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NOTE

Policy Department B Structural and Cohesion Policies

ANALYSIS OF THE HEALTH CHECK PROPOSALS: THE REFORM OF THE DECOUPLING SYSTEM

AGRICULTURE

June 2008

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IP/B/AGRI/IC/2008-057

01/06/2008

PE 405.400

EN

This note was requested by the European Parliament's committee on Agriculture and Rural Development.

This paper is published in the following language:

- Original: EN.

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Manuscript completed in June 2008

This note is available on the Internet at:

<http://www.europarl.europa.eu/activities/committees/studies.do?language=EN>

Brussels, European Parliament, 2008.

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Content:

The risk of structural breakdown in European agriculture cannot be prevented unless the measures introduced reinstate the justification and functionality, i.e. the legitimacy, of aid. Under the following proposal the SPS would be revised in two stages, with short-term conversion to a *territorial flat rate per new entitlement* and medium term conversion into a new CAP that would focus aid on certain types of farmers and on territories truly in need of support.

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1. Introduction: CAP and territory

The Common Agricultural Policy (CAP) – core and benchmark policy in the building of Europe for nearly five decades – remained essentially unaltered until recently, when a succession of in-depth reforms have been introduced (in 1992, 1999, 2003 and 2005). Although such reforms are still underway, the perception is that for both internal and external reasons, the new CAP is going to be increasingly called into question.

Internally, to date the territorial impact observed after decades of implementation of the CAP is a growing concentration of agricultural aid in but a few beneficiaries, coupled with the precipitous disappearance of *territorial agriculture*¹ in many rural areas, in particular economically “backward” areas”. The most recent CAP reforms have presumably intensified these adverse social and territorial effects.

Externally, the CAP continues to be a point of contention for most developed and developing countries in World Trade Organisation (WTO) negotiations. The successive CAP reforms can in fact be seen as a leap in the dark from a highly interventionist policy, an attempt to maintain its viability by adapting aid to the provisions of multilateral trade agreements.

Hence, we are faced with the need to continue the progress made in the elimination of the most perverse effects of present CAP. The “Health Check” affords an opportunity to take yet another step in that direction, in particular by revising the Single Payment Scheme (SPS) and its knock-on effects for the rest of the CAP. This proposal reworks some of the options considered by the Commission, and therefore addresses the advisability of converting the SPS into a territorial flat rate per new entitlement, in a move away from the “historic” or “regional” models, and prioritizing support to professional farmers conducting their activity in certain rural territories.

This is because a CAP embracing a market policy, decoupled from the sectors of agricultural production and persisting in an uneven and unjustified distribution of aid, jeopardises not only its own legitimacy, but the ongoing existence of farming in vast expanses of the countryside, inside the European Union (EU) and often in developing countries, where the activity needs to be maintained for economic, social and environmental reasons.

We believe that any renewal of the legitimacy of the CAP will depend on the extent to which it reinforces the social and territorial dimension of its measures and instruments. Thus, the present proposal aims to contribute to build the new CAP, in the awareness that this will mean moving from an essentially *sectoral* to a more *territorially* oriented policy, in which measures are applied differentially in the existing types of *farmer- holdings* and *rural areas*.

In short, the idea is to further a CAP that favours more *sustainable agriculture and rural development*. Consequently, the proposal is to introduce a general *multifunctional* criterion in the definition of the chief measures and instruments of the new CAP. The suggestion is to prioritize the first pillar *single payment* and the second pillar *compensatory allowances* depending on the *functionality* of the various types of *farmer-holdings and rural areas*. This will necessitate a stage-by-stage review of the existing policies

¹ For a definition of this concept see Regidor J.G. (2005: 4).

2. CAP reform and SPS

As prior analysis has shown², the adoption of the SPS as the core of the new CAP is not without drawbacks. Indeed, the rigidity of the model and the additional costs involved in its application have made it a revisable instrument since its inception. From an internal perspective, however, and with the passing of time, what calls these payments and allowances into question is their lack of legitimacy.

When the support for farming via guaranteed prices and supplementary border measures was instituted these arrangements were justified: domestic production in the EEC had to be encouraged. Once this justification is disregarded because such encouragement is either no longer necessary (decoupling) or inappropriate (international trade rules), doubts arise around present SPS functionality. From the standpoint of taxpayers, at least, who are largely unaware of the historic evolution of the CAP, the SPS lacks any substantial justification.

