



**Paper 1: Achieving a Transition Away from CAP
Direct Payments**

Paper prepared by IEEP for the Land Use Policy Group

Kaley Hart, Matt Rayment, and Hannah Lee

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EXECUTIVE SUMMARY

Decoupled direct payments under Pillar 1 of the CAP currently account for the majority of agricultural expenditure in Europe. Introduced in 2005, their purpose was to compensate farmers for the dismantling of production support to help them adjust to a more market-oriented situation. The reforms aimed to position the EU more favourably within the WTO by shifting the bulk of Pillar 1 into the Green Box. However, the rationale for direct payments is coming under significant scrutiny as a result of the EU Budget Review and the discussions surrounding the post 2013 CAP and they are becoming increasingly difficult to justify in their current form.

The Land Use Policy Group (LUPG) has stated in its 'Vision for the Future of the CAP post 2013' that, *'during the next programming period, we believe there needs to be a transfer of funds from income support into the direct purchase of environmental services'* (LUPG, 2009). However, given the significance of direct payments as a proportion of gross farm income for many farm types, their immediate cessation is politically unrealistic and could have undesirable economic, environmental and social impacts.

Some form of transitional arrangement appears necessary, therefore, in order to ensure ongoing economic stability as the nature of support payments evolves. This paper examines what sort of transitional arrangements might be needed to facilitate a shift in the basis of payments towards a rationale that is more focused on the provision of environmental goods and services. The paper considers the advantages and disadvantages, as well as the opportunities and risks associated with the range of transitional options proposed.

Proposed future model of support and its anticipated impacts

In order to formulate and appraise a range of alternative options for the transitional period, IEEP has developed a broad model to show what a future system of support, more focused on the provision of environmental goods and services, might actually look like. This model draws on the general principles outlined in the LUPG Vision as well as more recent work undertaken by a range of stakeholders, research institutes and academics. As explained in Section 2 of this paper, the model is a device to inform the development of a range of suitable transitional options, and to allow exploration of a range of possible future economic, environmental and social outcomes. It does not necessarily represent the ideal future situation in LUPG's view.

The proposed model is intended to comprise a significant element of a future CAP. It puts the delivery of environmental goods and services at the heart of its rationale and provides a more targeted approach to supporting land managers. Payments for basic stewardship (available across the farmed countryside) are combined with more targeted incentives and capital grants. In targeting CAP funds towards clear objectives and the achievement of specific outcomes, the proposed model is intended to provide a more efficient and defensible rationale for public spending than under the current system. It should be noted, however, that two significant elements likely to feature in any future CAP are not included within the model, namely any remaining market support mechanisms and support provided to meet the socio-economic needs of rural areas.

The way in which the proposed model has been set out allows for flexibility in how it might be applied in practice. However, it should be noted that many of the predicted social, economic and environmental impacts will depend on the precise way in which changes are implemented. Section 3 of this paper gives a broad outline of the likely impacts of shifting the basis of payments away from the current approach and towards a system more focused on achieving environmental outcomes. It considers the likely budgetary redistribution

between Member States; changes in the distribution of support between farms; average farm incomes; patterns of agricultural production and the impacts on farm structures as well as the effect on environmental management activity across the farmed countryside. This assessment is based on an understanding of the current implementation of the CAP by EU Member States and the likely economic conditions facing agriculture during the 2014 – 2020 period as well as the results of a number of modelling exercises on future CAP scenarios.

It is clear that re-focusing payments on environmental outcomes is likely to have wide-ranging effects on the farming sector. These impacts will differ between farm types and between regions. Overall, there is likely to be a shift in support away from the intensive arable, livestock and permanent crop producers and towards more extensive farming systems. This would seem likely to help slow down the rate of structural change predicted under current policy and economic conditions, as well as reducing the trend towards significant levels of land abandonment in less competitive regions. Some farmers however, particularly intensive producers, would see some reduction in income in the short term as a result of removing direct payments.

In the longer term the situation can be expected to stabilise as the prices of land, inputs and other assets adjust to the new system of support. The proposed changes should promote more sustainable food production within environmental limits, without any significant reduction in overall levels of production. In relation to the environment, the proposed shift in the basis of payments should lead to a significant increase in the quantity and quality of environmentally directed management carried out across the countryside, within both extensive and intensive systems.

The extent and variation in these social and environmental impacts will be particularly dependent on the way in which the future model for support is designed; the degree of subsidiarity attached to the new arrangements; the levels of co-financing; the basis on which payment rates are calculated; the way in which the support package is implemented and ultimately the scale of uptake. Levels of uptake will be dictated by the attractiveness of payments and their associated conditions, with farmers comparing the returns available with those that it would be possible to achieve by staying outside the support system.

Transitional options

Taking account of the likely impacts of the proposed future support model, Section 4 identifies four transitional options that have the greatest potential to ease the adjustment away from the current system of support towards a new CAP more focused on achieving environmental outcomes, for the time period 2014-2020. These are:

- a gradual switch in the basis of support payments over time;
- a differential switch in the basis of payment according to a farm's level of economic returns and environmental value;
- the phasing out of direct payments through the introduction of a bond scheme;
- the introduction of counter-cyclical payments.

A number of other measures which could be combined with these options were also identified, including 'orange ticket' cross compliance (whereby receipt of direct payments is conditional on entry into a voluntary agri-environment scheme), early retirement measures and the use of national budgetary envelopes (akin to current Article 68 measures). In order to facilitate a smooth adjustment process, one of the key roles identified for the transitional options was the need to provide support for investments designed to enhance the sustainable competitiveness of the agricultural sector. Such investments should improve the ability of the farming sector to meet the challenges of mitigating and adapting to climate change, improving water management and halting declines in biodiversity.

The main obstacles to making the transition away from income support and towards a more environmentally focussed payment system are likely to be political. While there is strong support for reform from certain Member States, and from a range of stakeholder groups representing environmental, consumer and taxpayer interests, the barriers to reform are substantial. These include resistance to change from some farming interests and also from many Member States, particularly those who would emerge as net losers once the nature of the support system was changed. Another major issue is that of national co-financing. There is considerable reluctance amongst many Member States to increase their contributions to CAP payments and this is likely to be a key issue in terms of the relative attractiveness of changing the basis of payments. It is highly likely that any transitional options will have to be based on minimal (if any) increases in current levels of Member State co-financing for them to be considered as a realistic option.

Of the various different transition options that were identified, the most straightforward and least administratively complex appears to involve a simple switch in the basis of payments over the short to medium term (four to seven years). Incorporated within this option, would need to be the increased availability of funding for investments to enhance sustainable competitiveness, thereby helping to facilitate a more gradual and sustainable process of structural change than might otherwise be experienced. Although a swifter transition would enable resources to be allocated to environmental priorities more rapidly, it was concluded that the impact on farm businesses would exacerbate existing patterns of structural change and meet greater political resistance.

Other transitional options such as the bond scheme and 'orange ticket' cross compliance are also viewed as having considerable merits. However they may require substantial administrative effort and it is not clear that the benefits of using these sorts of measures would be sufficient to justify the potential additional administrative cost, especially given the relatively short timeframe over which they could be operated. However, these options are certainly worthy of further consideration and Member States could be given the discretion to use them as part of a package of transitional measures, should they be considered effective.

Despite the anticipated political resistance to such changes in the architecture of the CAP, it is evident that some revisions to the current policy framework are inevitable given the various pressures for reform. In themselves these will necessarily lead to a reallocation of support between Member States, between regions and and between sectors. More detailed work is now needed to elaborate what different variants of the proposed model might look like in practice. Key variables include the weightings applied to each of the different elements within the model; the design of the support payments, levels of co-financing and the degree of national and regional discretion given to Member States. Such work would allow for a more thorough investigation into the precise nature of the transitional arrangements that would be needed, with minimum adverse economic and social consequences.

1. INTRODUCTION

Direct payments under Pillar 1 of the CAP currently account for the majority of agricultural expenditure in Europe. Introduced in 2005 as a result of the 2003 CAP Reforms, their purpose is to compensate farmers for the dismantling of production support so as to help them adjust to the reforms. However, the rationale for direct payments is coming under significant scrutiny as a result of the EU Budget Review and the discussions surrounding the post 2013 CAP. In their current form, they are becoming increasingly difficult to justify.

It is argued by some that the primary rationale for the CAP in the future should be to support the provision of environmental goods and services, promote the sustainable use of natural resources, and to support the maintenance of viable rural communities. The Land Use Policy Group (LUPG) has stated in its 'Vision for the Future of the CAP post 2013' that:

'During the next programming period, we believe there needs to be a transfer of funds from income support into the direct purchase of environmental services.'

Given the significance of direct payments as a proportion of gross farm income for many farm types, their immediate cessation is politically unrealistic, and could have undesirable economic, environmental and social impacts, even if accompanied by the immediate introduction of a new system of support focused on achieving environmental objectives. Among other things, the removal of direct payments could hit those producers with low economic returns hardest, leading to threats to their ongoing viability. A sizeable proportion of these economically fragile farms utilise more extensive forms of production and very often it is these farms that deliver significant environment benefits, for example High Nature Value farmland. Where this is the case, the cessation of direct payments could undermine the ongoing delivery of environmental goods and services and may also impact negatively on rural economies and communities in many areas.

As recognised by the LUPG in its Vision, if the logic for support is re-oriented primarily towards environmental objectives, some form of transitional arrangements would be necessary in order to ensure ongoing economic stability as the basis for payments changed. The Vision document, however, makes it clear that, in LUPG's view *'any income support retained in the short term should be targeted, with conditions, on those farming systems making the greatest contribution to the management of services to society'*.

The main aim of this paper is to identify and examine what sort of transitional arrangements might be needed to facilitate the shift in the basis of payments towards one that is based on the provision of environmental goods and services, as proposed in the LUPG Vision. It considers the advantages, disadvantages, opportunities and risks associated with the range of transitional options proposed.

However, in order to formulate and appraise alternative transitional options, it is first necessary to define what a future system of support might look like in order to determine the anticipated economic, environmental and social effects that the transitional options need to address. The LUPG vision sets out a number of general principles for a future CAP. This paper, therefore, has combined these with more recent thinking on possible architectures for a future CAP to outline a heuristic model for a future system of support.

This paper therefore:

- Sets out a possible model for a future CAP, which is designed to be consistent with the principles set out in LUPG's vision (Section 2);

- Provides a brief overview of the current implementation of the CAP by EU Member States, in order to understand the starting point from which reform will take place; considers the likely economic conditions facing agriculture during the 2014 – 2020 period; and considers the implications and likely impacts of the implementation of the proposed CAP reform, which will need to be considered as part of the transition scenario (Section 3);
- Proposes a series of transitional options over the period 2014-2020 for moving away from the current system of farm support towards one focused on supporting environmental services, assessing their relative advantages and disadvantages, administrative feasibility and political acceptability (Section 4); and
- Draws general conclusions about the appropriateness of the different types of transitional arrangements proposed (Section 5).

2. POSSIBLE MODEL FOR A FUTURE CAP

The objectives set out in the LUPG vision could be delivered through a number of different approaches. This section presents a potential architecture for a future policy that could achieve the desired outcomes (Table 1), accompanied by a commentary on the way in which variations in a range of parameters could alter the focus and nature of the outcomes. It should be stressed at the outset that this model has been proposed by the authors as a possible means of implementing LUPG's Vision for the future of the CAP, rather than being a statement of LUPG policy in this area.

The model set out in Table 1 focuses solely on the way in which a future CAP could be structured to deliver environmental goods and services through area and capital payments, in keeping with the principles set out in the LUPG vision document. It does not cover all the elements that might form part of a future CAP – for example, it does not consider the future of market intervention, nor does it focus on measures to promote social objectives, both of which could form important additional elements of a future CAP and would need to be allocated a proportion of the total budget.

The proposed model has been informed by the recent thinking on the architecture of a future CAP (such as the proposals by Bureau and Mahé (2007), the policy scenarios used within DG Agriculture's recent Public Goods study (Cooper *et al*, 2010), the recent blueprint for a future CAP developed by a coalition of five NGOs (BirdLife *et al*, 2009), the recent paper by Buckwell (2009) for the European Parliament, the paper from the Group of the Progressive Alliance of Socialists and Democrats in the European Parliament (2010), and the outline set out in DG Agriculture's discussion paper on a post 2013 CAP (DG Agriculture, 2009b)).

The model is not intended to be a detailed blueprint for a future policy. Rather it acts as a heuristic device, setting a direction of travel to serve as a means of capturing the key issues in order to frame the subsequent discussion on transitional arrangements.

