MS must receive back at least 80% of what it contributes to modulation (in case of Germany 90%). An analysis of the impacts of the current modulation is found in Tables A1-A3 in note 10 of Annex E.

85 Portugal will apply from 2008 10% voluntary modulation with a EUR 5 000 franchise. In the UK the voluntary modulation is applied without franchise and the rates foreseen in 2012 are the following: 14% in England, 6.5% in Wales and 9% in Scotland and Northern Ireland.

86 This will happen in 2013 for EU-10 and 2015 for Romania and Bulgaria.

The fourth option looked into the potential impact of an idea under consideration in the European Parliament that introduces a progressive element in modulation based on different thresholds of payments, thus addressing in parallel equity issues[87].

Table 29. – Policy options for modulation

Option	***Modulation***	***Description***
0	Status quo – baseline	No change in the present set of measures. Currently, reduction in payments under the CAP is made through the linear, 5% reduction of payments above € 5 000 from compulsory modulation.
1	Increase in EU-15 compulsory modulation by 8%, using current distribution key	Increasing the existing (basic) compulsory modulation by with a higher level of compulsory modulation would be one possibility, based on the current EU-15 distribution key method employed.
2	Increase in EU-25 compulsory modulation by 8%, using current distribution key	Increasing compulsory modulation to EU-15 fails to offer to new MS the opportunity to address the new challenges of the CAP through increased rural development. A second option could be to increase the basic compulsory modulation by the same amount as in option 1, but including the new MS (EU-25), using the same distribution key method for EU-25, updated with 2005 data[88].
3	Increase in EU-25 compulsory modulation at different rates	The limitations of applying more basic modulation only to EU-15 with the existing key (option 1) and the difficulties of opening up the current agreement on the exemption of new MS from basic modulation (option 2) could be potentially avoided by proposing changes to the re-distribution criteria. From the broad range of different re-distribution criteria, the one analysed applies 6% modulation for EU-15, but applies only a last step of 2% for EU-25 because only in 2013 would EU-10 complete the transition to the full level of direct payments. To address the issue of redistribution, in this option the last 2% of modulation for both EU-15 and EU-10 remains within the MS, the 6% for EU-15 being allocated based on the current distribution key.
4	Progressive modulation, current distribution key + funds remaining in MS	This option considers the economic size of the farm as an element in the calculation of modulation. Part of the funds from extra "basic" modulation is to be distributed in accordance with the prevailing rules governing modulation funds, while additional amounts ("special modulation") are to remain within the MS in which they accrue. This option is inspired from the EP COMAGRI Report on the HC Communication[89]. However, here a different variant is applied to allow comparison with the previous three options. It keeps the present €5 000 (to avoid two systems running in parallel), and changes the % reduction of the different payment thresholds to arrive an 8% reduction at the highest threshold.

87 In order to make comparisons between MS, the impact of increased compulsory modulation on voluntary modulation has not been calculated. However, it is assumed that, in the event of its application, any amounts generated by compulsory modulation would replace equivalent amount of voluntary modulation.

88 This option is purely hypothetical, and Romania and Bulgaria would be excluded because they do not reach high levels of direct payments until late in the period. Furthermore, since data are currently not available, they cannot be included in the simulations at this stage.

89 The Report was presented by MEP Goepel, and implies a trigger threshold of € 10 000, above which basic modulation would apply.

Table 30. – Three options increasing basic compulsory modulation across EU-27

	EU-15		EU-10		EU-2	
	Extra modulation	Total modulation	Extra modulation	Total modulation	Extra modulation	Total modulation
Option 1	+ 8%	13%	0%	0%	0%	0%
Option 2	+ 8%	13%	+ 8%	13%	"	"
Option 3	+ 8%	13%	+ 2%	2%	"	"

Table 31. – Option 4: Progressive modulation across EU-25

		€5 000–100 000	€100 000 –200 000		€200 000–300 000		above €300 000	
Option 4		Extra mod'n	Extra mod'n	Special mod'n	Extra mod'n	Special mod'n	Extra mod'n	Special mod'n
2012	2013	2%	4%	4%	6%	6%	8%	8%

5. ANALYSIS OF IMPACTS

The modulation options under consideration were analysed and evaluated according to economic and budgetary impacts (effect on farmer direct payments, potential economic return to farmers through Pillar II, link to competitiveness and broader economic impacts on rural areas, and net budget impact by Member States), social impacts (income impact on farmers[90], link to broader rural society issues, and governance issues such as administrative consequences) and environmental impacts.

The baseline for comparing the impact of the examined options is the current situation of 5% compulsory in EU-15, with no modulation in EU-12 (option 0). For the distribution of funds among MS, net modulation has been estimated on the basis of projected direct aids in 2013 including sugar, fruit and vegetables and wine for all options. For option 4, the progressive element of the modulation was estimated on 2006 data of actual payments (CATS). These data differ somewhat from the data of the actual budget allocation.

5.1. Global effects on budget and MS transfers

Results presented here summarise two different aspects of each modulation option[91].

- the overall budgetary impact of each modulation option on the level of funds released to MS (shift from Pillar I to Pillar II) at the EU level,
- the impact of each option on increasing the RD funds from their presently budgeted level.

[90] The data used for the simulations of direct payments per holding and income are the Farm Accountancy Data Network (FADN), which is representative of the commercial farm EU population, and covers around 90% of EU agricultural production and 93% of total direct payments.

[91] More details are found in note 10 of Annex E.

The table presented below indicates that different variations of allocating the 8% modulation increase proposed in the HC Communication would transfer between €2.0 and 2.2 billion for RD funds. The difference between options 1 and 2, an additional €200 million or 10% in total RD, is indicative of the potential share of the new MS in modulation when they enter into the system[92].