In any event, the SPS can and should be improved both in the short term as a result of the "Health Check" and in the medium term, at the end of the present programming period in 2013. The options for SPS reform submitted by the Commission are discussed in the following items, along with their cross-over effects on other CAP instruments, as an introduction to the proposal for improvement.

2.1. Assessing the SPS options

Based on the information available³, of the five options submitted, *option 0* (maintain the status quo) would appear to be obviously unacceptable. With the results of the initial period of adaptation of the new payment model now at hand, the distributive imbalance deriving from the SPS is scarcely defensible. Even the surveys on European citizens' perception of the CAP⁴ show the legitimacy of this model to be in free fall.

Other elements of the SPS itself, such as the possible transfer of payment entitlements which would effectively be a goodwill payment to owners of eligible land and perhaps lead to their withdrawal from any manner of productive activity, depart from the objectives of the agricultural policy laid down in the EU Treaty. In other words, the very conception of the model renders its continuation unfeasible.

Option 1 (adoption of an EU-wide flat rate per eligible hectare) was rejected by the Commission, in light of its heavy redistributive impact on the flows of funds received by the Member States. One half of the EU countries, the ones with most to lose, would obviously oppose the reform.

Moreover, no favourable intra-country redistributive effects have been identified, in particular because the physical rather than the economic dimension of holdings would prevail and no consideration would be given to different types of land use. The mechanistic nature of this proposal is also surprising, as is its modest contribution towards legitimising the new payments.

² European Commission (2008a).

³ European Commission (2008a: 21-37).

⁴ European Commission (2008b).

Option 2 (extension of the Single Area Payment Scheme (SAPS) to all Member States) makes the weak functioning of the present payment system even more visible. Here, farmers would actually be paid by the area of crops held which, in addition to raising the goodwill for the owners of eligible land, would aggravate the uneven distribution of payments within States applying the SPS.

Neither would this appear, then, to be a suitable way to move from a historic SPS to a regional SPS based on payments per hectare. It is less a question, however, of deciding whether the CAP should move toward a Europe-wide flat rate system in the longer term, which would involve determining how, when and in what types of productive sectors, than of building a new legitimacy for payments depending on the type of farmer and territories that truly need them.

Option 3 (regional flat rate per eligible hectare) has several advantages over the preceding two. In particular it would entail the recovery of payment entitlements for fallow lands, which may be significant in countries adhering to the *historic SPS model*, where land is now being abandoned in many rural areas, and a certain degree of redistribution in favour of farmers whose holdings are smaller, economically speaking. Nonetheless, the alternative is insufficient to offset the negative effects identified above.

Actually, the most fragile component of this option is the “type of region” considered. Most of the countries opting for a regional SPS model define regions along political and administrative lines, which take no heed of farming activity functionality in the various types of rural territories. In essence the same as *Option 1* but applied by regions to avoid inter-country flow transfers, this alternative has barely any redistributive effects within countries.

Lastly, *Option 4* (regional flat rate per entitlement) is a hybrid option between the two basic (*historic* and *regional*) models, with no apparent redistributive advantages. While it prevents the extension of payments to new beneficiaries, it favours payments to professional farmers over mere landowners.

This feature, i.e., equating the holding of historic payment entitlements to professional farmers, does in any event pave the way towards a more appropriate SPS revision. Payments should indisputably prioritize professional farmers, whether viewed individually or collectively, who engage in multifunctional activities with a favourable economic, social and environmental impact. This would introduce a new factor that could justify payments: the need to maintain farming activity across certain vast expanses of rural areas.

2.2. Some cross-cutting effects

Any SPS reform, particularly if it is implemented along the lines of *Options 3 and 4*, will entail many cross-cutting effects on other main elements of the CAP. The issues discussed below would affect the adjustment of Article 69 of Regulation 1782/2003 and the closely inter-related second pillar of the CAP.

Adjustment of Article 69

Apparently, most Member States have made little relevant use of Article 69⁵. The lack of connection between the objectives formally attributed to the article and their achievement is

⁵ European Commission (2008a: Annex C1).

readily visible. This instrument, furthermore, has failed to halt the effects of aid decoupling on many farmers and rural areas in terms of eradicating the high risk of their ceasing in the activity and abandoning their holdings.