The model assumes an architecture in which the current two Pillar structure has been subsumed by a horizontally tiered approach. In keeping with the LUPG Vision, the existing direct payments no longer exist within this model. Rather, the model puts the delivery of environmental goods and services at the heart of its rationale as a means of delivering the outcomes identified in the LUPG Vision. It is intended to be a more efficient means of using public money, with funds targeted towards clear objectives and the achievement of specific outcomes. Specifically, it comprises:

- The presence of a regulatory baseline, strengthened with the introduction of new legislation, such as the proposed Soil Framework Directive or future climate change related regulation;
- The provision of area payments focused on encouraging a basic level of sustainable land management across the farmed landscape, referred to as Stewardship payments;
- The provision of supplementary top-up payments for farms or farming systems that are of high social or environmental value but which would be at risk of disappearing without additional support;
- The extension of targeted, tailored support for the enhanced provision of environmental and social goods and services – including both area based payments as well as grants to assist with capital investments to enhance environmental sustainability, for example in new technology;
- Measures to support advice, training and capacity building that are available to all farmers and relate to the implementation of regulation as well as to the management required through incentive payments and training programmes in current best practice and the use of new technologies.

The model does not assume a hierarchy of payments, in that each payment type is independent of others. For example, receipt of targeted support would not necessarily be dependent on also being a recipient of basic stewardship payments. In addition the payments do not assume a particular mode of design or delivery – for example the basic stewardship payments and the supplementary payments could be designed in the form of agri-environment payments (as with the current Entry Level Stewardship, Uplands Stewardship, and Organic Entry Level Stewardship models in England or other basic agri-environment schemes operating in many other Member States) or a much simpler approach could be developed that would incur lower transaction costs.

Unless there is a major change in rural development policy, this proposed new system of support for achieving environmental outcomes under the CAP would need to be accompanied by a wider programme of support for rural economies and communities, helping to encourage farm diversification and to deliver wider economic and social objectives in rural areas. In the short term at least, there will also be a need for significant investment to enhance competitiveness, resilience to climate change and encourage the restructuring of the farming sector in ways which are environmentally sustainable, through support for capital investment, marketing and co-operative ventures, of the type that can be funded currently under Axis 1 of the European Agricultural Fund for Rural Development (EAFRD).

In addition, some form of limited market intervention is likely to continue in order to prevent excess volatility in agricultural commodity prices. However, this should not involve routine intervention and distortion of the normal working of markets. Beyond the CAP framework, there is a continuing need for investment in agricultural research and technical development.

It is beyond the scope of this paper to define these additional elements of the CAP in more detail. The focus is on the possible options to facilitate a shift in the basis of payments away from the current system of direct payments under Pillar 1 of the CAP towards a new system of support focused on the provision of environmental goods and services.

Table 1 Potential model for a future suite of area and capital payments to support the delivery of environmental goods and services as part of the CAP

COMMON AGRICULTURAL POLICY: Area and capital payments to support the delivery of environmental goods and services*	
Advice, Training and Capacity Building	<p>Targeted support for the enhanced provision of environmental services arising from land management – both agriculture and forestry management (in relation to biodiversity, landscape, soils, water, climate change etc). Measures to be tailored to meet the needs of specific areas and targeted at the appropriate geographic scale. To include:</p> <ul style="list-style-type: none"> • Area based payments (i.e. agri-environment, forest environment) • Capital Investment Grants (to aid environmental improvements in relation to farming, forestry or processing and marketing of food and forestry products)
	<p>Supplementary payments for those systems or farms that are known to be of environmental value and which are economically vulnerable (i.e. High Nature Value systems, organic farms etc). These will tend to be extensive mixed and livestock farms, predominantly in upland areas, but not exclusively.</p>
	<p>Basic stewardship payments - regionally determined payments to encourage a basic level of sustainable land management across the farmed landscape. Eligibility could be open to all providing scheme requirements are met, or restricted to certain types of farm.</p> <p>Payments would be for basic environmental management – to include options for maintaining the existing environmental resource through the continuation of relevant management practices, as well as environmental improvements through the introduction of specific management options. Options could be determined by farm type/farm system.</p> <p>Receipt of payments would be conditional on adherence to appropriate EU, national and regional legislation as well as a set of additional environmental standards, building on those currently available under cross-compliance. This would include a requirement that all farms in receipt of this payment would be required to manage a proportion of their farm for environmental purposes to ensure a minimum level of maintenance of landscape features/ habitats/ soil functionality / water quality / carbon sequestration etc.</p>
	<p>Regulatory Baseline incorporating relevant:</p> <ul style="list-style-type: none"> • Existing EU and national legislation • Any future EU or national legislation, i.e. proposed Soil Framework Directive, requirements emanating from the Floods Directive etc • Future climate change related regulation, particularly relating to limits on GHG emissions
	<p>* All payments within this model can be independent of one another</p>

Variations in the environmental, social and economic outcomes achieved through the implementation of such a structure would depend *inter alia* upon the following variables:

- The scale of the **overall budget transferred** from direct payments into the new system of support payments based on environmental criteria (rather than other rural development measures, for example);

- The nature of the **allocation criteria** for allocating the available budget between different Member States;
- The relative **weighting given to the different elements** within the model and therefore the relative distribution of financial resources between the different types of support available;
- The **degree of co-financing** required for the different types of support;
- The degree of **subsidiarity** provided to Member States in choosing how to implement the new support schemes, including issues relating to targeting, eligibility etc.
- The **design** of the different types of support (i.e. targeted agri-environment models in contrast to simpler approaches), including the level of payments and their associated transaction costs.

The range of factors influencing these variables and their implications for the future CAP and the transitional arrangements that will be needed are set out in Box 1.

Box 1 Key Variables Affecting the Implementation of the Proposed Model

Overall Budget Transfer to the new model of support. Simply combining the current EAFRD budget with the budgetary ceilings for Pillar 1 direct payments, originally calculated on the basis of historic production levels, does not necessarily represent optimal levels of public expenditure under the new system. Whilst both environmentalists and rural development interests can argue that the costs of meeting environmental needs and priorities are sufficient to justify a budget of this size, or even greater, equally there are demands to reduce the CAP budget and to allocate resources to other priorities. Clearly the level of resources transferred into any new support structure, as well as the allocation of future resources between payments for environmental goods and services and other priorities (especially other rural development measures), will be a key determinant of the scale of the economic, social and environmental impacts of a switch in the basis of payments and will therefore affect the nature of the transitional options required.

Budget Allocation Criteria. Equally, the nature of the criteria for allocating the budget between Member States will affect the level of budget available for distributing between the different elements of the new model of support.. The scale of change from the existing budget allocations (both for Pillar 1 and Pillar 2) will differ depending on the allocation criteria used but will inevitably lead to a redistribution of funds between Member States. This will impact on the level of expenditure transferred from the current system of support to the new types of payments and schemes that would be developed by Member States and will also lead to a redistribution of funds between different categories of farms within Member States, with implications for the transitional arrangements needed.

Weighting given to Different Elements in the Model. Within the new system of environmental support there is flexibility to vary the allocation of expenditure between different types of payment. The balance of expenditure, for example between area payments designed to secure basic levels of environmental management, and more targeted payments and investments linked to the management of specific features or practices, as well as the proportion of the budget allocated to advice and training and to investments in environmentally sustainable infrastructure, will affect the economic and environmental impacts of the proposed reform. It will affect the degree to which payments are spread evenly across the agricultural industry or concentrated on particular sectors or types of holding. We might also expect differences in the income effects of different payments, and the degree of agricultural and environmental change they achieve. Again, the weighting of expenditure between different elements of the new model could be set at EU level or by Member States

according to subsidiarity, or the Commission could specify guidelines for the minimum proportion of the budget to be allocated to each element (as is the case for the various measures under EAFRD).

Co-financing. Co-financing is a significant consideration in the transfer of funds from direct payments to a system of support focused on the provision of environmental goods and services. Under the current system direct payments are 100% financed by the EU, while EAFRD measures are co-financed by the Member States. If, as is often assumed, payments for achieving environmental outcomes under the new model require co-financing at present levels, the additional national financing that would be needed as a result of the transfer of resources from Pillar 1, would place significant budgetary demands on Member States as well as increasing the total level of overall public spending on the policy. Maintaining current co-financing rates, but reallocating only a proportion of the current budget for direct payments to the proposed new model for support would limit the overall budget, but would benefit net contributors to the CAP budget at the expense of net beneficiaries. An alternative, potentially less contentious solution would be to reduce required rates of Member State co-financing of the new support payments, or to require different rates of co-financing for the different types of support provided under the new model – for example allowing basic stewardship payments to be fully financed by the EU, while requiring co-financing for other measures, or vice versa. Given the reluctance of many Member States to commit additional national resources to the agricultural sector, care would need to be taken that such provisions did not make some measures less attractive than others to Member States.

Subsidiarity. The degree of national and regional discretion allowed for determining the overall allocation of budgets between the different types of payments under the new model will be a key determinant of the economic, social and environmental impact of the reform package. It will also be a key influence on transitional arrangements. The more responsibility Member States are given in the allocation of payments, the more variation there will be in the design, focus and subsequent impact of support provided to farmers across the EU-27, and the more Member States will need to be given the flexibility to determine how the new payment system is phased in over time.

Payment Design. The design of the new support payments and the basis on which they are calculated will also be key determinants of their subsequent impact. A key issue will be the degree to which the design and implementation of payments is subject to detailed rules at EU level, and what the basis for such payments is – for example, whether all or just a proportion of payments will need to adhere to EU rules regarding costs incurred and income foregone. The fact that the provision of environmental goods and services would be the core rationale for the majority of spending under the CAP, might suggest that some of these rules need to be reconsidered. For example, there may be a greater focus on the need to maintain farming systems where environmentally beneficial management practices predominate by enhancing the ability of such systems to support a viable income, and focusing less on payments that aim to make the desired management practices as profitable as those that would be implemented if an individual were maximising their income from the farm. In broadening and mainstreaming environmental support measures, there will also be pressure to minimise transactions costs. The design of the new payment regime will clearly affect its impacts and the challenge of transition.

3. IMPLICATIONS OF CHANGING THE BASIS OF CAP SUPPORT

In order to inform the identification and subsequent assessment of potential transitional arrangements for shifting the basis of payments towards the new model of support, it is first

helpful to consider the likely economic, social and environmental implications of the model defined in Section 2.

This section starts by providing a short review of the current implementation of Pillar 1 and Pillar 2 of the CAP and then sets out the economic conditions that are likely to face the agriculture sector during the transition period. The likely impacts of moving towards a system of support based on the provision of environmental goods and services for farm incomes, structures and land management practices are then considered as well as the redistribution of expenditure between and within Member States.

3.1. Overview of the Current Application of the CAP in the EU-27

Progressive reforms of the CAP since the 1980s have shifted expenditure away from market support measures towards direct payments, most of which have been progressively decoupled from production since 2005 (see Annex Figure 1). Expenditure on rural development measures has increased gradually over this period. However, direct payments still account for almost 70% of the CAP budget, and rural development measures little over 20% (including modulation, but without national co-financing). This indicates the proportion of payments that would be affected by a shift in rationale if the model for the future of the CAP set out in this paper became a reality.

Following the 2003 CAP reform, some direct payments for certain types of crops and livestock remained coupled to production in some Member States. DG Agriculture (2009b) calculated that, by 2008, 85% of support had been decoupled from production. There has been significant variation in the degree of decoupling by Member States. For example, in 2006 the proportion of coupled payments was 25% in France and Spain, close to zero in Germany and the UK, but exceeded 60% in Cyprus and Malta. By 2013, it is estimated that decoupled payments will account for 92% of all direct payments, with coupled payments remaining predominantly in the suckler cow, goat and sheepmeat sectors (DG Agriculture, 2009b).

The EU-15 Member States were given considerable flexibility in how they could allocate direct payments between farmers. In nine Member States and Scotland and Wales in the UK, the direct payment was granted on an historic basis, in other words, payments were linked to the production levels and related claims in a particular base year. Other countries adopted a regional model whereby payments gradually moved towards the same per hectare payment across a given region over a set transition period (four Member States and England). In the remaining EU-15 Member States, intermediate solutions were put in place. Malta and Slovenia apply the regional model under the Single Payment Scheme, and the ten remaining new Member States apply the transitional Single Area Payment Scheme (SAPS) which is only available for a limited period.

Modulation was introduced in 2003 to redistribute funds between the two pillars. Modulation involves a cut in direct payments for all farmers receiving direct payments above €5,000, with the corresponding amounts channelled into the rural development budget. The size of the cut in direct payments has been progressively increased since its introduction, and will be at least 10% by 2013, with higher rates applying to those in receipt of higher annual direct payments¹.

¹ 'Progressive modulation' was introduced as part of the CAP Health Check agreement in December 2008, whereby farmers in receipt of more than €300,000 of direct payments per year are subject to higher rates of modulation.