Table 32. – Overall budgetary impact of modulation options

	Option 1	*Option 2*	*Option 3*	*Option 4**
EU-15 contribution	*8%*	*8%*	*6% + 2%*	*2%+4%+6%+8%*
EU-10 contribution	*0%*	*8%*	*2%*	*2%+4%+6%+8%*
Total EU funds released to RD	*1 985.15*	*2 183.6*	*2 034.7*	*660.32*
Total increase in MS funds to RD**	*1 689.8*	*1 628.8*	*1 722.6*	*496.0*
Total increase in RD funding	*3 674.9*	*3 812.4*	*3 757.4*	*1 156.2*

Source:DG AGRI calculations based on net modulation of budget projections for direct payments in 2013 and an estimate based on 2006 CATS data for progressive modulation.

Note: The corresponding total of option 4 is proportional to the percentages of progressive modulation. Thus the EP option would yield half of the funds presented here.*

** *Calculated on the basis of no change to current co-financing rates by MS.*

The rather limited contribution of EU-10 is not only explained by the lower level of average payments in EU-10 compared to EU-15 (see section I), but also by the larger number of beneficiaries falling under the €5 000 threshold[93].

With respect to the net effects on MS, results of the various options are summarised in the table below, which shows the effect of modulated funds on the percentage net returns of a MS from the CAP budget and the increase in their RD budget. The net effect (A in the table) is the difference between the modulated funds from Pillar I payments and receipts from these funds under Pillar II for each MS, and is presented as a percentage of their present position as recipients of CAP funds.

The increase in RD funds (B in the table) is measured as the percentage change from the present RD expenditure foreseen. Under *option 1*, only EU-15 is affected by the extra funding available at EU level for Pillar II measures, which would amount to €1 985 million in budget year 2013. The increase in MS match funding would amount to €1 690 million, giving rise to a total increase in RD funding of €3 675 million. The main net beneficiaries would be Portugal, Greece and Spain, and the main net contributors France and Germany.

With respect to the current allocation of funding foreseen for Pillar II measures in 2013, the average EU increase of Pillar II funding would be 18%. The highest increase would be for Denmark, and the Netherlands (in the UK, the resulting significant increase is assumed to compensate an equivalent decline in voluntary modulation).

92 Note that the above figure excludes Romania and Bulgaria.

93 On the other hand, new MS have a much more significant level of RD funds than EU-15.

Table 33. – Impact of modulation options on MS net returns (A) and RD funds (B)

	Option 1		*Option 2*		*Option 3*		*Option 4*	
	net % change		net % change		net % change		net % change	
	A	B	A	B	A	B	A	B
Belgium	– 20%	+ 53%	– 20%	+ 53%	– 15%	+ 56%	– 20%	+ 13%
Denmark	– 20%	+ 82%	– 20%	+ 82%	– 15%	+ 87%	– 19%	+ 22%
Germany	– 10%	+ 29%	– 10%	+ 29%	– 8%	+ 29%	– 6%	+ 11%
Greece	+ 85%	+ 20%	+ 25%	+ 13%	+ 62%	+ 17%	+ 20%	+ 3%
Spain	+ 19%	+ 29%	– 11%	+ 21%	+ 15%	+ 27%	– 3%	+ 7%
France	– 20%	+ 48%	– 20%	+ 48%	– 15%	+ 51%	– 19%	+ 13%
Ireland	+ 15%	+ 25%	– 20%	+ 17%	+ 11%	+ 24%	– 8%	+ 5%
Italy	+ 22%	+ 16%	– 11%	+ 12%	+ 17%	+ 15%	– 2%	+ 4%
Luxemburg	– 20%	+ 16%	– 20%	+ 16%	– 15%	+ 17%	+110%	+ 10%
Netherlands	– 20%	+ 62%	– 20%	+ 62%	– 15%	+ 66%	+ 17%	+ 23%
Austria	+ 56%	+ 8%	+ 12%	+ 6%	+ 41%	+ 7%	+ 11%	+ 1%
Portugal	+390%	+ 15%	+232%	+ 10%	+284%	+ 12%	+ 125%	+ 2%
Finland	+ 20%	+ 10%	– 12%	+ 8%	+ 16%	+ 10%	–3%	+ 2%
Sweden	– 20%	+ 15%	– 20%	+ 15%	– 13%	+ 16%	– 20%	+ 4%
United Kingdom	– 20%	+ 82%	– 20%	+ 82%	– 15%	+ 87%	– 8%	+ 27%
EU-15	***n/a***	***+ 18%***	***n/a***	***+ 32%***	***n/a***	***+ 35%***	***n/a***	***+ 10%***
Cyprus	n/a	n/a	+ 49%	+ 9%	0%	+ 2%	+ 34%	+ 2%
Czech Republic	n/a	n/a	– 20%	+ 11%	0%	+ 4%	– 7%	+ 7%
Estonia	n/a	n/a	+ 71%	+ 7%	0%	+ 1%	+ 39%	+ 2%
Hungary	n/a	n/a	– 19%	+ 10%	0%	+ 3%	– 4%	+ 5%
Latvia	n/a	n/a	+363%	+ 13%	0%	+ 1%	+224%	+ 2%
Lithuania	n/a	n/a	+292%	+ 13%	0%	+ 1%	+144%	+ 3%
Malta	n/a	n/a	+ 17%	+ 2%	0%	+ 1%	0%	+ 1%
Poland	n/a	n/a	+856%	+ 13%	0%	+ 1%	+346%	+ 2%
Slovak Republic	n/a	n/a	– 9%	+ 7%	0%	+ 2%	– 1%	+ 4%
Slovenia	n/a	n/a	+157%	+ 7%	0%	+ 1%	+101%	+ 1%
EU-10	***n/a***	***n/a***	***n/a***	***+ 9%***	***n/a***	***+ 2%***	***n/a***	***+ 3%***
EU-25	***n/a***	***n/a***	***n/a***	***+ 20%***	***n/a***	***+ 18%***	***n/a***	***+ 6%***

Source: DG AGRI calculations based on net modulation of budget projections for direct payments in 2013 and an estimate based on 2006 CATS data for progressive modulation.