Attributing the poor results of the implementation of Article 69 to either the rigidity involved in the obligation to use the funds in the same productive sector in which the withholding was made or to the small percentage of funds to be withheld (up to 10% of each Member State's payment ceiling) is unconvincing. It might be more persuasively argued that the reason may have been national or regional agriculture authorities' scant interest in reducing the volume of direct payments to SPS beneficiaries.

Against this backdrop, SPS reform would involve broadening the objectives attributed to Article 69 (Article 68 in the draft new Regulation⁶), which would constitute a saving clause in the general SPS model. In any event, its provisions would always have a foreseeable impact limited to certain uses and areas experiencing problems that would be subject to a series of conditions and requirements. Furthermore, insofar as these measures may involve partial aid decoupling or even recoupling, they would be subject to the restrictions deriving from compliance with the WTO's Blue Box criteria.

Consequently, the task attributed to new Article 68, under any of its options, appears to be disproportionate and hardly viable. The advantage of a bias in favour of social and environmental objectives is more than offset by the higher administrative costs involved and the forfeiture of simplification. Article 68 actually becomes an element within the SPS measures that reintroduces a certain social and territorial functionality in the CAP objectives, but which is unable to correct the uneven distribution of aid among farmers or, ultimately, reinforce the legitimacy of the SPS model.

Second CAP pillar

The key measures under the second pillar are commonly known to be subsidiary and supplementary to the first pillar measures. This is particularly applicable to the measures stemming from axes 1 and 2 of EC Regulation 1698/2005. In this context, any SPS reform will eventually affect all the measures whose purpose is to "improve agricultural competitiveness" (with measures to "restructure and promote innovation", for instance) and any "improving the environment and the countryside" (with measures "targeting the sustainable use of agricultural land"). Consequently, SPS reform will entail a revision of the second pillar.

If SPS reform is pursued along the lines of *Options 3 and 4*, the question is whether it would make more sense to reinforce the aid under new Article 68 or to intensify the focus on axes 1 and 2 in the EAFRD. Indeed, if decoupled SPS payments are unified, the second pillar compensatory allowances would also have to be unified, eliminating the present enormous differences in aid outlays among Member States⁷; this would lead to a possible medium term unification of the two pillars, excluding the axis 3 and 4 measures of this rural development regulation.

More specifically, the effects of *Option 3* should entail a revision of the types of regions considered. Since political-administrative regions do not coincide with agricultural and rural territorial criteria, it would make perfect sense, likewise in line with the objectives laid down in

⁶ European Commission (2008c).

⁷ See the Annex to Regulation EC 1698/2005.

new Article 68, to consider a typology for agricultural and rural areas. Differential support would have to be provided in such areas, pursuant to the arrangements in place in a small number of countries that apply the regional SPS model⁸. In this regard, the value of the present types of areas that are eligible for second pillar aid may be called into question⁹.

Similarly, *Option 4* would appear to infer the need to distinguish between professional farmers and mere landowners. Inasmuch as payment would be made in terms of entitlement, it would be possible to favour certain professional farmers owning certain types of holdings. In this regard, the definitions of *professional farmer* and *priority holding* would have to be included in the new regulation replacing Regulation EC 1782/2003¹⁰.

2.3. Conclusion

The Commission's proposals contain elements that would improve the present situation with regard to the SPS. The change from a *historic* to a *territorial model*, which does not concur exactly with the existing "regional unified entitlement per hectare model", is regarded to be a suitable approach. Since the objective should be to attempt to encourage the continuity of farming in certain types of areas, all countries should receive the same level of support for the same types of beneficiaries and areas.

At the same time, since aid decoupling is regarded to be irreversible, in certain territories agricultural activity should be supported with measures associated with the second pillar instead of exceptional measures such as provided for in new Article 68. In this regard, States' move towards more unified payments would entail paying equal compensatory allowances to the same types of beneficiaries and areas.

In short, the risk of structural breakdown in European agriculture cannot be prevented unless the measures introduced reinstate the justification and functionality, i.e. the legitimacy, of aid. Under the following proposal the SPS would be revised in two stages, with short-term conversion to a *territorial flat rate per new entitlement* and medium term conversion into a new CAP that would focus aid on certain types of farmers and territories truly in need of support.