The proportion of CAP expenditure allocated under Pillar 1 and Pillar 2 varies significantly between Member States, reflecting past patterns of production as well as national preferences and payment histories. In general, rural development measures represent a higher proportion of total CAP expenditure in the newer Member States, where expenditure is almost evenly split between Pillar 1 and Pillar 2 payments. By contrast, on average, rural development expenditure only accounts for approximately 20% of total Pillar 1 and Pillar 2 expenditure in the EU-15, although Pillar 2 expenditure can be significant in some Member States, for example Austria and Portugal (see Annex Table 1).

Furthermore, there are also wide variations in the application of rural development support between the four axes of Pillar 2. On average, measures under Axis 2, particularly the agri-environment and the natural handicap measures, account for the largest proportion of overall planned expenditure under the EAFRD. These are the measures that are most similar to the types of payments that would be eligible for funding under the new model of support. However, this masks some significant differences between Member States, with less than 30% of the total budget allocated to these measures in Romania and over 70% in Ireland, Finland, Austria, the UK and Sweden.

This suggests that giving Member States the freedom to choose how to reallocate direct payments between the different types of payments available under the new model – for example between basic stewardship payments, more targeted payments, capital investments, advice and training - might lead to significant variations in levels of environmental expenditure, unless minimum spend requirements were put in place as is currently the case under the EAFRD.

Payment rates per hectare also vary significantly between Member States. Average direct payments in the EU-27 are estimated to be €266 per hectare, ranging from an average of €83/hectare in Latvia to €544/hectare in Greece (see Annex Figure 3). The average per hectare Pillar 1 payment is almost double the average Pillar 2 expenditure per hectare (including national co-financing) for the 2007-13 programming period (see Annex Table 2). This ratio differs considerably between Member States. Within the New Member States, average per hectare payments under Pillar 2 are generally higher than those under Pillar 1, once national co-financing is taken into account, whilst the inverse is true in the EU-15.

Article 68 of Council Regulation 73/2009 currently gives Member States some flexibility in the way they spend direct payments by allowing them to divert up to 10% of the national ceiling of Pillar 1 payments into national envelopes, which can be used for a variety of purposes. The majority of Member States have chosen to make use of this mechanism, in contrast to the use of Article 69 of Council Regulation 1782/2003, its less flexible predecessor. However, while the majority of Member States propose to use it to introduce sector specific payments, especially to support ongoing production in the dairy sector, a number, (e.g. Italy, Portugal, Denmark, Spain and France) are intending to use it to introduce new agri-environment type measures or to introduce payments to support specific types of production which are important for the environment, notably organic farming or extensive grazing (for example Ireland, France, the Netherlands, Poland, Portugal and Finland). The ways in which Member States are proposing to use Article 68 are set out in Annex Table 3. The use of Article 68 for environmental purposes may provide some indication of which Member States might be more receptive to a future system of support focused on the provision of environmental goods and services.

In 2008 Pillar 1 direct payments represented just over 30% of aggregate farm income for the EU-27, albeit with a wide variance between Member States, reflecting differences in the type of agricultural production and the structure of the farm sector (see Annex Figure 4). This

illustrates the importance of direct payments for farm incomes in many Member States, with implications for the types of transitional options that would be necessary to facilitate a shift towards the new model of support.

In several key categories of agriculture extensive farms tend to be far more dependent on Pillar 1 direct payments, and therefore more economically vulnerable if these payments were to cease, than intensive farms. For some extensive farm types, especially grazing livestock farms across the EU-27 and extensive mixed farms in the EU-12, overall support, from both Pillar 1 and Pillar 2, exceeds farm income from sales to a very significant degree (Osterburg, unpublished).

3.2. Economic Conditions during the Transition Period

The effects of a transition away from direct payments towards a system of payments focused on achieving environmental outcomes needs to be considered against the likely conditions affecting agriculture during the 2013 to 2020 period. Clearly we would expect dependence on direct payments, as a means of supporting incomes, to be greater the more challenging the economic conditions facing agriculture, while the transition away from them is likely to be eased if conditions are more benign. Key exogenous factors likely to affect farm incomes over the period include agricultural commodity and input prices, trends in consumer demand, technological innovation and further liberalisation of world trade. The outlook is characterised by a degree of uncertainty, particularly in relation to the degree to which the ongoing financial and economic crisis will impact upon the sector (DG Agriculture, 2009a).

Agricultural commodities saw a significant spike in prices in 2007 and 2008 as a result of a combination of factors including poor harvests, low stocks, the weakness of the US dollar, high energy prices affecting the costs of inputs, population and economic growth in developing and transitional economies, and increased demand for biofuels (HM Government, 2009). Prices have since fallen. Indeed, the economic crisis has led to a decrease in output prices and higher input costs, which have led to cumulative income losses for EU farmers in 2008 and 2009, equivalent to the cumulative income gains from reforms since 1994 (Haniotis, 2010). However, projections from the OECD (2009a) and the European Commission (DG Agriculture, 2009) suggest that prices will strengthen with economic recovery over the medium term.

The general outlook for agricultural commodity prices over the coming decade is for higher average prices than in the previous 10 years, but below recent peaks. Prices are expected to respond to trends in demand for different commodities (for example, the growth in global food demand and the likely expansion in demand for biofuels) as well as the increasing scarcity of resources as a result of climate change (Tangermann, 2010b).

Looking ahead to 2017, the OECD (2008) expects the average level of world wheat and coarse grain prices to remain higher than in 2005, but well below levels in 2007-2008. Average prices are expected to increase as a result of rising global demand for food, while ongoing volatility, for example in response to weather and harvests, can be anticipated. A similar outlook is envisaged for the EU, although cereal prices are likely to be subject to greater fluctuations than in the past (DG Agriculture, 2009). In relation to the livestock sector, dairy prices are expected to decline in the short term, with some recovery in the medium term, but no growth in meat prices is forecast in real terms over this period, with prices for beef, pigmeat and poultry expected to decline. In terms of production, an increase in the output of pigmeat and poultry alongside declines in the production of sheep and beef are anticipated within the EU to meet changes in consumer demand. Following a short term contraction of production in the dairy sector, this is anticipated to recover in the medium

term, albeit below quota levels. As a result the abolition of dairy quota is not projected to have a significant impact on dairy prices or production levels (DG Agriculture, 2009)

The outlook for agricultural incomes is positive for the EU-27, with aggregate income in real terms and per labour unit forecast to increase by 7.5% by 2015 compared to 2007. Much more significant increases are predicted in the EU-12 than the EU-15 due to the continued increases in direct payments being phased in to the EU-12 Member States over this time period.

In general, therefore, moderately favourable market conditions are anticipated over the period following the 2013 CAP reform for most sectors, which should help to facilitate the transition away from Pillar 1 direct payments. The main sector that is likely to experience economic difficulties appears to be the beef sector as a result of declining consumer demand for beef and imports from outside the EU. Nonetheless, the removal of direct support is still likely to present challenges for much of the farming sector, particularly those sectors where direct payments form a considerable proportion of farm income.

3.3. Predicted Economic, Social and Environmental Impacts of Changing the Basis of Payments

It is beyond the scope of this paper to forecast the effects of the shift towards the model proposed in Section 2 in any detail, especially as it is only broadly defined and there are many variables which will affect its impact. However, the shift towards new payments linked to the delivery of environmental outcomes, will have implications for the distribution of the CAP budget between Member States, regions and farms, with impacts on farm incomes, production and farm structures, which themselves will influence shifts in land use and land management practices, as well as impacting on rural social dynamics.

The exact effects of this shift in the basis of payments will depend on the way in which the new system of support is designed, financed and implemented (see Section 2), with potentially significant variations being experienced between different Member States and regions. Clearly the greater flexibility that Member States have in determining the distribution of the budget between the different types of measures and payments, the greater will be the variations in impact. For example, some Member States may choose to allocate a large proportion of the available budget to basic stewardship payments, in an attempt to maintain support distributed across the majority of farmers, whereas others may choose to devote more resources to supporting specific types of farming, such as high natural value farming systems, or more demanding environmental schemes. Geographical variations in implementation, and therefore impact, would be reduced if there are more elements laid down at the EU level, such as a uniform payment level or fixed tiers for all farms (e.g. a common basic area payment) or detailed EU guidelines (e.g. on the percentage of budget allocated to different types of payment).

It is assumed, for the purposes of this paper, that the overall level of agricultural spending does not increase in the period up to 2020, despite the possibility in theory that the level of overall agricultural spending would rise if most or all of the new payments were required to be match funded by Member States, as under the current rules applied to Pillar 2.

It is interesting to note that results of the recent Scenar2020 II study (Nowicki *et al.*, 2009), which looked at the impacts of a range of future policy scenarios on the agricultural sector suggest that *“the differences in CAP and trade policies have more effect on agricultural income and the number of farms than on agricultural production and land use. Land prices and, to a lesser extent, agricultural wages play a key role in absorbing the negative impact of*

changes in the CAP and trade policy on the agricultural sector and rural areas and contribute to mitigating the fall in production levels.” In addition, a comparison of the way that the agriculture sector has reacted to liberalisation in a number of OECD countries (OECD, 2009b) concluded that, in practice, the agriculture sector often adapts to the removal of agricultural support better than is initially anticipated, either through increasing its efficiency or by producing higher quality products or experimenting with different products for the market. This will have implications for the nature, design and duration of transitional options.

Some of the potential economic, social and environmental impacts that might be anticipated are set out below.

Budgetary Redistribution between Member States/Regions

The proposed shift in the basis of payments is likely to see a redistribution of the CAP budget, away from regions of high productivity and towards areas of higher environmental value. In principle, the reformed system should encourage and reward environmentally beneficial practices in all areas, including those of greatest productivity. However, the current distribution of Pillar 1 direct payments, based on compensation for cuts in market price support, continues to be linked largely to patterns of historic production although with variations between Member States. There will be little logic in retaining this distribution of support in a reformed CAP that is refocused on environmental objectives. The new system is likely to involve a more equitable distribution of support payments according to criteria such as agricultural area, the environmental assets and needs within an area (for example the proportion of priority habitats or species; nationally or regionally important landscapes; High Nature Value farmland; priority catchments for water quality; potential for carbon storage etc) or the degree to which the land suffers from natural handicaps (such as poor soil quality, steep slopes, difficult climatic conditions etc).

Some indications of the likely redistributive effects of such a change can be derived from various studies that have been undertaken in recent years. Estimates of the redistributive effects of simply converting the current Pillar 1 direct payment budget into a uniform flat rate per hectare payment across the EU-27 indicate that the largest net beneficiaries on a per hectare basis would be Latvia, Romania, Estonia, Lithuania and Bulgaria, with the largest losers being Greece, Malta, the Netherlands, Belgium and Cyprus (Buckwell, 2008; Thurston, 2008). The main sectors that would be likely to benefit would be those that had low levels of CAP payments in the base period (the period over which the levels of direct payments were calculated), for example, fruit and horticulture, and lead to significant payment reductions in the intensive beef, dairy and cereal sectors.

However it is unlikely that the criterion of area of agricultural land alone would reflect the provision of environmental benefits at all adequately. Clearly, once a wider range of criteria are taken into account, then the redistributive pattern changes significantly. For example, a working paper by ECIPE (Zahrnt, 2009) considers the impact of criteria such as agricultural and forestry areas as well as the area of land designated as Natura 2000 and area of land under organic farming for reallocating budgetary resources between Member States. He forecasts that a refocusing of CAP support, using these criteria under a ‘progressive’ scenario², would result in a shift in the distribution of the budget towards Sweden, Finland, the Baltic countries, Spain, France and the UK, at the expense of those Western European

² Under the ‘progressive scenario’ agricultural area and GDP/capita are given a greater weight than the current distribution of Pillar 1 payments (2/3:1/3) in determining the allocation of budgets between Member States.

countries that have benefited most from previous systems of support. The picture for the Central and Eastern European Countries (CEECs) is mixed, with many seeing average payments reducing slightly under this situation, largely due to the fact that Pillar 2 already accounts for a higher proportion of the total CAP budget than in many of the EU-15. Average expenditure per hectare of UAA under Pillar 2 is already significantly higher in the CEECs than in other Member States.

It is clear that the scale and nature of the redistributive effects of any future system of support will be dependent on the allocation criteria that are chosen for distributing the budget across Member States. While there is likely to be a considerable redistribution of support towards the Central and Eastern Member States if more environmental criteria are adopted, equally the budget reductions predicted in Northern and Western Member States may be cushioned to some extent by the increase in the availability of funds for environmental purposes, given their current low Pillar 2 budget levels. This is an area where more detailed analysis is needed.

Changes in the Distribution of Support between Farms

Under the current system of support it is the larger, more productive farms in the EU-15 that receive the vast majority of Pillar 1 direct payments, given the historic basis of the majority of payments. Changing the basis of payments to one based on environmental criteria would be likely to lead to a shift in the distribution of support away from intensive arable, livestock and permanent crop producers to favour extensive farming systems.