Note: Column A corresponds to net gain/loss with respect to current returns from CAP budget, B corresponds to percentage increase in current RD budget. Where n/a, impact not applicable.

Table 34. – Impact of modulation on MS average direct payments (A) and income (B)

	Option 1		*Option 2*		*Option 3*		*Option 4*	
	Net % change		Net % change		Net % change		Net % change	
	A	B	A	B	A	B	A	B
Belgium	–6%	–1%	–6%	–1%	–6%	–1%	1%	0%
Denmark	–7%	–3%	–7%	–3%	–7%	–3%	0%	0%
Germany	–7%	–3%	–7%	–3%	–7%	–3%	0%	0%
Greece	–3%	–1%	–3%	–1%	–3%	–1%	1%	0%
Spain	–5%	–1%	–5%	–1%	–5%	–1%	0%	0%
France	–7%	–3%	–7%	–3%	–7%	–3%	0%	0%
Ireland	–5%	–3%	–5%	–3%	–5%	–3%	1%	0%
Italy	–5%	–1%	–5%	–1%	–5%	–1%	0%	0%
Luxemburg	–6%	–2%	–6%	–2%	–6%	–2%	0%	0%
Netherlands	–6%	–1%	–6%	–1%	–6%	–1%	1%	0%
Austria	–4%	–1%	–4%	–1%	–4%	–1%	1%	0%
Portugal	0%	0%	0%	0%	0%	0%	2%	1%
Finland	–5%	–2%	–5%	–2%	–5%	–2%	1%	1%
Sweden	–7%	–6%	–7%	–6%	–7%	–6%	0%	0%
United Kingdom	1%	1%	1%	1%	1%	1%	1%	0%
EU-15	***–5%***	***–2%***	***–5%***	***–2%***	***–5%***	***–2%***	***0%***	***0%***
Cyprus	n/a	n/a	–3%	–2%	–1%	0%	0%	0%
Czech Republic	n/a	n/a	–8%	–4%	–2%	–1%	–2%	–1%
Estonia	n/a	n/a	–5%	–2%	–1%	–1%	–1%	0%
Hungary	n/a	n/a	–6%	–3%	–1%	–1%	–1%	–1%
Latvia	n/a	n/a	–4%	–2%	–1%	0%	–1%	0%
Lithuania	n/a	n/a	–4%	–2%	–1%	0%	0%	0%
Malta	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Poland	n/a	n/a	–2%	–1%	–1%	0%	0%	0%
Slovak Republic	n/a	n/a	–8%	–6%	–2%	–1%	–2%	–1%
Slovenia	n/a	n/a	–1%	0%	0%	0%	0%	0%
EU-10	***n/a***	***n/a***	***–4%***	***–2%***	***–1%***	***0%***	***–1%***	***0%***
EU-25	***–4%***	***19%***	***–5%***	***–2%***	***–4%***	***–2%***	***0%***	***0%***

Source: DG AGRI calculations based on FADN data.

Budgetary impacts under *option 2* affect all EU-25. The extra funding available at the EU level for Pillar II measures would amount to €2 184 million in budget year 2013. The increase in MS match funding would amount to €1 629 million, giving rise to a total increase in RD funding of €3 812 million. The largest net transfers occurring from France and Germany, and the main net beneficiary Poland[94].

The interest of this option is not so much for the present, since new MS will not in fact contribute to modulation before 2013; it is rather as an indication of potential transfers in the future with the current distribution key. Only three EU-15 MS are net recipients of modulated funds under this option, while three new MS would also be net contributors.

With respect to the current allocation of funding foreseen for RD measures in 2013, the average EU increase would be 20%, with Denmark and the Netherlands again the main beneficiaries. Yet, despite the net transfer of funds from EU-15 to EU-10, the relative impact on EU-10 RD programmes is rather small because of the already high level of Pillar II in the new MS.

Budgetary impacts from *option 3* fall between the first two options, with funding available at EU level for Pillar II measures would amount to €2 034 million in budget year 2013. The increase in MS match funding would amount to €1 723 million, giving rise to a total increase in RD funding of €3 757 million. However, the redistribution effect for this option differs because the special modulation would be retained by the Member State, which generated the savings.

The main net beneficiaries would be Greece and Portugal, and the main net contributors once more France and Germany. The current allocation of funding foreseen for Pillar II measures in 2013 would increase by 19%, with Denmark and the Netherlands showing the biggest gains.

Under *option 4*, funding available at EU level for Pillar II measures would amount to €545 million, with an extra €114 million being retained by MS. The increase in MS match funding would amount to €496 million, giving rise to a total increase in RD funding of €1 156 million. All impacts are thus considerably below the previous three options. The main net beneficiaries would be Portugal and Spain, and the main net contributors once more France and Germany. The current allocation of funding foreseen for Pillar II measures in 2013 would increase by 5%, with Denmark and the Netherlands showing the biggest gains.

5.2. Economic and social impacts per farm

One way of measuring the social impact caused by increased modulation is to look at the effects on farmers' income. Each percentage point of modulation results in an actual reduction of the income per AWU[95]. This reduction will be less than the effect

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94 These results reflect the weight given in the current allocation key to agricultural area, agricultural employment and GDP.

95 As an income indicator, Farm Net Value Added per Annual Work Unit is used because it is the most comparable between Member States. The FNVA is the difference between the output plus current subsidies and the intermediate consumption and depreciation. With this amount of money the farmer still needs to pay the external factors (wages, rent and interest).

on the amounts of direct payments received, since farmers have other incomes than solely the direct payments. The data are presented in the table above.

Under *option 1*, when compulsory modulation is increased by 8% in EU-15, the average income per AWU falls from €20 730 to €20 380, corresponding to an income cut of –2% for the average EU-15 farm. Cuts range from 1% (Belgium, Greece, Spain, Italy, and the Netherlands) to 6% in Sweden.