⁸ This is the case of Sweden where, apparently, three types of regions are distinguished, and the United Kingdom to some extent.

⁹ Article 50 of Regulation EC 1698/2005.

¹⁰ European Commission (2008c: Article 2).

3. New SPS: a territorial proposal

One way to generate a simpler and more effective and efficient system would be to reform the SPS pursuant to an improved version of *Options 3* and *4*. This improvement would consist in transforming the historic and regional SPS into a hybrid model, based on a *territorial flat rate per new entitlement*, in which the updated entitlements under the two models would be integrated and the reference regions would be replaced with farming and rural areas. In the short term, the proposal would mean revising the changes envisaged in existing Regulations EC 1782/2003 and EC 1698/2005.

3.1. A first step

The adoption of a *territorial flat rate per new entitlement* would be justified to the extent that it would improve SPS payment distribution and functionality by prioritizing certain farming and rural areas regarded to be priorities. To this end, the present situation, characterized by high social concentration of aid and intense disappearance of *territorial agriculture*, should be corrected.

Social concentration of aid

The uneven distribution of aid among beneficiaries is notorious, as the European Commission (EC) has, officially acknowledged on a number of occasions. More than that, the successive reforms of the CAP have seriously aggravated this lack of equity, measured by the growing imbalance in the distribution of "direct payments" between the "beneficiaries" (see Annex: Figure 1). Note that this inequality is somewhat less sizeable in the new Member States.

It should be noted that, while the average benefit rate (ECU/Active Working Unit (AWU)) rose in all holdings with the 1992 CAP reform, growth was three-, four- and five-fold for the medium-size, large and very large economic size units, respectively. Hence, the financial returns generated by agriculture (the sum of income from market sales plus subsidies) go to a smaller and smaller number of holdings of larger and larger economic size (see Annex: Figure 1 bis). In other words, the CAP is engineering a loss of social cohesion within the EU.

Therefore, the consequences of this concentration of aid are both economic and social. In short, the CAP reinforces the unequal distribution of agricultural income among farmers, a growing portion of whom - the ones with small holdings - are pressed into turning away from agriculture or in any event into seeking new sources of rural income ("multi-activity"). "Part-time farming" is thus becoming the rule rather than the exception among this type of holdings.

Disappearance of *territorial agriculture*

But there are territorial consequences as well. The social concentration of aid has a huge territorial impact: the disappearance of holdings is on the rise. For instance, aid concentration has been highest in some of the more economically advanced regions (territories) where the most productive holdings are located (see Annex: map). As a result, the level of support reaching many of the more economically backward rural areas is declining, due to the type of holdings that prevail in such areas. The CAP does not appear to be contributing to interterritorial cohesion.

The evolution in the EU of these different categories of holdings over the last few decades has followed a pattern of *adjustment* (decrease in number of farmers) and *restructuring* (concentration of holdings). The CAP prompted this *conversion* to make European agriculture more competitive, but insufficient consideration has been given to the fact that maintaining this type of farming in several rural areas was necessary to ensure sustainable rural development.

European agricultural adjustment is still incomplete in some of the EU-15 countries and is lacking altogether in the new EU-12 nations. These adjustment processes, moreover, are characterised by declining numbers of workers in certain occupations, especially those related to “family farming”, and a growing number of “agricultural employers” and “employees”. Therefore, *adjustment* entails the disappearance of *territorial agriculture* across vast rural areas.

Territorial proposal

This proposal would comprise two elements. The first would consist in unifying SPS payment entitlements, both in countries that have been applying the historic and those applying the regional model, and offering this option on a voluntary basis to new Member States temporarily applying the SPS. The new model is based on a *territorial flat rate per new entitlement*, i.e., a new payment entitlement that would vary depending on the agricultural and rural area where the farmland is located.

The application of this new model would entail revising existing payments entitlements by updating land eligibility and the unit payments to adjust them to the financial ceilings established for the present programming period. The possibility of transferring the new payment entitlements might also be questioned, requiring any that are not activated to be assigned to the national reserves. At the same time, giving up all farming activity would have to entail forfeiture of beneficiaries’ entitlements. All the foregoing would have to be laid down in the draft revision of Regulation EC 1782/2003, primarily in new Title III.