Changes in Average Farm Incomes between Farm Sectors

In the long term, it is not anticipated that there would be any significant fall in farm incomes across the agricultural sector as a whole as the basis for payment shifted from one based on income support and largely related to historic production patterns, towards payments focused on achieving environmental outcomes. Over time, there would be a process of adjustment in asset markets, whereby land prices and costs of other agricultural assets and inputs would adjust to the new policy situation, thereby reducing the impact on farm incomes. In the short term, however, reductions in farm incomes would be experienced as a result of the removal of direct payments, which could accelerate existing trends in structural change. This would be an important issue for a transition strategy to address.

Impacts on farm incomes will vary between regions and sectors as a result of the change in the distribution of support between farm types and regions, depending on the way in which the new payments are calculated, the stringency of environmental conditions, the distribution of the budget between the different tiers and management prescriptions and the degree to which farmers are willing to embrace the new system of payments.

Farmers will be compensated for the additional costs resulting from the environmental management requirements of the new system. However, there are questions about how far such calculations would take account of the removal of direct payments and the level of fixed as well as variable costs, especially on less profitable and generally more extensive farms where margins could be particularly affected by the switch in support. The degree to which more productive farms are affected will also depend on the degree to which they decide to engage with the new system and can gain entry to environmental schemes. For all farmers the formulation of the new schemes and the extent to which they are aimed at a wide spectrum of producers or a more selected group would be a critical issue.

A Change in the Pattern of Agricultural Production

A change in the basis of support will undoubtedly have an impact on the pattern of agricultural production between sectors and regions. The nature of these impacts will be affected by the design and subsequent implementation of the new model of support in different Member States and regions of the EU-27 as well as changes in commodity and input prices.

Recent modelling work carried out by Janssen (2010) using the CAPRI³ model, demonstrates what the effects of removing Pillar 1 direct payments would be on production in the arable and livestock sectors if no changes were made to the current Pillar 2 budget. This indicates that there would be a reduction in the overall agricultural area, with a concentration of production in the more productive areas. In relation to the arable sector, the extensive arable areas would be most affected, while the more intensive production systems tend to be insulated from significant impact. Indeed, on more productive land there is likely to be a tendency to cease to produce less profitable crops, combined with a shift towards higher yielding crops that are able to provide better market returns. This may well lead to an increase in cereal yields in some areas. In relation to the livestock sector, reductions in production are likely to be witnessed predominantly in the suckler cow sector, given that a significant proportion of coupled support currently remains in this sector. Increases in prices of feed concentrate are also forecast and this may lead to declines in the pig and poultry sector.

However, the introduction of the new system of support payments should help to counterbalance some of these impacts. Under the proposed model, it is anticipated that a greater proportion of support will be available to support extensive arable, livestock and mixed systems. If payments to such farming systems are sufficiently attractive, recognising the full opportunity costs of farming in less productive areas, then there should be less likelihood of such land leaving production. Equally, the requirement to manage a proportion of the farmed area for environmental purposes may lead to the conversion of a small proportion of land to other habitats and farmland features, which in turn will lead to some localised reduction in production levels. However, this is unlikely to lead to any significant reduction in overall levels of production. More likely is that it would lead to a re-evaluation of the crop composition on farm, and either constrain the substitution of lower yielding crops with higher yielding alternatives or varieties or focus on increasing yields from the remaining productive area.

Ultimately it is anticipated that the proposed change in the basis of support should provide a policy framework that constrains significant levels of land abandonment and promotes more sustainable food production within environmental limits, particularly within areas of medium to low productivity. In more productive areas, such a shift should also help to improve the sustainability of production, but the extent to which this is possible will be predicated on the attractiveness of the new model of support in relation to potential returns from the market that would be possible by staying outside the support system. The enhanced regulatory baseline proposed in the future model of support, which would include some additional climate related requirements, would also help to ensure basic levels of environmental protection across the farmed countryside, as long as these were adequately enforced.

³ The Common Agricultural Policy Regional Impact (CAPRI) model is a partial equilibrium model which is used to model the economic impacts of changes in policy on the agricultural sector.

Structural Change Constrained for some Sectors and Regions

Any change in farm incomes is likely to precipitate some form of structural change. Structural change is an ongoing process that is occurring at different rates in different parts of the EU-27 as a result of broader macro-economic drivers and these trends will continue. Current trends predict a continued decline in the number of farms and this decline is likely to be more pronounced in the EU-12 as agriculture declines as a proportion of total income and employment (Nowicki *et al.*, 2009). Under the Scenar2020 II liberalisation scenario⁴, (which in contrast to the new model of support proposed in this paper, also removes market support measures), an accelerated decline in farm numbers is anticipated by 2020. Overall predictions were for a reduction in farm numbers of one third in the EU-27, with a 25% reduction in the EU-15 and a 40% reduction in the EU-12, much faster than the present rate of decline.

The impact of restructuring will differ between farm types and regions, depending on the economic and social pressures they face. It is predicted that there will be particular pressure on the mixed crop and mixed livestock sectors, with suckler cow enterprises particularly affected by the removal of direct payments, which continue to be coupled to production in many Member States.

As described above, the introduction of a new system of payments focused on achieving environmental outcomes may help to slow down the rate of structural change that is already predicted under current policy and economic conditions, and should avoid the accelerated reductions that are anticipated under the Scenar2020 II's liberalisation scenario. In particular, the new payment system should help to reduce the pressures facing smaller, more extensive producers. However, the extent to which this is the case will be dependent on the payments available to farmers in terms of the payment rates, the overall budget available, and the way in which this is apportioned between the basic environmental payments and more demanding options.

An Increase in Environmental Management Activity

The new system of payments should bring about an increase in environmental management across the farmed landscape. Demand for participation in agri-environment schemes in many Member States outstrips the available budget, and limited budgets also constrain the options available to land managers under such schemes. This is demonstrated by Member State proposals and justifications for their use of the additional funds available within their RDPs as a result of the 2008 CAP Health Check (DG Agriculture, unpublished). In light of this, a new model of support focused on the provision of environmental goods and services should lead to an increase in the area under environmental management, as well as an increase in more demanding management activity, such as the re-creation and restoration of wildlife habitats and farmland features. The findings of evaluations of the existing agri-environment and LFA schemes would imply that, if the payments offered are well designed and targeted, this should lead to improvements in the state of the environment across the board, in relation to landscape diversity, biodiversity, water quality, soil functionality, carbon storage, greenhouse gas emissions and increase the ability and resilience of habitats and species to adapt to climate change (EPEC, 2004; Oréade-Brèche, 2005; IEEP, 2006, Kleijn *et al.*, 2006; CSL and CCRI, 2008; Natural England, 2009).

⁴ The liberalisation scenario under the Scenar2020 II consists of a removal of all market support measures, all direct payments and a 100% increase in the Pillar 2 EAFRD budget

The way in which the new support system is designed and the payments calculated will have a bearing on the extent to which such improvements are experienced, especially in more productive areas where the payments, and the conditions attached to them, will need to compete with market prices for key commodities. Indeed, the picture is unlikely to be positive in all areas. For example, if there is an increase in the production of highly productive arable crops in particular areas, where the new system of payments may not be attractive, this could lead to some localised increases in the levels of nitrates and phosphates in water courses from increased fertiliser and pesticide use to increase yields.

Overall Impact

It is clear that there will be winners and losers from the shift in the basis of payments towards a model coherent with the principles set out in LUPG's Vision (see Section 2) at both the farm level and regional level. It is difficult to be specific about the impacts as these will depend on the degree of redistribution of budgets between Member States; the approach to co-financing; the degree of subsidiarity in implementing the new policy; the basis on which the payments are calculated, and the degree to which Member States and regional authorities choose to alter the balance of payments between different regions, farming systems and types of environmental scheme.

It seems likely that, in areas where extensive systems predominate due to natural conditions, the anticipated increase in the environmental benefits secured will be achieved through a range of support to encourage the sustainable management of the land that also helps to bolster farm incomes, maintain extensive production and constrain large scale structural changes. The impact on more intensive farming systems and productive areas will be more mixed. The extent to which environmental outcomes are achieved in these situations will depend on the scale of uptake. This in turn will be predicated on the attractiveness of payments and their associated requirements and conditions, compared to the returns from the market that would be possible by staying outside the support system. There will also be changes in the dynamics of rural economies, with the possibility of some decline in the demand for, and hence prices of, agricultural inputs. However, this will be accompanied by increased demand for the skills, equipment and materials needed for carrying out environmental management activity, which in turn benefits suppliers and contractors.

Given the significant potential impacts of these changes, the design of transitional arrangements will be important. Political resistance to progressive and redistributive reforms of this nature will also be inevitable, and transitional measures will need to address this.

4. MOVING TOWARDS A FUTURE CAP – DEVELOPMENT AND DESIGN OF TRANSITIONAL ARRANGEMENTS

This section sets out a number of different options for shifting the basis of payments under the CAP over the period 2014-2020 from direct payments towards a new model based on supporting the provision of environmental goods and services. The aim of transitional arrangements is to provide the agricultural sector with an element of economic stability, avoiding any sudden shocks that might endanger the ongoing viability of those farms and farming systems that are important for the environment, alongside achieving environmental improvements across the agricultural sector as a whole. In proposing various transitional options, we are mindful of the statement in the LUPG vision that *"any income support retained in the short term should be targeted, with conditions, on those farming systems*

making the greatest contribution to the management of environmental services for the benefit of society.”

Various options are available to facilitate the adjustment towards the new system of support proposed in this paper. Though these may differ in the detail of the mechanisms employed, they are broadly similar in the sense that they all involve a range of variants in order to facilitate:

- Shifting the basis of payments away from direct payments and towards payments rewarding the provision of environmental services alongside a range of other rural development measures;
- Increased investment designed to enhance the sustainable competitiveness of the agricultural sector, thereby improving its ability to adapt to a system of support focused on achieving environmental outcomes;
- The allocation of increased budgets for the provision of environmental goods and services between different types of payment and different geographical areas. This may involve the broadening and deepening of existing agri-environment schemes and/or the introduction of new forms of incentive or grants;
- Reallocation of resources between different Member States.

In addition there are a number of principles that need to be applied to any public payments, and these apply to the transitional arrangements as well as to the new system of support. Payments should be:

- Predictable;
- Easy to manage, without creating an unreasonable administrative burden;
- Decoupled from production, although payments may be focused on particular farming systems where these are critical for the provision of public goods; and
- Consistent with other EU policies and WTO rules, and not subject to legal challenge.

The range of potential options that are considered in this section are set out in Box 2.

Box 2 Range of Transitional Options Considered

Option 1: Switching the basis of payments over time	Option 2: Variable Transition	Option 3: Bond Scheme	Option 4: Counter-Cyclical Payments
A simple shift in the basis of payment from direct payments to the new model of support over four different timeframes (7 years, 4 years, 12 years, immediate)	Similar to Option 1 but with different rates of transition for those farms producing lower economic returns but whose continuing existence is important for the environment than those applying to farms producing higher economic returns	Phase out direct payments by capitalising payment entitlements into a bond which can be freely traded. Phase in new model of support as for Options 1 and 2.	Replace, or supplement a reduced level of direct payments with counter-cyclical payments so that payments are only made if the price of a commodity falls below a certain price. Phase in new model of support as for Options 1 and 2.
<p style="text-align: center;">Other measures to accompany Options 1-4</p> <ul style="list-style-type: none"> • 'Orange Ticket' Cross Compliance • Early Retirement Measures <p style="text-align: center;">Use of national envelopes (Article 68 measures)</p>			

To set the transitional options in context, it is helpful to summarise the key changes that would arise in the CAP support system from the proposed shift in the basis of payments.

Table 2 provides a condensed comparison of the current system with the situation in 2020 if the new model of support focused on environmental outcomes were introduced.

Table 2 Comparison of the existing system of CAP support with the proposed new model.

	Starting Position (2013)	End Position (2020)
Size of Budget	CAP comprises 42% of total EU budget	CAP budget remains broadly unchanged.
Focus of Budget	The majority (65-70%) of the budget is allocated to direct payments under Pillar I. Rural development measures account for 20-25% of the CAP budget (excluding national co-financing)	Support focused on the provision of environmental goods and services accounts for a large proportion of the budget. Measures to support the socio-economic infrastructure of rural areas will also exist as well as a small level of expenditure for applying limited market intervention measures. Member States have some discretion to determine the balance between these different elements of the CAP to reflect

		their specific circumstances.
Allocation of Budget between Member States	Budget allocation largely reflects historic production levels, with western Member States receiving a greater proportion of the budget. Pillar 2 budget allocations between Member States largely influenced by historic spend.	Budget distribution likely to reflect a combination of criteria, such as agricultural area, environmental assets and natural handicaps.
Environmental requirements	Direct payments are subject to limited environmental conditions through cross compliance; and agri-environment and other incentive schemes reward management that goes beyond this 'reference level'.	Basic stewardship payments reward general standards of environmental management; the regulatory baseline will go beyond the current suite of cross compliance conditions. Higher levels of environmental benefit are provided by additional, more targeted incentives and grants.
Basis for payment	Direct payments reflect historic levels of production, as well as base area of eligible hectares.	Likely to involve basic area payments as well as higher levels of payment for achieving specific environmental outcomes, reflecting the full opportunity costs of undertaking the management required.