Option 2 affects all EU-25[96], and results in a drop of average farm income by 2%, from €16 610 to €16 320 per AWU. The range of cuts per MS is between 1% for Belgium, Greece, Spain, Italy, the Netherlands, and Poland to 6% for Sweden and Slovakia.

Option 3 has the same impacts for EU-15 as option 1 but also affects EU-25, but in a more modest way for new MS. The average income in EU-10 declines from €6 310 to €6 280 per AWU (–0.5%). The average cut of 2% in EU-25 farm income ranges between –1% in Slovenia and –2% in Poland to –7% in Denmark, Germany and Sweden and –8% in the Czech and Slovak Republics.

Option 4 has the more modest impacts. The average income in EU-25 declines from €16 610 to €16 560 per AWU (–0.3%). The average cut in income ranges is most significant in the Czech and Slovak Republics, Sweden and Hungary.

5.3. Environmental impacts

All options increase available funds in Pillar II. As a result, they positively benefit the availability of funds for agri-environmental programmes, and the higher the level of transfer to the second pillar, the higher this benefit for RD will be. However, the impact per farm will depend not just on the impact of an eventual income drop on production, which is general is minimal, but also on the capacity of each farm to absorb funds from rural development programmes.

All these effects are difficult to quantity, but they generally move in the same direction. They would tend to support more environmentally friendly methods, while cross compliance would guarantee existing standards do not deteriorate.

5.4. Administrative impacts

In terms of administrative consequences, applying an extra 8% compulsory modulation across EU-15 (option 1), rather than the current situation of 5%, with the same distribution key as today, would not be expected to have any considerable impact on the administrative burden of MS, or farms.

The options affecting new MS would potentially increase their administrative burden, but not with respect to the existing baseline; new MS will enter into the system anyway (EU-10 by 2012).

The most complicated option would be with progressive modulation, because it would imply a change in the present system of financial management. This burden is similar to the one discussed under the upper payment limitations, while the risk of

[96] EU-24 since Malta is not included at this stage.

farm splitting could also occur (although this risk is rather small as ling as the gap between the progressive cuts is also small).

5.5. Supplementary analysis

The above analysis of the four options considered has demonstrated that option 4 (progressive modulation) presents the advantages of combining elements of both individual payment limits and modulation and of minimising distributive effects between MS. However, the progressive modulation option, as analysed, has the disadvantage of bringing EU-10 into the modulation system earlier than foreseen, of generating relatively low levels of funding for reinforcing those RD measures needed to address the new challenges to agriculture and of being administratively complex.

To address these shortcomings while retaining the advantages of progressive modulation, further analysis has been made of a system of progressive modulation based on the following principles:

– all receipts from modulation stay within the MS which generates them;

– for EU-15, basic modulation, applying to all payments above €5 000, is increased by 2% annually from 2009 until it reaches 8% in 2012;

– a progressive element is introduced, whereby payments are reduced by additional steps of 3% for successive payment thresholds levels (0% for €5000 to €99 999; 3% for €100 000 to €199 999; 6% for €200 000 to €299 999; and 9% above €300 000);

– EU-10 become eligible for modulation in 2012 (with a basic rate of 3%);

– a new system for the financial management of direct aids, establishing net global ceilings per Member State, is introduced.

The progressive modulation system would apply over time according to the schema below:

Table 35. – Proposed schema for Progressive Modulation

	Current Modulation			Progressive Modulation Rates				
Budget Year	**EU-15 Payment Level**	**Basic Rate**	**EU-15 Payment Level**	**0 - EUR 5.000 (Franchise)**	**EUR 5.000 to EUR 100.000**	**EUR 100.000 to EUR 200.000**	**EUR 200.000 to EUR 300.000**	**Above EUR 300.000**
2007	100%	4%	96%	0%	0%	0%	0%	0%
2008	100%	5%	95%	0%	0%	0%	0%	0%
2009	100%	5%	95%	0%	0%	0%	0%	0%
2010	100%	5%	95%	0%	2%	5%	8%	11%
2011	100%	5%	95%	0%	4%	7%	10%	13%
2012	100%	5%	95%	0%	6%	9%	12%	15%
2013	100%	5%	95%	0%	8%	11%	14%	17%
Budget Year	**EU-10 Payment Level**	**Basic Rate**	**EU-10 Payment Level**	**0 - EUR 5.000 (Franchise)**	**EUR 5.000 to EUR 100.000**	**EUR 100.000 to EUR 200.000**	**EUR 200.000 to EUR 300.000**	**Above EUR 300.000**
2013	90%	0%	90%	0%	3%	6%	9%	12%

The budgetary impacts of the proposed progressive modulation are presented in the table below. In this analysis, the impact on those Member States currently applying voluntary modulation (UK, PT) has been taken into account, on the basis that any increase in compulsory modulation amounts substitutes existing voluntary modulation amounts. However, since it is assumed that the same rate of co-financing

will apply to the new compulsory modulation amounts as is currently the case, for the UK and PT, both applying voluntary modulation, the net increase in MS RD funding will differ where there are different co-financing rates applied under voluntary modulation.