The second element would necessitate taking into general consideration a *typology of farming and rural areas* by which the new payment entitlements would have to be differentiated. This typology would modulate the amount of the flat rate per new entitlement to ensure that certain areas in greatest need of support would receive priority attention. This new typology would be based on economic (productive limitations in mountain areas, for instance), social (maintaining the population and activity in backward rural areas) and environmental (contributing to conserving the areas of greatest value and natural and cultural resources) functionality.

The general introduction of this area typology in first pillar measures such as the SPS would involve reintroducing the territorial justification in the CAP. In this regard, partial decoupling itself, which still appears to be a necessary element for the subsistence of a number of agricultural sectors, might be replaced by this new territorial payment. All of this would call for revising the typology of the areas to which the proposed revision to Regulation EC 1698/2005 would be applied, considering in particular the need to question the present definition of *less favoured areas*¹¹, as certain analyses have suggested¹².

¹¹ European Commission (2008d).

¹² IEEP (2006).

3.2. Making the future CAP reform easier

In the medium term, this proposal would call for the future CAP to introduce *multifunctionality* as a general criterion in the definition of several of its chief measures and instruments. In a nutshell, the suggestion would be to apply the CAP measures by type of *rural area* and *holding*, so the *single payment* laid down in the first pillar and the *compensatory allowances* established in the second pillar could be modulated in keeping with territorial *functionality* and the *functionality* of the different types of farm holdings.

The aim would be to provide priority support for so-called *territorial agriculture*. In practice this would mean “focusing aid on *professional farmers who own holdings in priority rural areas* and truly need support to continue to practise multifunctional farming in the rural environment, to help these areas surmount their relative socio-economic backwardness and conserve their natural and cultural resources” (Regidor et al., 2008: 61).

Meeting this objective will entail redistributing new payment entitlements by *types of farmer-holdings* and *types of areas*. This redistribution, so necessary to re-establishment of CAP legitimacy, could be readily implemented with a priority matrix that would automatically relocate the sums to be paid¹³. Such a matrix, consisting of three types of rural areas and two main types of beneficiary farmer-holdings, can be used to allocate the main aid payments (see table in the Annex).

The crucial question, once the two types of classification schemes are set up, is to establish the priorities for applying CAP measures to the various categories. If it is felt that the CAP should favour the most professional farmers and least economically developed holdings in the rural-most areas, a higher level of support should be granted to *territorial agriculture* than other holdings, and such support should focus more on certain types of rural areas (i.e.: $A1 > B1$ and $A1 > A2$, and so on, where $A1$ is the unitary support that should be received by a farmer-holding engaging in *territorial agriculture* in a *backward* rural area). If this is accepted, this *priority matrix* would constitute a filter for redistributing the aid to which any given beneficiary farmer may be entitled.

The consequences for the CAP of this proposed second stage in the SPS reform suggested above would be hugely favourable. The new CAP would be much simpler, for it would comprise two types of aid: aid justified by *multifunctionality*, which would focus on several types of farmer-holdings and territories (in favour of *territorial agriculture*), and all other aid originating in the revised SPS that would provide a *safety net* for all other beneficiaries to offset the risks and instability inherent in their activity. In this regard, Regulation EC 1782/2003 could be greatly simplified with respect to the present draft revision.

¹³ For a fuller description of the key elements of this proposal, see Regidor J.G. (2005).

4. Conclusions: favourable impact of the proposal

The application of this proposal would have many wide-ranging impacts. In terms of **inter-country** distribution, **the financial effect** of this proposal would be **neutral**. Redistribution would be at the domestic level in each, substantially improving the economic impact on the backward regions and on certain social groups living in rural areas. This proposal, therefore, would have an **effect on the interregional distribution of wealth** if applied at the country level: regions with a higher proportion of “backward” rural areas would be the ones to benefit most.

This proposal would **enhance territorial cohesion**, with rural areas becoming the chief beneficiaries of CAP aid, which would be distributed in direct proportion to their degree of rurality and their level of relative economic disadvantage. This objective of the proposal is closely related to the needs derived from the new realities surrounding the much more rural EU-27: rural development of the new Europe has become an objective of cohesion policy.