The four possible transitional options are set out below including a discussion of their relative advantages and disadvantages.

4.1. Option 1: Switching the Basis of Payments

Option 1 involves four different variants which differ in the timescale over which the shift in the basis on which payments are made would take place. Option 1a represents a medium term, seven year transition period; Option 1b looks at what the implications might be of a more rapid four year transition; Option 1c considers a longer transition period of 12 years; and Option 1d outlines the issues surrounding an immediate switch with no transition period. The relative advantages and disadvantages of the different options are discussed at the end of the section.

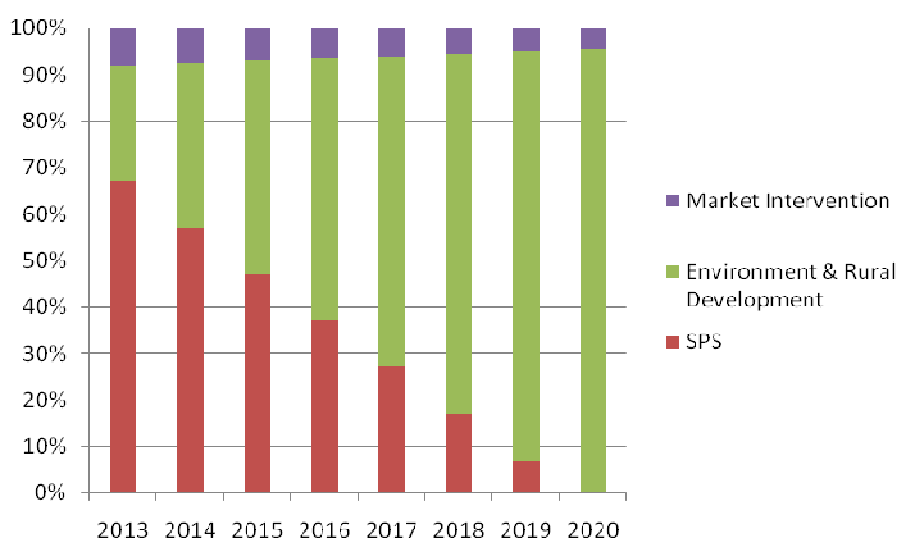
Option 1a: Medium Term Transition

This option would involve changing the basis of payments over a 7 year period, effectively the duration of the 2014-2020 programming period. For example, this could be achieved by reducing the value of direct payments, as currently calculated, to 85% of 2013 levels in 2014, 70% in 2015, 55% in 2016, 40% in 2017, 25% in 2018 and 10% in 2019 and reallocating the funding that was made available to Member States to be distributed according to the new system of support with a focus on environmental and other rural development outcomes. Over the same period the proportion of the budget allocated to market intervention payments would also be reduced. It is proposed that there is a requirement for a proportion of the redistributed funds to be allocated over the short term to investments in measures designed to promote the sustainable competitiveness of the

farming and forestry sectors. The remainder of the funding would be used to phase in payments focused on the provision of environmental goods and services until the desired distribution of the budget was achieved in 2020.

This would involve a gradual reallocation of resources between Member States to accommodate the new payments, based on a revised set of criteria that were in keeping with the purpose of the new system (for example area of land under different land uses, specific environmental criteria etc). Cross-compliance conditions would continue to be applicable under the system of payments and could be reinforced by new conditions, for example those relating to climate change.

A simple illustration of the change in the distribution of CAP payments between direct payments and a more environmentally focused system of support and investment is given in Figure 1.



Source: IEEP calculations

Figure 1 Illustration of Changes in CAP Support under Option 1a

Option 1b: Accelerated Transition

This is similar to Option 1 but involves a more rapid phasing out of direct payments over four years rather than seven. This could involve reducing payments to 75% of 2013 levels in 2014, 50% in 2015, 25% in 2016 and zero in 2017, for example.

Under this option, it is envisaged that a higher proportion of the CAP budget would be used for funding investments in sustainable competitiveness in the early years, with a slower expansion of environmentally focused payments. This would facilitate the structural changes needed to enable farmers to make improvements in farm infrastructure and introduce new technologies that will enable them to deliver the environmental outcomes that will underpin the new system of payments.

This option would mean that the basis of payments would shift fully to payments for environmental outcomes by 2017, as well as providing a higher level of funding up front for investment in measures designed to enhance competitiveness and aid restructuring in an environmentally sustainable way.

Option 1c: Longer-Term Transition

The third option involves a longer-term phasing out of the Single Payment Scheme and its replacement by the new system, with SPS finally being removed by perhaps 2025. The new system of payments focused on achieving environmental outcomes would be phased in over this period. The effect would be to permit a much more gradual reduction in current income support payments of around 8% per year. As a consequence the new resources available for environmental and rural development schemes would be significantly reduced in the early years. Transitional investment support would therefore be introduced more gradually than in Options 1a and 1b.

Option 1d: Immediate Switch in the Basis of Payments

Rather than simply phasing out direct payments, Option 1d would involve their immediate conversion into a basic stewardship payment, as the type of payment with the simplest, and most universal environmental requirements under the new model of support. Effectively this would involve an immediate merger of the first pillar of the CAP with the land management payments of the second pillar and could be achieved by establishing new environmental eligibility criteria and conditions to replace the current system of cross compliance, and reframing the payments to reflect their status as new area-based stewardship payments for environmental management. Initially, under some form of pre-eligibility phase, payment rates for those farmers who met the environmental eligibility criteria, could be set at the rate of the direct payment in 2013.

The transitional process would then focus on two aspects. Firstly, over the transition period there would need to be a gradual reallocation of financial resources between Member States on the basis of a more focused and so legitimate set of criteria, as under Option 1a. Secondly, over time Member States would need to develop strategies to ensure a distribution of funds between payments for the maintenance of the existing environmental resource, more demanding actions needed to restore and recreate habitats or features, and capital investments to improve the sustainability of the farmed environment, in keeping with the needs of the local area and the provision of advice and training. The basis for basic stewardship payments would also need to move away from current direct payment rates to reflect the environmental management and outcomes required.

Advantages and Disadvantages of the Different Variants of Option 1

The main difference between the different options is the rate of the change at which the transition takes place. Harvey (in House of Commons, 2007) suggests that 'sudden, but reliable change will induce rapid and viable responses; gradual change is much more likely to produce mal-adaptations and responses. This is even more likely when there is strong political resistance to the changes anyway, and every effort being made to slow them down or reverse them.' However, while this may be true, there are a number of other factors that need to be considered, not least the social impacts of the transitional arrangements as well as any administrative implications that any change in the nature of the payments may have.

For example, while an immediate or rapid shift to the new system of payments may be appealing in the sense that there would be a clear focus for the payments on delivery of environmental outcomes from the outset, in practice it is likely to be met with considerable resistance from some sectors, institutions and national governments. Such resistance would not be conducive to achieving the aims of the new model, as Member States would be under considerable pressure from domestic stakeholders to design a system of payments that required no significant change from the current system. A longer period of transition avoids sudden shocks to the industry and, as long as the transition period is time limited to ensure that change is not avoided, it gives time for attitudinal and behavioural change to take place

and for advice and training to be made available to explore the economic and social opportunities that a shift towards an environmentally focused support system may offer.

In addition, different speeds of transition would also be likely to impact upon the rate and scale of structural change that would take place, with a faster rate of transition potentially leading to more significant structural changes, not all of which will be environmentally beneficial. A longer period of transition, as proposed under Options 1 a, b and c would allow for funding to be made available to farms for investments that improve the sustainability of their operations, which should help facilitate a more gradual and sustainable process of structural change.

However, it is important that farmers, as the recipients of the support, have a clear understanding of how the payments are to change over time, what the new system of support is going to look like, how it will be implemented, and the timescale so that they can work out the implications for their individual farm business and make decisions accordingly. Too long a transition period is unhelpful as it may delay decision making. In addition, if it goes beyond the seven year period of a financial perspective, then there is an increased likelihood that changes may be made to the overall policy structure, which would have knock-on implications for the transitional arrangements.

One of the major issues with all variants of Option 1 is that of national co-financing. If the resources reallocated to the new model of support were to be subject to similar co-financing rates as at present, this would have substantial resource implications for Member States and could deter use of the EU funds available. Therefore it is likely that reduced, or even zero, rates of national co-financing would need to apply to the budget transferred from direct payments to the new system of support, so that national contributions to agricultural support were not subject to significant increases, which does not appear realistic politically at present.

4.2. Option 2: Variable Transition

The second main option is similar to the various approaches explored under Option 1. However, instead of a steady rate of reduction in income support payments applied across all farm types, this option would involve varying the rates of reduction to mitigate against negative effects on farms producing lower economic returns, but whose continuing existence is important for the environment. It would not be feasible to define this approach on a farm by farm basis, so it would be necessary to identify those broad categories of farms capable of making a rapid transition to the new system of support and those likely to require a more gradual transition. For example, deeper and more rapid cuts could be implemented for more profitable farm categories, with the phasing out of direct payments being more gradual and taking place over a longer time period for lower income categories that are also providing a high level of environmental goods and services.

However, the practicalities of implementing such a transition could be extremely complicated. In particular, given the variance in the profitability of different farm sectors over time, it would be very difficult to define which sectors and which levels of income should be subject to different transitional arrangements to make the system effective and efficient. In addition, while this option might provide a cushion for those land managers farming land that might be at risk from abandonment or intensification without some form of support, it is precisely this type of land for which the new system of support should be most attractive. There is a risk, therefore, that this option might actually slow down, rather than promote the take up of the new forms of support available for the delivery of environmental outcomes.

4.3. Option 3: Bond Scheme

This option would involve phasing out the Single Payment Scheme over a set time period, as in Options 1a, 1b or 1c, but allow entitlements to the payment to be capitalised in a bond which could be traded on financial markets. Those farms eligible for the Single Payment in 2013 would be automatically and unconditionally eligible for a declining proportion of that payment in the subsequent years 2014-2020 in the form of a bond. The value of the bond could decline at a similar rate to those proposed in Options 1a-1c. The entitlement to these payments then could be freely traded. The budget that would be freed up as a result of the degressive profile of the bond annuity payments over time would be transferred to fund the new system of support.

Such a bond scheme has been advocated by various proponents of CAP reform (most notably Tangermann, 1991; and Swinbank and Tranter, 2004), as a means of decoupling agricultural support, not just from production (and indeed from any form of farming activity), but also from land, and giving farmers the flexibility to respond to the removal of income support over time. The new system of support would be phased in over time in the same way as proposed under Options 1a-c. Cross compliance would, therefore, not be compatible with a bond scheme (Swinbank and Tranter, 2004), and would need to be removed. This may not matter, however, as a revised set of regulations and conditions could be introduced in relation to the new system of support.

No additional expenditure would be required from the CAP, aside from any extra costs required for administering the system. The bond would simply constitute a right to a diminishing series of payments over time. The rights to these payments would be unconditional and written into a paper asset which could then be traded on financial markets. As such, the bonds would have a known capital value and be time limited. Thurston (2002) calculated that a bond involving a starting payment of €10,000, declining at 5% per year, and with a 10 year lifespan, would have a capital value of €62,000, assuming a 5% discount rate.

Such bonds would provide farmers with a flexible financial asset which could be used in a number of ways while the new system of support is phased in. For example, farmers could choose to keep the bond and take a diminishing annual income or enjoy a large one-off windfall. For those wishing to stay in the industry it could be invested in equipment or used to finance capital investment in new business activities. For those wishing to leave the industry it could serve as an early retirement package.

Some have suggested that conditions should be attached to the way bond payments can be used. For example, the Land Use, Food and Policy Intergroup in the European Parliament (LUFPIG, undated) has suggested that an “agri-climate” bond could be created to support capital investment in renewable energy projects, possibly with a mandatory requirement for larger farmers to reinvest the proceeds in this way. The possible use of the bond to finance capital investment potentially reduces the need for other forms of investment support in the transition period. This option, therefore, could be more attractive in those Member States that face the greatest needs for investment in infrastructure and technology, for example many of the central, eastern and southern Member States.

Bond schemes may be a more attractive option for those farmers who are currently in receipt of significant levels of direct payments. However, it does raise questions about the extent to which it would be possible for smaller farmers to make use of such a bond for capital investment or for early retirement, given that it would be likely to be fairly small in value.