Table 36. – Impact of progressive modulation on EU and MS RD spending

Budget year 2013	EU RD contribution*	MS RD contribution	Total RD Spending	Current average co-financing rate	Proposed Progressive Modulation	Current Voluntary modulation	Adjusted voluntary modulation	Increase in EU RD funding	Increase in MS RD funding	Total increase in RD funding	Increase in currently foreseen RD funding
	A	B	C	D=A/C	E	F	G=F-E	H=E+G-F	I=(H/D)*(1-D)	J=H+I	K=J/C
Belgium	54,5	94,5	148,9	37%	36,6	0,0	0,0	36,6	63,5	100,1	67%
Danmark	61,6	53,4	115,0	54%	69,5	0,0	0,0	69,5	60,3	129,8	113%
Deutschland	1.131,1	711,2	1.842,4	61%	440,6	0,0	0,0	440,6	277,0	717,6	39%
Ellas	619,2	229,0	848,2	73%	71,4	0,0	0,0	71,4	26,4	97,8	12%
España	1.041,1	966,3	2.007,4	52%	265,7	0,0	0,0	265,7	246,6	512,3	26%
France	905,7	773,6	1.679,3	54%	537,5	0,0	0,0	537,5	459,1	996,6	59%
Ireland	307,2	257,2	564,4	54%	68,2	0,0	0,0	68,2	57,1	125,3	22%
Italia	1.258,2	1.282,8	2.540,9	50%	222,4	0,0	0,0	222,4	226,7	449,1	18%
Luxembourg	11,8	36,5	48,3	24%	2,2	0,0	0,0	2,2	6,8	9,0	19%
Nederlands	66,6	66,6	133,1	50%	54,9	0,0	0,0	54,9	54,9	109,8	82%
Österreich	511,1	511,0	1.022,0	50%	28,7	0,0	0,0	28,7	28,7	57,4	6%
Portugal	564,1	151,9	716,0	79%	32,9	40,8	7,9	0,0	0,0	0,0	0%
Suomi/Finland	271,6	601,1	872,7	31%	24,7	0,0	0,0	24,7	54,7	79,4	9%
Sverige	239,2	274,0	513,1	47%	43,6	0,0	0,0	43,6	49,9	93,5	18%
United Kingdom	267,4	267,3	534,7	50%	292,1	481,6	190,4	0,9	0,9	1,8	0%
Cyprus	21,0	21,0	42,1	50%	0,6	0,0	0,0	0,6	0,6	1,2	3%
Czech Rep	418,0	118,8	536,8	78%	49,8	0,0	0,0	49,8	14,2	64,0	12%
Estonia	113,3	33,3	146,6	77%	2,1	0,0	0,0	2,1	0,6	2,7	2%
Hungary	578,7	205,8	784,5	74%	46,4	0,0	0,0	46,4	16,5	62,9	8%
Latvia	151,2	46,6	197,7	76%	2,0	0,0	0,0	2,0	0,6	2,6	1%
Lithuania	253,6	75,2	328,8	77%	5,2	0,0	0,0	5,2	1,5	6,7	2%
Malta	10,7	3,3	13,9	76%	0,1	0,0	0,0	0,1	0,0	0,1	1%
Poland	1.850,0	557,6	2.407,7	77%	27,7	0,0	0,0	27,7	8,3	36,0	1%
Slovak Rep	317,3	95,6	412,9	77%	20,8	0,0	0,0	20,8	6,3	27,1	7%
Slovenia	112,0	32,2	144,2	78%	0,8	0,0	0,0	0,8	0,2	1,0	1%
EU-25	**11.136,03**	**7.465,6**	**18.601,7**	**60%**	**2.346,5**	**522,4**	**198,3**	**2.022,4**	**1.661,6**	**3.684,0**	**20%**

Source: DG AGRI calculations based on FADN data.

* *For UK and PT, both applying voluntary modulation, it is assumed that the same rate of co-financing will apply to the new compulsory modulation amounts as is currently the case. The net increase in MS RD funding will differ where there are different co-financing rates applied under voluntary modulation.*

This option would release a total of €2 022 million of EU funds for transfer to and use under Pillar II (column H, table above). This figure is comparable to that of options 1 and 3 above and considerably higher than the amount released by option 4. Though the biggest impacts of this measure would fall on FR (€537 million), DE (€441 million), ES (€266 million) and IT (€222 million), since there is no re-distribution of the EU funds generated, there would be no net budget impacts on MS.

Assuming the same EU co-financing rate, as currently applied in each MS, it has been calculated that the total contribution of RD funding by MS would increase by €1 661 million. Column I of the table above shows individual MS impacts.

The proposed modulation mechanisms would give a total increase (EU plus MS spending) of €3 684 million for Pillar II measures, which would represent a 20% increase at EU-25 level (column K). MS increases in RD spending would vary from +112% in DK and 82% in NL, to generally low increase in new MS.

Further analysis of the social impact of the proposed progressive modulation on farmer incomes, based on FADN data, is ongoing. It may be expected that the average impact per MS will follow similar trends to those observed under option 4, which already contained an element of progressive modulation. A more detailed breakdown of impacts at farm level, including those by payment size, can be found in note 10 of Annex E.

6. CONCLUSIONS

In relation to the attainment of the objectives for modulation, the status quo option, though negative in terms of its failure to address the budget needs for the current programming period, and new challenges facing EU agriculture, keeps within the constraints imposed by the current rules regarding the exemption of new MS. The lack of ambition of the status quo option would be the main reason for its exclusion in the light of the new challenges of the CAP.

Increasing modulation at EU-15 or EU-25 level, with the existing redistribution method, addresses the budget issue but in an imbalanced way. Restricting modulation to EU-15 excludes the new MS. Modulating EU-25 breaks the agreement for their exemption until 2012. The differentiated approach, outlined in option 3, contains more positive elements: more funding is available, the rules for modulation are respected until 2012 and the last step of modulation finds a balance in terms of the redistribution effect.

Option 4, progressive modulation, while bringing EU-10 into the system earlier than foreseen, lacks in ambition in terms of the funds released. However, this deficiency could be addressed by revising the percentage of basic modulation in the model, as well as the steps between the different payment thresholds.

The option also has some promising features, with regard to the fact that it permits MS to retain the funds generated and it integrates an element of progressiveness in the payment cuts, thereby addressing, to some extent, the problem in relation to the uneven distribution of farmer payments.

Supplementary analysis of a progressive modulation option, involving higher rates of step-wise modulation and which would be applicable to new MS only when they reach an equivalent level of direct payments to EU-15 in budget year 2013, has shown that it is possible to address the shortcomings of option 4 while retaining its positive features.