Despite the CAP, in many countries there are pockets of economically disadvantaged social groups that engage in farming and a high percentage of the rural population still lives below the relative poverty line. This proposal would **enhance social legitimisation of the CAP**, since it re-directs aid to the occupational groups most in need of support on the grounds of the *multifunctional* nature of their activity.

Among other advantages of this approach, appreciable **budgetary savings** may also be secured, without forfeiting **financial neutrality** among countries. Inclusion of this proposal would, furthermore, facilitate compliance with the **multilateral trade agreements** on agriculture in place and under negotiation. Finally, a voluntary adoption period could be envisaged for this proposal, by initially applying it to second pillar aid only and scheduling general adoption for 2013.

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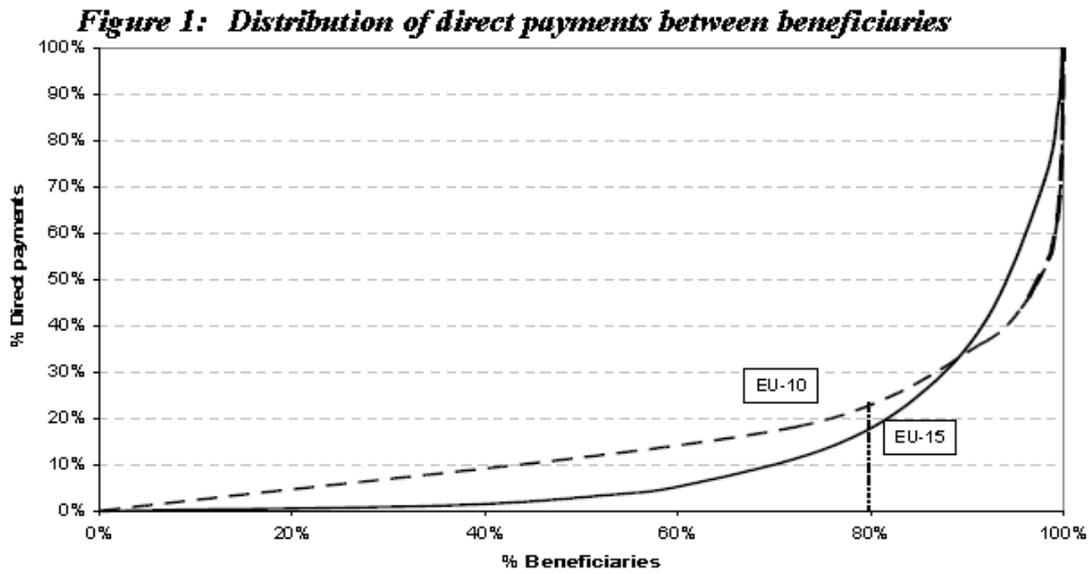
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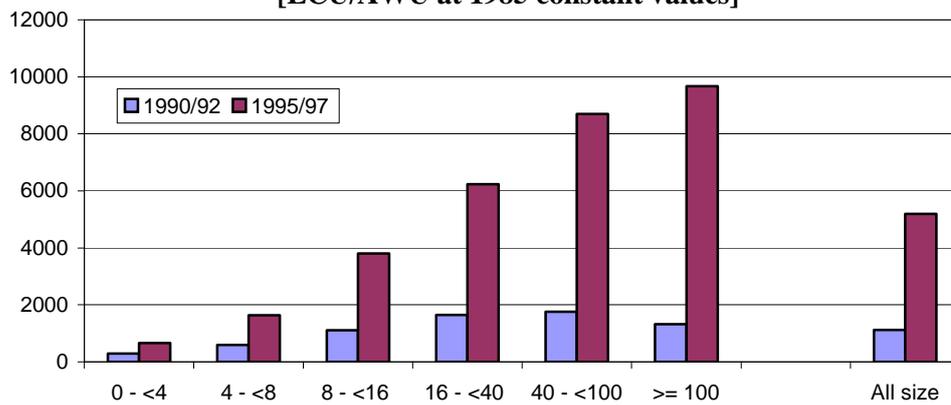
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Annex



Source: CATS data (2006 budget year)

Figure 1: Production subsidies per AWU by group of farms, classified by ESU (Economic Size Unit - FADN classification) [ECU/AWU at 1985 constant values]



Source: EC, 2001: Figure 19.