4.4. Option 4: Counter Cyclical Payments

The final option involves replacing or supplementing a reduced rate of direct payment with counter-cyclical payments. These are payments which compensate farmers if the price of a commodity falls below a certain level. This reduces the level of agricultural support needed at times of favourable market conditions, applying them only at times when market prices are low.

The Commission has resisted such an approach in the past, arguing that the budget making procedure is ill-suited to unpredictable expenditure (Bureau and Mahé, 2007). In addition, although counter-cyclical payments are widely used by the US, they have been criticised for being highly trade distorting, because they insulate producers from changes in market conditions and, to be effective, they have to be sector specific, and hence are effectively coupled to particular production systems. In addition, one of the major disadvantages of counter cyclical payments relates to cross compliance – if support is reduced in times of high prices, the incentive to comply with cross compliance is reduced at the time when arguably the requirements are needed the most (Bureau *et al.*, 2010).

Counter cyclical payments could in theory be used to supplement reduced direct payments during the transition period, providing a higher payment to farmers at times when market conditions are unfavourable. This could reduce the overall level of budgetary support for agriculture during this period, although the scale of expenditure would depend on prevailing market conditions. However, it would be likely to be opposed by the EU's trading partners and would introduce budgetary uncertainties, potentially hampering the smooth transition to the new system of support. Furthermore, it would introduce additional administrative burdens in creating a new payment regime for a limited period of time.

It has also been argued that counter-cyclical payments simply involve a public authority taking on a role that farmers might be expected to fulfil themselves in return for receiving a fixed payment (i.e. save some in good years for harder times), and that they are likely to involve a reversion to product specific payments, which would involve a complete reversal of the current orientation of the CAP (Bureau *et al.*, 2010). Table 3 provides a comparison of some of the main advantages and disadvantages of the different transitional options considered.

Table 3 Advantages and Disadvantages of Potential Transitional Options

Option	Advantages	Disadvantages
1 Switching the basis of payments over different timescales		
1a Medium term transition (7 years)	<ul style="list-style-type: none"> • Administrative simplicity and transparency. 	
1b Accelerated transition (4 years)	<ul style="list-style-type: none"> • Frees up resources for environmental payments more rapidly than 1a. 	<ul style="list-style-type: none"> • Greater negative impact on some farms as adjustment period is shortened • Political resistance to rapid removal of SPS.
1c Longer term transition (12 years)	<ul style="list-style-type: none"> • Achieves gradual transition, thus allowing longer term adjustment • Likely to be less politically controversial 	<ul style="list-style-type: none"> • Slow to free up resources for environmental payments • Slow to remove a system which many argue offers poor value for money

		<ul style="list-style-type: none"> • Likely to be opposed by proponents of radical reform • Greater opportunity for subsequent political decisions to overturn reform
1d Immediate switch in the basis of payments	<ul style="list-style-type: none"> • Reduces the number of concurrent support measures, so may be conceptually appealing 	<ul style="list-style-type: none"> • Practical complexities from merging current and new systems • Risk of failure to clarify distinct objectives and requirements of new payments compared to current system of cross compliance • Political resistance to rapid removal of SPS. Lack of time for building institutional capacity
2. Variable transition	<ul style="list-style-type: none"> • Potentially enables transitional support to be targeted to those types of farm that need it most 	<ul style="list-style-type: none"> • Complexity. • Likely to be unpopular among farms subject to accelerated removal of support. • Distinction between farms by type and size may be arbitrary and not necessarily a good indicator of economic vulnerability and administratively challenging. • May be subject to political dispute and special pleading. • Delaying phase out of SPS for certain farms does not necessarily help them to adjust over time
3. Bond scheme	<ul style="list-style-type: none"> • Allows greater flexibility to farmers to respond, potentially mitigating impacts. • Can be used to finance new capital investment for diversification. • Fully decoupled. 	<ul style="list-style-type: none"> • Not possible to attach environmental conditions to bond payments.
4. Counter-cyclical payments	<ul style="list-style-type: none"> • Potentially allows transitional support to be targeted at times and sectors needing it most 	<ul style="list-style-type: none"> • Budgetary uncertainties impede smooth transition to environmental payments • Payments being phased out would not be subject to cross compliance • Highly trade distorting and likely to meet international resistance • Goes in opposite direction to recent development of CAP

4.5. Other Relevant Measures for Inclusion within the Transitional Options

A number of other potential measures could be considered as components of the various transitional options described above. They are most relevant for Option 1 and its variants and Option 2. These include 'Orange ticket' cross compliance; early retirement; and/or the increased use of Article 68 type payments. The potential offered by each of these measures

and some of the benefits and disadvantages associated with them in relation to the options discussed are set out below.

“Orange Ticket” cross compliance is a form of cross compliance which requires farmers to enter an appropriate voluntary agri-environment scheme as a condition for continuing receipt of direct payments. It could be applied to the remaining direct payments during the transitional period, under Options 1a, b, c and Option 2, and require all land managers who wished to continue to receive the direct payments to enter into an agreement under the new system of support that ensured a basic level of environmental management across the farmed area. It would encourage rapid, and potentially a more universal uptake of the new suite of incentives during the transition phase. For this to be possible the scope, structure and budgets for such payments would have to be sufficient to permit universal uptake.

This mechanism could potentially aid transition by encouraging an increased and more rapid uptake of environmental schemes. However, extending the eligibility for environmental payments to all farmers at an early stage of transition may face administrative and budgetary constraints. The administrative effort to introduce these new requirements could be considerable. Under Options 1 and 2, the aim is to change the basis of payment over time, with the budget from the progressive reduction in direct payments being used to increase the budget available for the new system of support. Requiring entry into some form of agri-environment agreement from the start of the transition process could significantly increase demands on the budget in the early years and may mean that payment rates would need to be constrained initially so that the budget can be stretched sufficiently to meet the demand. There may also be administrative constraints with regard to the volume of agreements that can be processed. This would be more of an issue in Member States where current uptake comprises a low proportion of the total number of farmers or where there are problems with the eligibility of certain types of farms for agri-environment schemes.

In situations where budgetary and administrative issues are significant, introducing ‘orange ticket’ cross compliance may not be deemed justifiable given that it would only be necessary for a finite period while direct payments continued to exist. However, it does have its merits as a means of achieving accelerated uptake and coverage of environmental management across the farmed countryside and Member States could be given the option to introduce this measure should they deem it feasible and desirable.

Early retirement measures offer financial support for EU farmers seeking early retirement. It is currently a discretionary element of rural development policy under the CAP, and only a few EU member states, most notably France, Ireland and Greece have chosen to implement the measure (Caskie *et al*, 2008). The aim of this measure is to facilitate the process of structural change and encourage the modernisation of agriculture to enable it to respond to new priorities and opportunities, and facilitate those who are least equipped to respond to the challenges of the new system to leave the sector. It is likely that the proposed shift in the basis of CAP payments will further increase these challenges. Early retirement measures therefore have the potential to play a continuing role in facilitating this process, most simply by remaining an optional measure within an expanding rural development programme. However, a major disadvantage of early retirement measures is that they may be associated with a large deadweight effect, making payments to people who would be likely to leave farming in any case. The limited use of this measure by many Member States reflects this concern. The bond scheme (Option 3) may be a more efficient means of facilitating early retirement, and would not diminish the funding available for incentives and grants under the new system of support.

National Budgetary Envelopes - Article 68 of Council Regulation 73/2009 allows Member States to retain up to ten per cent of their national ceilings for direct payments to provide more specific forms of support to a range of sectors. There are now five purposes for which

the funds can be used: protecting the environment, improving the quality and marketing of products or animal welfare; payments for disadvantages faced by specific sectors in economically vulnerable or environmentally sensitive areas as well as for economically vulnerable types of farming; top-ups to existing entitlements in areas where land abandonment is a threat; support for risk assurance in the form of contributions to crop insurance premia; and contributions to mutual funds for animal and plant diseases (see Annex Table 3 for a list of the purposes for which Member States are proposing to use Article 68).

With regard to the environment, it could be argued that, given the shift in the basis of payments and the transition away from direct payments, Article 68 will become less relevant and the incentive to use it will be reduced. However, the environmental measures under Article 68 could continue to be used by Member States if they wished to further accelerate the transition towards the new environmental payments. In addition, other measures under Article 68 could provide Member States with the option of offering support for insurance or to support specific sectors in the short term, to mitigate the effects of the reforms during the transitional period. Any use of such support would need to be conditional on the understanding that such measures would cease once the reform was complete.

However, while the use of Article 68 type measures might look attractive in theory, their use potentially increases the complexity of transitional arrangements. While some of the ways in which the measure is now being used might be merged into the new system of payments (for example schemes that are introduced to promote environmental management), others would only be justified under a transitional period. As such, the value of introducing such measures when they would ultimately be phased out under the new system of support is perhaps questionable.

4.6. Overall Assessment of the Different Possible Transitional Options and Measures

The challenge of shifting the basis of payments under the CAP towards a focus on achieving environmental outcomes is to do so in a way that does not adversely affect the economic stability of the agricultural sector, and that minimises negative social impacts to ensure that the end goal is not undermined by the loss of the environmental value of the land that needs to be maintained or the people that are needed to manage it.

As such, one of the key challenges is to achieve the right balance and trade offs, at least in the short term, between delivering environmental outcomes and managing economic and social impacts at the farm level. Those transitional options which offer most scope for faster environmental gain are also likely to require more rapid adjustment at the farm level, which could impact negatively on farm incomes, and face greatest resistance, particularly from those who benefit most from Pillar 1 direct payments currently. It is important that transitional options are as simple to implement as possible, have clear objectives, clear timeframes for implementation and do not entail excessive administrative costs. Findings from OECD research (2009b) have suggested that the most effective transitional options tend to be based on measures that are already generally available and with which administrations and end users are already familiar.

The most straightforward and least administratively complex option involves the switching of the basis of payments over a specified number of years (Options 1 and 2). These options have a clear end point, clear objectives and continue to enable some form of influence over environmental management across the majority of the farmed countryside, as the majority of farmers would continue to be eligible for payments and cross compliance would continue to

apply The four and seven year timescales (Options 1a and 1b) would seem to be the most attractive, being short enough to ensure that the budget for the new model of support is expanding fast enough to be attractive to land managers, while also allowing sufficient time for farmers to adjust to the reductions in direct payments. The duration of transition is important, as too rapid a transition although enabling resources to be allocated to environmental priorities sooner, can be expected to have a more sudden impact on farm businesses. This may both accelerate structural change and meet greater political resistance, which may hinder achievement of the desired outcomes of a new system of support. A longer period of transition would allow for more gradual adjustment to the new system of support and gives time for investments to be made to enhance sustainable competitiveness, thereby helping to facilitate a more gradual and sustainable process of structural change. However, too long a transition period would be counterproductive as the impetus for change would be likely to be delayed.

A bond scheme offers greater flexibility in response at the farm level, while enabling resources to be allocated to the new system of support. It would appear to be a more efficient means of achieving restructuring than other measures, for example early retirement measures, which are often associated with considerable deadweight. However, it is unclear the extent to which a bond scheme is an appropriate mechanism to aid transition across the range of different farm types and sizes in the EU, particularly for farms in receipt of low levels of direct payments. A potential disadvantage is that cross compliance conditions could not be attached to a bond, although many cross compliance conditions are based in legislation and apply to all farmers irrespective of receipt of public support, and an enhanced set of environmental conditions would be attached to the new system of payments, so this need not necessarily be an issue.

Counter-cyclical payments, although potentially allowing better targeting of support at specific sectors, have clear disadvantages compared to direct payments, particularly because of their sector specific nature and the implications of this in relation to WTO requirements. The level of budget needed year on year is unpredictable and this would create uncertainties in relation to the level of funding available to support payments to farmers under the new model. Rather than adopt this approach, there may be some value in exploring the use of Article 68 to help support costs of insurance or provide support to specific sectors during the transition period as a means of mitigating against some of the farm level impacts that are likely to occur as the basis for payment changes, particularly for those types of farms that have lower economic returns, but whose continuing existence is important for the environment.

Existing cross compliance conditions can continue to play a role during the transitional period for those options which retain direct payments at some level. Retaining cross compliance provides a continued incentive for the majority of farmers across the EU-27 to continue to adhere to basic environmental standards, while direct payments remain a major part of the CAP. However, under all options, as the basis for payment changes, environmental requirements, akin to cross compliance, will be integrated into the new regime, but the area of land over which the new payments have purchase is likely to decline as there will undoubtedly be some decrease in the number of farms (particularly the more intensive production units) that will want to engage with the new system of support. 'Orange ticket' cross compliance could provide an alternative or additional requirement to those in receipt of direct payments. Making the receipt of direct payments conditional on entering some form of environmental scheme under the new system would certainly accelerate uptake and coverage of environmental management practices, but the benefits may be too financially and administratively burdensome to be attractive in some Member States.