7. SUMMARY TABLES

7.1. Comparison between different options and their respective impacts – New challenges

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – Simply transfer funds to Pillar II	Option 2 – Earmarking of transferred funds	Option 3 – Higher co-financing rates	Option 4 – Higher aid intensities	Option 5 – Obligation to implement New Challenges measures
Economic	Sectors lags in adaptation ☹	😐	😐	😐	😐	😐
Social	😐	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺	Response to public concerns ☺☺
Environmental	Increased risks from climate change ☹	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake ☺	Improvement due to higher uptake and better targeting ☺☺
Administrative burden	😐	Reprogramming of RD required ☹	Reprogramming of RD and separate reporting required ☹	Reprogramming of RD and separate reporting required ☹☹	Reprogramming of RD and separate reporting required ☹	Reprogramming of RD and separate reporting required ☹☹
Simplification	😐	😐	☹	☹	☹	☹☹

☺☺ very positive; ☺ positive; 😐 neutral; ☹ negative; ☹☹ very negative

IMPACTS	Option 0 – baseline	Option 1 – Simply transfer funds to Pillar II	Option 2 – Earmarking of transferred funds	Option 3 – Higher co-financing rates	Option 4 – Higher aid intensities	Option 5 – Obligation to implement New Challenges measures
Other	😐	😐	Increased uptake due to incentives ☺	Increased uptake due to incentives ☺	Increased uptake due to incentives ☺	Obligation helps higher uptake ☺☺

7.2. Comparison between different options and their respective impacts – Modulation

☺☺ strong positive impacts; ☺ positive impact; 😐 neutral; ☹ negative impact; ☹☹ strong negative impacts

IMPACTS	Option 0 – baseline	Option 1 – Increase basic compulsory modulation by 8% in EU-15	Option 2 – Increase basic compulsory modulation by 8% in EU-25	Option 3 – Increase basic compulsory modulation at different rates in EU-25	Option 4 – Introduce progressive modulation
Economic	Insufficient to meet additional demands for RD measures ☹	EU-15 direct payments reduced by 5% ☹ EU budget for RD up 18% (€ 2.0 billion) ☺	EU-25 direct payments reduced by 5% ☹ EU budget for RD up 20% (€ 2.3 billion) ☺	EU-25 direct payments reduced by 5% ☹ EU budget for RD up 19% (€ 2.1 billion) ☺	EU-25 direct payments reduced by 1% 😐 EU budget for RD up 5% (€ 0.6 billion) 😐
Social	2% farm income drop 😐 RD strengthens ☺	Farm income declines by a further 2% ☹ RD strengthens ☺	Farm income declines by a further 2% ☹ RD strengthens ☺	Farm income declines by a further 2% ☹ RD strengthens ☺	Farm income declines by less than 1% ☹ to 😐 RD strengthens ☺
Environmental	Insufficient to meet additional demands for RD measures ☹	Benefits from extra RD funding, but only in EU-15 ☺	Benefits from extra RD funding to EU-25 ☺☺	Benefits from extra RD funding to EU-25, but small in EU-10 ☺	Benefits from extra RD funding to EU-25, but small in EU-10 😐 to ☺
Administrative	No additional impact, current rules in place 😐	Present rules continue 😐	Modulation rules in EU-10 apply earlier ☹ to 😐	Present rules continue 😐	Modulation rules in EU-10 apply earlier ☹ to 😐
Simplification	No additional impact, current rules in place 😐	Present rules continue 😐	Modulation rules in EU-10 apply earlier ☹ to 😐	Present rules continue 😐	Introduces new rules and legislation ☹

7.3. Comparison between different options and their respective objectives – New Challenges

☺☺ respecting objective; ☺ possibly respecting objective; 😐 neutral; ☹ objective possibly at risk; ☹☹ objective at risk

OBJECTIVES	Option 0 – baseline	Option 1 – Simply transfer of fund to Pillar II	Option 2 – Earmarking	Option 3 – Higher co-financing rates	Option 4 – Higher aid intensities	Option 5 – Obligation to implement new challenges measures
Responsiveness to New challenges	☹☹	☺	☺	☺☺	☺	☺☺
Greater uptake of RD measures	😐	☺	☺	☺	☺	☺☺
Simplification	😐	😐	☹	☹	☹	☹☹

7.4. Comparison between different options and objectives – modulation

☺☺ respecting objective; ☺ possibly respecting objective; 😐 neutral; ☹ objective possibly at risk; ☹☹ objective at risk

OBJECTIVES	Option 0 – baseline	Option 1 – Increase basic compulsory modulation by 8% in EU-15	Option 2 – Increase basic compulsory modulation by 8% in EU-25	Option 3 – Increase basic compulsory modulation at different rates in EU-25	Option 4 – Introduce progressive modulation
Reinforce RD funds	☹☹	☺	☺☺	☺	😐
Respect rules for new MS	☺☺	☺☺	☹☹	☺☺	☹
Respect current key for distribution of modulation	😐	☺☺	☹☹	😐	☹

F – CONCLUSIONS

1. SUMMARY RESULTS

The purpose of the Health Check is to asses the experience of the 2003 CAP reform and introduce adjustments to simplify and increase the effectiveness of the policy and allow it to respond to present market opportunities and face new challenges. A wide range of possible options were examined, ranging from no policy change to fundamental reforms, against the CAP objectives of:

- a competitive agricultural sector,
- production methods that support environmentally friendly, quality products that the public wants,
- a fair standard of living and income stability for the agricultural community,
- diversity in the forms of agriculture, maintaining visual amenities and supporting rural communities,
- simplicity in agricultural policy and the sharing of responsibilities among Commission and member states,
- justification of support through the provision of services that the public expects farmers to provide.