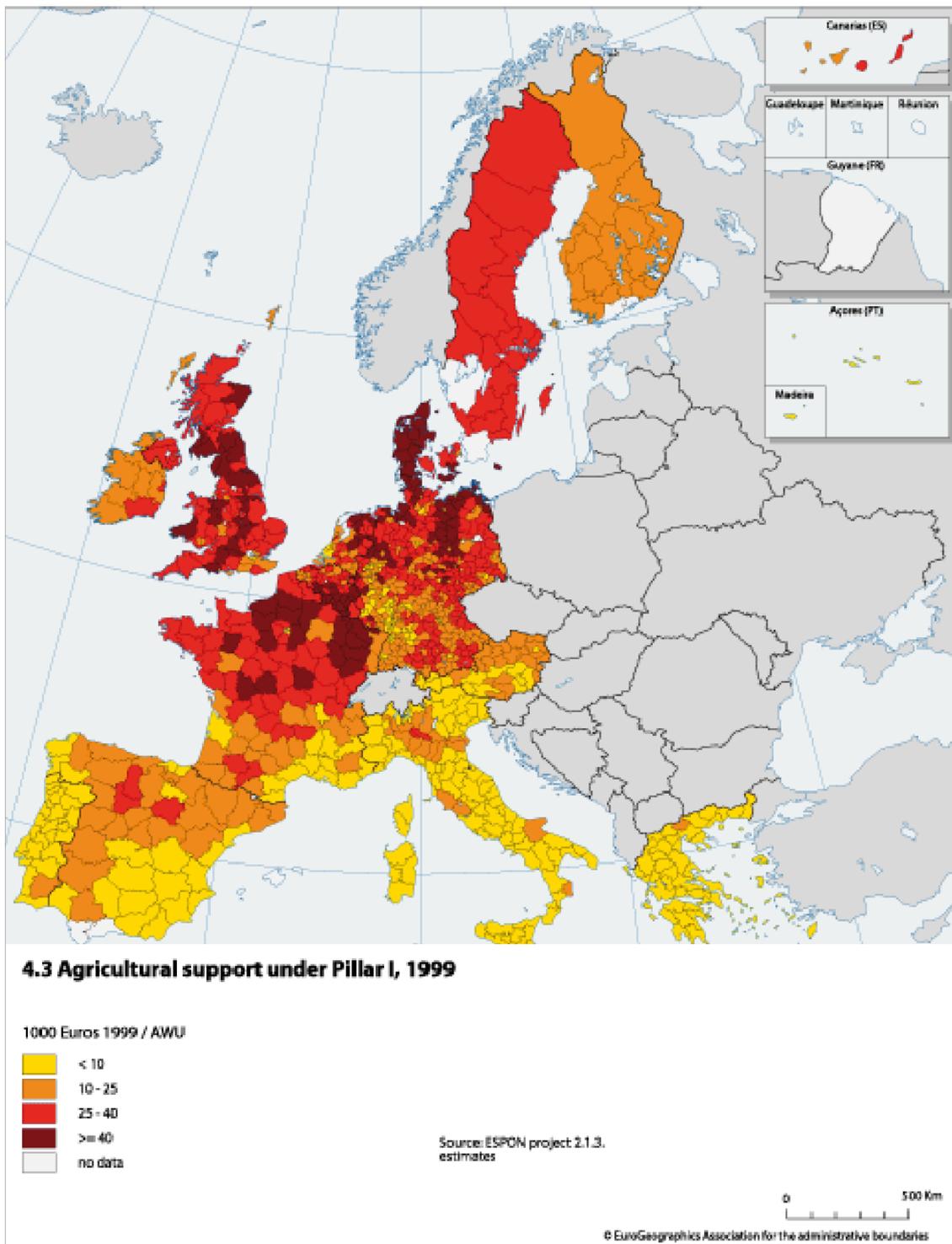


Table: Basic *priority matrix* for applying the CAP

<i>Type of rural area</i>	Type of farmer-holding	
	<i>Territorial agriculture</i>	<i>Others</i>
<i>Backward</i>	<i>A1</i>	<i>B1</i>
<i>Intermediate</i>	<i>A2</i>	<i>B2</i>
<i>Periurban</i>	<i>A3</i>	<i>B3</i>