The main constraints on the transition away from income support and towards environmental payments are likely to be political. While there is strong support for reform from certain Member States, and from a range of stakeholder groups representing environmental, consumer and taxpayer interests, the political barriers to reform are substantial. They include opposition to change from some farming interests, and from many Member States, particularly those with a long held resistance to reform and those which would be net losers from a redistribution of support from direct payments towards a new system. The scale of budgetary winners and losers would depend on the criteria adopted for allocating national shares and it is possible that there would be a significant number of winners. Another major issue is that of national co-financing. There is considerable reluctance amongst many Member States to increase their national contributions to different versions of the new model. This is likely to be a key issue in terms of the relative attractiveness of different versions of the new model. Generally, any transitional option towards a new model of support will need to involve minimal, if any, increases in current levels of Member State financing if it is to be considered as a politically realistic option. If this can be achieved then it should be possible to design and implement the transitional arrangements discussed above in a way that involves no net budgetary cost.

5. CONCLUSIONS

This paper has assessed a range of options to achieve a transition from the current Pillar 1 direct payments towards a system focused on achieving environmental outcomes, using a model that would account for a large element of a revised European agricultural policy in 2020. The measures in the model, however, only account for one, albeit a significant dimension of a future CAP. The paper has not considered the nature of support needed to meet socio-economic objectives, nor does it consider the future of market support mechanisms. These were assumed to be a continuing component of the CAP although outside the scope of the study.

The proposed model puts the delivery of environmental goods and services at the heart of its rationale as a means of delivering the outcomes identified in the LUPG Vision. It provides a more targeted approach to directing support to land managers, combining payments for basic stewardship available across almost the whole farmed countryside, with more targeted incentives and capital grants focused on achieving enhanced provision of environmental goods and services. By targeting CAP funds towards clear objectives and the achievement of specific outcomes, the proposed model should provide a much more efficient and defensible rationale for using public money.

The proposed model has not been tightly defined. This leaves a large degree of flexibility in the way in which it could be ultimately designed and then applied in practice. This does mean, however, that the nature of the likely social, economic and environmental impacts of such a model can only be defined in a generic sense and transitional options developed accordingly. This makes it difficult to determine in any detail which transitional arrangements would be most effective as this will depend on the precise form of the new model of support and its likely impacts.

It is clear, however, that re-focusing payments on environmental outcomes is likely to have wide-ranging effects on the farming sector. These impacts will differ between farm types and between regions. Overall, it is anticipated that there would be a shift in the distribution of support away from intensive arable, livestock and permanent crop producers to favour extensive farming systems, assuming the measures are costed and delivered appropriately so that extensive producers are able to access the new funds. If this is the case, it may help to slow down the rate of structural change that is already predicted under current policy and economic conditions, and help to constrain significant levels of land abandonment.

Some farmers, especially intensive producers, would see some reduction in income in the short term as result of removing direct payments. In the longer term the situation can be expected to stabilise as the prices of land, inputs and other assets adjust to the new system of support. In relation to the environment, a shift in the basis of payments as proposed should lead to a significant increase in the quantity and quality of environmental management carried out across the countryside.

The extent and variation in these impacts will be particularly dependent on the way in which the future model for support is designed, the degree of subsidiarity involved, levels of co-financing, the basis on which payment rates are calculated and the way in which the support package is implemented. The extent to which environmental outcomes are achieved will depend on the scale of uptake and scheme design. Uptake in turn will depend on the attractiveness of payments and their associated requirements and conditions, compared to the returns from the market that would be possible by staying outside of the support system.

In conclusion, of the different transitional options that have been identified, the most straightforward and least administratively complex appears to be a simple switch in the basis of payments over the short to medium term (four to seven years), accompanied by the availability of enhanced CAP funding for investments intended to enhance sustainable competitiveness, thereby helping to facilitate a more gradual and sustainable process of structural change than might otherwise be experienced (Option 1). This option has the advantages of a clear end point and objectives. It allows for a more gradual adjustment by farms to the new system of support as well as continuing to incentivise some form of environmental purchase across the majority of the farmed countryside in the form of cross compliance. Although a more rapid transition would enable resources to be allocated to environmental priorities sooner, the shock on farm businesses may accelerate structural change and meet greater political resistance, which may hinder achievement of the desired outcomes.

Other transitional options such as the bond scheme and 'orange ticket' cross compliance have certain merits. However they may also require considerable administrative effort and it is not clear that the benefits would be sufficient to justify the potential additional administrative cost. However, these options are certainly worthy of further consideration and Member States could be given discretion to use them should they be considered to be an effective and efficient means of facilitating the adjustment to the new system of payments, although such a high level of subsidiarity would be a huge challenge.

There is likely to be considerable political resistance to proposals for a new model of support based funds on the principles set out in the LUPG vision. However, revisions to the current policy framework are inevitable given the various pressures for reform and this will necessarily lead to a reallocation of support between Member States, regions, sectors and individual farms. The proposed model changes the basis of payments towards paying for activities that achieve environmental outcomes. However, although there may be some reluctance amongst Member States to support such a change, this is not an argument for rejecting the whole model. It could be applied in a range of different ways to meet different local priorities and needs within an effective European framework. The transitional options outlined here also suggest that even moving some way along the trajectory towards this model would bring significant benefits.

The next challenge is to develop in more detail what the different variations of the proposed model might look like in practice in relation to variables such as the weighting between different measures, the design of support, levels of co-financing and the degree of national and regional discretion given to Member States in these respects. A range of different variants could be drawn up, and the impacts of each of these assessed in terms of their likely impacts on farm incomes, production levels, farm structures and land management practices by farm type and region. Greater understanding of the economic, social and environmental implications of each variant is needed. This more detailed analysis would then allow for a more thorough investigation into the precise nature of the transitional arrangements that would be needed. The ultimate aim is to ensure that shifting the basis of payments under the CAP towards a focus on achieving environmental outcomes is achieved in a way that does not adversely effect the economic or social stability of the sector, or undermine the environmental objectives by triggering inappropriate changes in farm structure and management.

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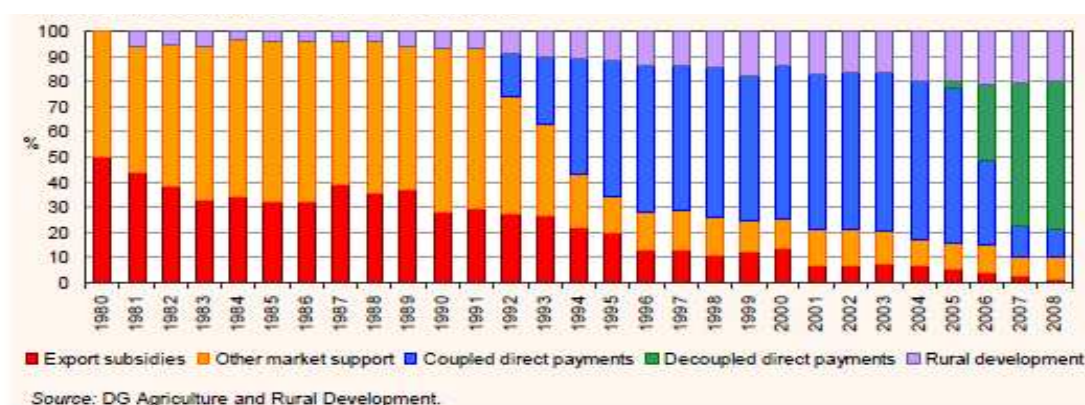
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ANNEX 1 CURRENT APPLICATION OF THE CAP IN THE EU-27

Annex Figure 1 illustrates the changes in the proportion of budgetary expenditure allocated to different types of payment under the CAP since 1980, when the CAP solely comprised export subsidies and other market support measures.



Source: DG Agriculture Policy Perspectives Brief 1, December 2009

Annex Figure 1 Changes in CAP Expenditure since 1980

Annex Table 1 indicates that, in general, rural development measures represent a higher proportion of total CAP expenditure in the newer Member States, where expenditure is almost evenly split between Pillar 1 and Pillar 2 payments. By contrast, on average, rural development expenditure only accounts for approximately 20% of total Pillar 1 and Pillar 2 expenditure in the EU-15, although Pillar 2 expenditure can be significant in some Member States, most notably Austria and Portugal.

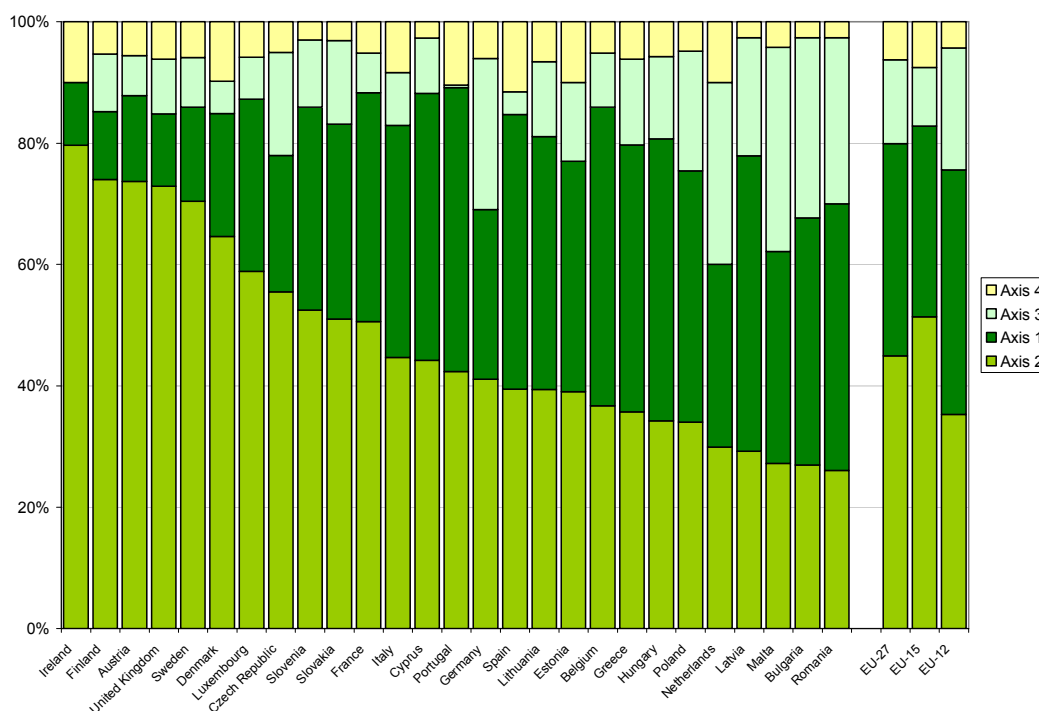
Annex Table 1 Pillar 1 and Pillar 2 budgets for 2007-13, taking into account transfers resulting from additional rates of compulsory modulation¹

	Pillar 1 post Health Check (million euros)	Pillar 2 post Health Check (million euros)	Pillar 2 as a proportion of Total Budget
Denmark	7,080	578	7.55%
United Kingdom	27,357	4,605	14.41%
Netherlands	5,852	593	9.20%
Belgium	4,195	448	9.65%
France	57,491	7,557	11.62%
Germany	39,451	8,751	18.15%
Spain	32,182	7,509	18.92%
Ireland	9,264	2,340	20.17%
Greece	14,346	3,707	20.53%
Italy	26,603	8,658	24.55%
Sweden	5,232	1,826	25.87%
Luxembourg	255	95	27.14%
Finland	3,915	2,154	35.49%
Austria	5,154	4,026	43.86%
Portugal	3,951	4,035	50.53%
EU-15	242,330	56,882	19.01%
Hungary	6,487	3,806	36.98%
Czech Republic	4,500	2,816	38.49%
Cyprus	217	165	43.19%
Poland	15,039	13,399	47.12%
Lithuania	1,868	1,766	48.60%
Slovakia	1,920	1,969	50.63%
Bulgaria	2,489	2,609	51.18%
Slovenia	712	916	56.27%
Latvia	725	1,054	59.25%
Estonia	494	724	59.44%
Romania	5,502	8,124	59.62%
Malta	20	78	79.59%
EU-12	39,974	37,426	48.35%
EU-27	282,303	94,308	25.04%

¹NB: These figures do not account for additional voluntary modulation receipts as applied in the UK and Portugal

Source: IEEP calculations based on European Commission budget figures.