The analysis of the status quo of the CAP shows that the current policy framework, as reformed in 2003, contributes positively to fulfilling the principal CAP objectives. The options analysed which indicate fundamental policy changes, did overall not indicate the need for a radical reform in order to better meet the CAP objectives. However, the analysis showed that there are areas where adjustments of the current policy would lead to more optimal solutions.

The historic model of the SPS and optional partially coupled support enabled the smooth transition to decoupling in MS whose variable production structures implied a need for successive integration into the SPS in 2003. However, the time now seems ripe to allow MS to consider a targeted adjustment towards a more flat rate for payments, which would address the societal concerns of unequal distribution of payments between farmers. Another way of addressing the uneven distribution of payments is through the introduction of progressive modulation of funds. For the areas where the SPS does not address specific concerns, solutions could be addressed through Article 69. A revision of Article 69 would allow MS to use part of their available SPS support to target particular sectors and regions with specific needs from an economic, social or environmental point of view. This revision would allow for mitigating negative effects on income, it would contribute to the vitality of rural areas and to promoting environmentally beneficial farming practices, while respecting WTO commitments.

Revising the scope of cross compliance, by deleting and adding requirements, contributes to easing the administrative burden as well as addressing new challenges that were not as present at the time of the 2003 reform. At the same time, environmental benefits of set aside could be retained through GAEC and Rural Development Measures.

In terms of agricultural markets, the phasing out of milk quotas and removal of set aside will allow the farmers to better respond to market situation. Moreover, restricting intervention quantities to zero for all feed grains and introducing a tendering system in all sectors would make the system more efficient and simple, while at the same time provide a safety net role. Within the current CAP there would also be an increased possibility to promote the use of risk management tools and techniques through Article 69 and Rural Development funds.

The continuation of the move to producer support and full decoupling of remaining sectors would have a positive impact on farm income in most regions due to higher transfer efficiency of direct support, and any possible environmental and social effects could be addressed through Article 69 and by allowing transitional period for the sector to adjust.

The analysis shows that most new challenges are being addressed in the Strategic Guidelines for Rural Development that set EU priorities for the RDP in the period 2007–2013. In total, more than 25 sub-measures directly or indirectly related to climate change, renewable energies, risk and water management have been included in the programmes. The best way to strengthen their role within the Rural Development policy is to create mechanisms that guarantee that they are taken up by Member States and that ample financing is provided through modulation.

2. IMPACT ON STAKEHOLDERS

The overall impact of the proposals on farmers is positive. By enhancing their market orientation and reducing existing policy rigidities, proposals allow them to better grasp existing opportunities and respond to challenges. The overall income effect of proposal moving to a further decoupling is also positive, as the flexibility in production choices allows farmers to adjust to what is more profitable for them.. There are, however, some sectors where specific pressure on farm income may emerge. This is generally the case in regions where alternative production choices are very limited and a significant part of farm income is associated to the level of coupled support. In these cases, options have been identified that would allow the mitigation of such income pressures either by continuing existing support or by allowing accompanying measures that would ease the transition of farming to an economically sustainable situation.

The overall positive effect of more market orientation, further decoupling and the removal of supply control will enhance the competitiveness of the EU industry, especially in the dairy industry. The expected impact on employment would also be positive overall. There are however specific regions and sectors where potential problems on employment have been identified, and for which the impact on employment, although rather limited overall, could still be felt more strongly at the local level. In all such cases, existing measures both in the first pillar an especially in RD could facilitate necessary adjustments, especially since a transition period has been suggested to allow the industry to adapt.

EU consumers should benefit from the Health Check mainly through the reduction of market intervention and the abolition of supply-management tools, notably the mandatory set aside in the arable crop sector and the production quotas in the dairy sector. These measures are expected to reduce the prices of arable crop products and the prices of meat products (in particular those of poultry and pig meat). Likewise, the phasing-out and eventual abolition of the milk quota system is foreseen to induce a significant welfare gain for consumers through the decrease in farm milk price, that would result in lower dairy commodity prices.

The extent to which final consumers will fully benefit from the Health Check measures is linked to the low and declining share of agricultural raw materials in food production costs and to the competitive structure of the food supply chain. Over the medium to long term there is no significant evidence of partial transmission of price changes between the farm and consumer levels, although this may happen in the short run in some sector/country specific situation.

With respect to the environment, the Health Check will allow a further positive contribution of the CAP by a significant and targeted proposed shift of funds to RD to respond to new challenges including climate change, biodiversity and water. The loss of set aside could be compensated by a combination of adjustments in GAEC and by the use of some of the additional RD funding.

Finally, with respect to taxpayers the overall contribution of the Health Check is not so much in term of the overall budget which is fixed in the Financial Perspectives. It is rather with respect to the increase in the transfer efficiency of the existing budget, by reallocating existing funds and better targeting these funds to meet the overall policy priorities of the EU.

3. CROSS-CUTTING EFFECTS

The detailed analysis of the Impact Assessment focused mainly on the individual areas of the proposals. However, there also are cross-cutting impacts both because the overall philosophy of proposed adjustments is the same and because there are linkages between the various areas, whether of economic, environmental or social nature. The various options are summarised in tables 32 while their cross-cutting effects and presented in table 33.

From the latter table it becomes evident that impacts associated with the additional risks related with proposed adjustments are more often cutting across the various areas, while the revised Article 69 is considered as the most appropriate means of best addressing these impacts. The linkage of cross compliance and new challenges is also one that requires a certain balance in proposed solutions since changes in cross compliance affect the existing baseline of mandatory standards and obligations for farmers, and as a consequence impact on the compensation for higher voluntary standards introduced via RD measures linked to new challenges.

Finally, cross-cutting effects are also important in another area, that of administrative costs. For farmers, HC proposals are either neutral or moving in the direction of reducing them. With respect to administrative costs for public administrations, on the other hand, things are more complex because to a large extent they depend on the choices of MS. In terms of quantifying such costs, the relevant issue is not the overall costs, which are often referred to in the relevant debate. Most of these costs will be made anyway because they are linked to the need of scrutiny not just of public support but also of the implementation of existing legislation.

What is relevant for the HC is the marginal cost (or cost saving) of any additional measures linked to the HC. Yet what this cost is depends on the existing MS administrative structure and their capacity to readjust their implementing measures. In most cases, the qualitative assessment of such costs indicates very small changes with existing rules, but their exact level cannot be quantified. It is only in the area of new challenges that certain additional administrative costs could be identified because of the need to review RD programmes and identify necessary adjustments, yet their exact level is not possible to quantify at this stage.

4. BUDGETARY IMPACT

Since the 2003 CAP reform, the CAP has an in-built mechanism of financial discipline if expected expenditure runs the risk of exceeding the financial ceiling for market expenditure and direct aids. Most CAP support is now fixed and the market outlook has significantly improved since 2003. As a result, the risk that the financial discipline is applied (i.e. reduction in direct aids) have diminished compared to previous expectations.

Proposals for modulation in the Single Payment Scheme and Rural Development are by design neutral with the respect to the EU budget, as it is a simple compulsory transfer between the second and the first pillar of the CAP. For national budget the increased modulation could lead to additional national expenditure in view of the necessary co-financing needed in Rural Development. This would mean that some Member States have the possibility of returning to the (higher) level of national expenditure originally foreseen before the decision on the Financial Framework 2007–2013. As regards the transfer of measures into the Single Payment Scheme there could be moderate financial

consequences for the EU-budget, but most of the transfers are also budgetary neutral.

With respect to market measures, the recent increase in world prices has led to a clear improvement of prospects with respect to expectations when the 2003 reform was decided. The reform of maize intervention has since then resolved part of the previously expected problems in cereals market, and the present proposals on cereals intervention improve further the situation. Some additional expenditure towards the end of the present financial framework is relatively small. In dairy the impact is more one of the timing of expenditure (before or after 2013).

The expiry of the dairy quota will bring additional pressure in butter under all options. The present proposal, by initiating a gradual process of a quota phasing-out, is overall more beneficial not just for the sector, but also for long-term developments of the CAP. However, the need for some limited additional expenditure on butter exports cannot be excluded. Whether this materialises will depend on factors that are at this stage unknown (DDA Agreement, world market developments). Therefore the present proposals include a review clause in 2012 that would allow developments in dairy markets to be assessed to determine if additional measures will be needed to avoid any increase in the budget. Some savings are foreseen as a consequence of abolition of existing measures. However, the biggest budgetary effect of the soft landing on the milk quota is a loss of budgetary revenue due to the foreseen decrease in milk levy.

5. SUMMARY OF DIFFERENT ANALYSED OPTIONS

	SPS model						Market					New Challenges	
Option	**SPS model**	**A.69**	**Cross compliance**	**Partially coupled support**	**Upper limits**	**Lower limits**	**Cereal intervention**	**Set aside**	**Milk quotas**	**Other support schemes**	**Risk management**	**New Challeges**	**Modulation**
0	Status quo	Status quo	Status quo	Status quo	Status quo	Status quo	Status quo	Status quo	Quota extension	Status quo	Status quo	Status quo	Status quo
1	EU flat rate	Targeted revision	Better targetting the scope	Full decoupling	Fixed individual limits at a certain level	Current individual lower limits	reduction of the intervention to safety net level	removal of set aside	Quota expiry	Full decoupling	EU wide frame work	Transfer of additional funds to Pillar II	Increase in compulsory modulation by 8% in EU 15
2	SAPS for all MS	Extended revision	Broadening the scope	Targeted selective decoupling	Progressive individual limits	Increased individual limits	restrict quantities to zero for all feed grains	5% environmental set aside	Quota phasing out	Targeted selective decoupling	Enhanced role of risk management in current CAP instrtuments	Earmarking	Increase in basic compulsory modulation by 8% in EU 25
3	Regional flat rate per hectare						Tendering system	New GAEC environmental features				Higher co-financing rates	Increase in basic compulsory modulation at different rates in EU 25
4	Regional flat rate per entitlement							Strengthening set-aside in pilar II				Higher aid-intensities	Progressive modulation
5												Obligation to implement New Challenges measures	

6. SUMMARY OF CROSS CUTTING ISSUES BETWEEN ANALYSED OPTIONS

Option	SPS model	A.69	Cross compliance	Partially coupled support	Upper limits	Lower limits	Cereal intervention	Set aside	Milk quotas	Other support schemes	Risk managemen
SPS model											
A.69											
Cross compliance											
Partially coupled support		↑									
Upper limits	↓										
Lower limits	↓										
Cereal intervention											
Set aside			↑				↑				
Milk quotas		↑									
Other support schemes		↑									
Risk management		↑		↓			↓		↓	↓	
New Challeges			↑					↓			
Modulation	↑				↑					↓	

Note: Impact is indicated by direction of arrow.

G – MONITORING AND EVALUATION

In order to provide for monitoring of the future performance of the CAP and in particular evaluate how the Health Check attained its objectives, Commission services will follow the developments in the foreseen period of adjustments under the Health Check.

The monitoring and evaluation will use, among others, the following indicators (many of them used for the impact assessment of the Health Check and/or in the multi-annual evaluation programme for CAP policies):

Single Payment Scheme:

- development in farm income,
- amounts of direct payments and their distribution between farms;

Markets:

- volume of public stocks in intervention,
- agricultural export performance (e.g. EU share in world trade in agricultural products),
- international and domestic production;

New challenges:

- rural development expenditure,
- uptake of Rural Development measures, especially those addressing new challenges (climate change, renewable energies, water management, biodiversity),
- funds shifted to Rural Development through modulation.

There will also continue to be evaluations and studies on particular issues of CAP performance and the Commission will continue to follow relevant projects under the research framework programmes.