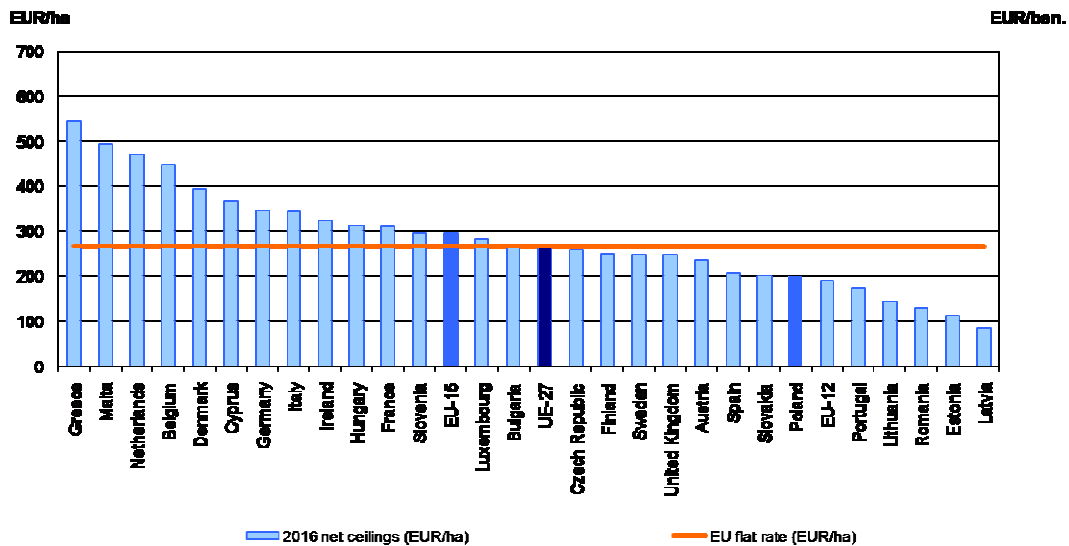
Annex Figure 2 illustrates the variation in projected expenditure of rural development funding under EAFRD between the four axes and between Member States.



Source: Cooper et al., 2010 - IEEP calculations based on programmed expenditure within individual RDPs for 2007-13.

Annex Figure 2 Distribution of 2007-13 EAFRD planned expenditure by Member State

Annex Figure 3 and Annex Table 2 shows that direct payments also vary significantly across Member States when they are expressed on a per-hectare basis. Focusing solely on the direct payments under the SPS (including ongoing coupled payments), and using the European Commission figures in Annex Figure 4, the average figure for the EU-27 over the 2007-13 period was estimated at approximately €266 per hectare, with a wide variation across Member States (from €83/ha in Latvia to €544/ha in Greece). The high figures in Greece are largely due to the economic influence of historic payment levels for permanent crops, such as cotton and tobacco.



Source: DG Agriculture

Annex Figure 3 Average direct payments per hectare of UAA by Member State

Annex Table 2 shows that the average per hectare Pillar 1 payment is almost double the average Pillar 2 expenditure per hectare (including national co-financing) when calculated across the EU-25 for the 2007-13 programming period (Romania and Bulgaria are not included within these figures). This ratio differs considerably between Member States, with direct payments in Denmark worth eight times more per hectare than Pillar 2 payments compared with countries like Estonia, Latvia and Slovenia where the average Pillar 2 payment per hectare is almost twice that of Pillar 1 payments. Within the New Member States, the average per hectare payments under Pillar 2 are generally higher than those under Pillar 1, once national co-financing is taken into account, whilst the inverse is true in the EU-15.

Annex Table 2 Intensity of spend for CAP Pillar 1 and Pillar 2 by hectare of UAA

Member State	Years 2000–2006			Years 2007–2013		
	Pillar 1	Pillar 2	Ratio Pillar 1: Pillar 2	Pillar 1	Pillar 2	Ratio Pillar 1: Pillar 2
	Average EUR/ ha UAA	Average EUR/ ha UAA		Average EUR/ ha UAA	Average EUR/ ha UAA	
Belgium	678.07	37.07	18.29	439.00	118.00	3.72
Czech Republic	107.66	53.14	2.03	181.00	145.00	1.25
Denmark	429.17	17.92	23.95	380.00	44.00	8.64
Germany	316.72	71.26	4.44	338.00	111.00	3.05
Estonia	84.81	70.82	1.20	85.00	159.00	0.53
Ireland	430.79	86.76	4.97	318.00	146.00	2.18
Greece	1 002.40	88.22	11.36	519.00	182.00	2.85
Spain	288.63	46.93	6.15	182.00	66.00	2.76
France	203.82	31.53	6.46	302.00	57.00	5.30
Italy	368.92	75.46	4.89	303.00	187.00	1.62
Cyprus	290.87	92.09	3.16	233.00	305.00	0.76
Latvia	77.75	64.71	1.20	61.00	114.00	0.54
Lithuania	40.18	54.23	0.74	96.00	116.00	0.83
Luxembourg	187.52	100.58	1.86	287.00	408.00	0.70
Hungary	57.74	62.65	0.92	218.00	173.00	1.26
Malta	406.97	658.31	0.62	371.00	1 429.00	0.26
Netherlands	608.44	35.60	17.09	434.00	71.00	6.11
Austria	204.65	145.96	1.40	228.00	342.00	0.67
Poland	107.21	71.22	1.51	146.00	167.00	0.87
Portugal	176.70	110.48	1.60	156.00	173.00	0.90
Slovenia	243.50	179.90	1.35	210.00	341.00	0.62
Slovakia	50.35	76.68	0.66	147.00	195.00	0.75
Finland	228.18	151.75	1.50	250.00	418.00	0.60
Sweden	216.36	56.39	3.84	239.00	175.00	1.37
United Kingdom	244.99	13.60	18.02	249.00	77.00	3.23
EU-25	231.98	51.20	4.53	237.00	119.00	1.99

Source: 2000–2006 EEA own calculations; 2007–2013 Farmer et al., 2008 (from CAPRI model). Pillar 2 figures refer to total public expenditure (EU funds plus national contributions). Data: UAA 2005, DG Agriculture and Rural Development Statistical reports, 2008.

NB; Romania and Bulgaria are not included within these calculations

Source: EEA, 2010, drawing on 2000-2006 EEA own calculations; 2007-13 Farmer et al., 2008 (from CAPRI model); Pillar 2 figures refer to total public expenditure (EU funds plus national contributions); Data: UAA 2005, DG Agriculture and Rural Development Statistical reports, 2008.

Article 68 of Council Regulation 73/2009 allows Member States to divert up to 10% of the national ceiling of Pillar 1 payments into national envelopes, which can be used for a variety of purposes. Member States have chosen to use Article 68 in a range of different ways, as set out in Annex Table 3.

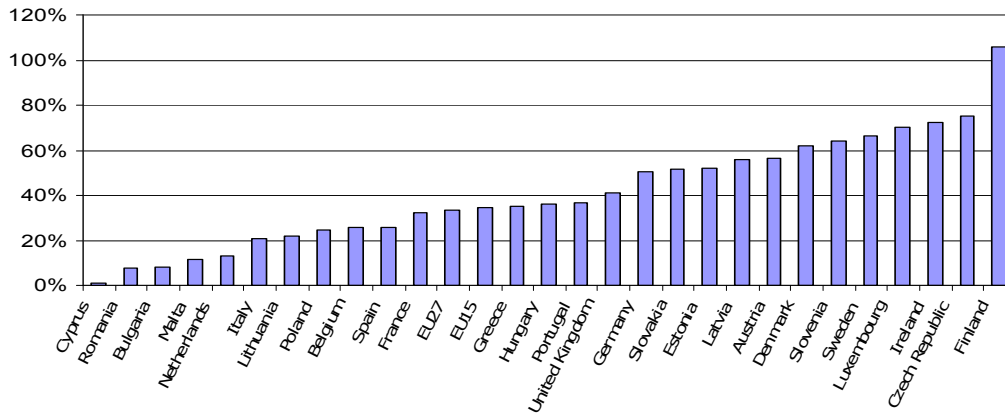
Annex Table 3 Proposed use of Article 68 in the EU-27 Member States

Member State	Measures Proposed	Proportion of National Ceiling and/or Total Funds Proposed	Previous use of Article 69
Austria	Coupled dairy cow premium of approximately €50 per cow (up to 30 cows per farm)	3.50%	No
Belgium	No use of Article 68 proposed		No
Bulgaria	No use of Article 68 proposed in 2010, although likely to propose its use to support the dairy sector in 2011		No
Cyprus	No use of Article 68 proposed		No
Czech Republic	To address to dairy market crisis	3.50%	No
Denmark	Support for extensive farming and support for the establishment of perennial energy crops	1.60%	No
Estonia	Provide headage payment to support small dairy farms (less than 100 dairy cows)	1.75%	No
Finland	Beef cattle premium, dairy cow premiums	57m	Yes - aid for cultivation of winter cereals, aid to raise suckler cows of certain beef breeds, aid for heavy slaughtered male bovines and heifers.
France	Small premiums for protein and oilseed crops, starch potato production		
	Quality premium for slaughtered lambs		
	- coupled sheep and goat headage payment	€135m - 33% of total funds allocated to A.68	No
	- coupled payment for mountainous milk production (2c/litre).	€45m - 11% of total funds allocated to A.68	
	Support for protein crops	€40m - 10% of total funds allocated to A.68	
	Support for organic production	€50m - 12% of total funds allocated to A.68	
Germany	No details	€100m - 24% of total funds allocated to A.68	
	new risk management allocations for sanitary risks	€40m - 10% of total funds allocated to A.68	
Greece	Quality improvement of durum wheat, olive oil and sugarbeet	5.30%	No
			Yes - for cultivation of durum wheat, quality beef, production of milk in

					LFAs, quality tobacco and quality olive oils
	Support of livestock production (premiums for beef, sheep and goat, dairy cows), in particular LFAs				
Hungary	Coupled support payments in the milk sector				No
	Restructuring programs for fruit and vegetables and for tobacco			15-20m	
Ireland	Uplands Sheep Scheme area payment (up to 15ha per holding)			18m	No
	Grassland Sheep Scheme from 2010			6m	
	Grassland Dairy Efficiency Programme			1m	
	Support high environmental value farming				
Italy				7.5% (322m by 2012) in total	Yes - cultivation of durum wheat, suckler cows of meat breeds, minimum grazing period in the ovine sector, a minimum of 2 years rotation in the sugar sector and incentives for oilseeds to produce bio-ethanol.
	Improving the quality of agricultural products			147m	
	Agri-environment measures supporting the farm insurance system			99m	
				70m	
Latvia	Extra support in the dairy sector - probably based on production			5.13m (3.5% of SAPS envelope)	No
Lithuania			No use of Article 68		No
Luxembourg			No use of Article 68		No
Malta			No use of Article 68		No
Netherlands			No use of Article 68 - at least in 2010 and 2011		No
Poland				170m	No
	Headage payments for cattle			32% (28.5m)	
	Headage payments for ewes			1.7% (1.5m)	
	Area payments for pulses and grain legumes			12% (10.8m)	
	Decoupled tobacco payments to those switching to labour-intensive production in areas under restructuring			55% (49m)	
Portugal	A headage payment for maintaining extensive livestock systems of indigenous breeds			2.76m	Yes - the marketing of arable crops, aid for organic production, maintaining pure and indigenous breeds in the bovine and ovine sector, and marketing for the olive and sugar sectors.
	Improving the quality of agricultural products			9.7m	
	A headage payment supporting economically vulnerable types of dairy farms			8.8m	
	An agri-environment measure to protect the olive her			6.65m	

	An agri-environment scheme to support extensive grazing, notably high nature value meadows, unstocked agri-forestry areas with extensive grazing by small ruminants, and "agro-silvopastoral systems of holm oak and Pyrenean oak"	6.7m	
Romania	Additional aid for the milk sector in LFAs	3.50%	No
	Aid for organic farming		
Slovenia	Additional payment for suckler cow production, area payment for dairy holdings in mountain areas and on steep slopes, grassland premium.	10%	Yes - specific types of farming in the beef and veal sector contributing to environmental protection.
Slovakia	Support for the dairy sector in LFAs	3.50%	No
Spain	Dairy quality premium	19.8m including 0.8m for organic production	Yes - its use of Article 69 has been maintained in its use of Article 68.
	Suckler-cow top up payment	47.96m	
	Top up for quality meat production	7m	
	Cotton and sugar support in certain intensive and irrigated areas	9.63m	
	For tobacco 10% of decoupled support will be retained to support improving quality and competitiveness in the sector	5.8m a year for 5 years	
Sweden	Promotion and quality certification schemes	0.45%	Yes - participation in quality certification schemes, quality and marketing measures, participation in agricultural fairs.
UK	No use of Article 68 in 2010 in England, NI and Wales		
	Scotland to retain previous Article 69 measures		Yes- production of beef bred calves,

Annex Figure 4 shows the proportion of agricultural income that is made up from direct payments, using 2008 data. Direct payments account for over 60% of factor income in seven Member States, (Finland, Czech Republic, Ireland, Luxembourg, Sweden, Slovenia and Denmark) and under 20% in Malta, Romania, Bulgaria and Cyprus.



Source: Buckwell (2009) based on Eurostat data for 2008

Annex Figure 4 Direct Payments as a proportion of Factor Incomes, EU-27