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THE BUDGETARY ASPECTS OF THE NEW CAP PAYMENTS

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POLICY DEPARTMENT B: STRUCTURAL AND COHESION POLICIES

AGRICULTURE AND RURAL DEVELOPMENT

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Abstract:

This note examines the available political and scientific evidence that can shed some light on the likely post-2013 CAP budget. Substantial uncertainties exist with regard to funding availability, funding needs, and the relationship of the CAP with other policies. If the CAP moves boldly towards promoting European public goods, one can expect that a significantly smaller budget will be sufficient and that competition from other policy areas for EU funding will not constrain the future CAP during the next financial perspectives.

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CONTENTS

Introduction **5**

1. The Financial and Economic Crisis **7**

2. Funding Availability **9**

2.1. Size of the EU Budget 9
2.2. Agriculture and Competing Policy Areas 9

3. Funding Needs **13**

3.1. Objectives of the CAP 13
3.2. Farm Income 13
3.3. Food Security in the EU 14
3.4. Public Goods 15
3.5. Co-financing of the CAP 16

4. Structure of the CAP and Integration With Other Policy Areas **19**

5. Scenarios and Transition Strategies **21**

5.1. Funding Needs in a European Public Goods Scenario 21
5.2. Transition Strategies 22

6. Distribution of the CAP Budget Across Member States **25**

Conclusion **27**

Annex 1: Explanation of Current CAP Subsidy Allocation Across Member States **29**

Annex 2: Potential Criteria for Allocating CAP Payments Across Member States **31**

Bibliography **33**

Introduction

The EU has begun to prepare for the next financial perspectives that will guide EU expenditures for several years after 2013. One approach to this discussion is to make normative recommendations on how the budget *should* be spent. The alternative approach, pursued in this paper, is to ponder the *likely* size and shape of the future EU budget. While it is too early to put down precise numbers on post-2013 CAP spending, it is useful to consider the main elements in this equation one by one. This paper provides a list of the relevant questions and the evidence available for answering them, considering political constellations and dynamics as well as scientific findings.

It does not address CAP spending up to 2013. Owing to the implementation of past reforms, the shift towards decoupled direct payments will continue within the first pillar, and the second pillar will continue to expand slowly at the expense of the first. The overall CAP budget size will remain fairly stable, so that its share in a slightly increased EU budget will decrease.[1] These developments are not decisive for the post-2013 CAP budget.

Section 2 sums up key data on the financial and economic crisis that will pervade all aspects of the budget debate. Section 3 looks at funding availability for agriculture in the EU budget. Section 4 addresses CAP funding needs as a function of the policy objectives established for the CAP and the repartition of responsibility between the EU and the Member States. Section 5 discusses the internal structure of the CAP and its external links to other policy areas. Section 6 estimates financing needs for a CAP focused on European public goods and considers transition strategies. Section 7 develops criteria for the distribution of CAP payments across Member States. The concluding section reflects on the way forward in the CAP (budget) debate.

[1] See European Commission (2009e) and European Commission (2009a) for a detailed account of CAP expenditures in 2008. See Council of the European Union (2009), European Parliament and Council of the European Union (2009) and European Commission (2009d) on expenditures up to 2013. See also Massot (2009) for an overview.

1. THE FINANCIAL AND ECONOMIC CRISIS

The financial and economic crisis will have profound impacts on the future CAP budget. It will leave a lasting strain on national budgets, and will transform the politics of public spending. All of the following considerations – the size of the EU budget, the share of the CAP in the EU budget, co-financing in the CAP, as well as the objectives and structure of the CAP – are shaped by the crisis.

DG Economic and Financial Affairs provides the following analysis:[2]

- EU GDP is projected to fall by 4% in 2009 and by 0.1% in 2010.
- Budget deficits deteriorated from 0.8% in 2007 to 2.3% in 2008, and they are expected to widen to 6.0% in 2009 and 7.3% in 2010.[3] The hardest hit Member States are Spain, the UK and Latvia with an expected budget deficit in 2010 of 15.6%, 13.8% and 13.6% respectively.
- Member States plan to exit from fiscal stimulus in 2010 or 2011, but these strategies are founded on optimistic economic assumptions. Also, the outlays for the banking sector cannot yet be calculated. Member States have invested 13% of GDP into banking support and approved 31% of GDP for further measures. It remains to be seen how much of this money will actually be spent and how much will be recuperated. Past experiences around the world with systemic banking crises indicate extremely high fiscal costs. The situation is aggravated by the large size of the EU banking sector, the high leverage of many financial assets that are hard to unwind, and the fact that the global dimension of the crisis complicates recovery. In an adverse scenario, rehabilitation of the banking system will cost 16.5% of GDP to public finances.
- The average EU public-debt-to-GDP ratio will increase from 61.5% in 2008, to 72.6% in 2009 and to 79.4% in 2010. Public debt is anticipated to exceed GDP in Italy, Greece, and Belgium in 2010. Ireland will see its debts increase by 36.4% between 2008 and 2010, Latvia by 30.7%, the UK by 29.7%, and Spain by 22.8%.

This deterioration of public finances endangers the Stability and Growth Pact. In 2008, only Hungary and the UK were subject to excessive deficit procedures. In February 2009, procedures were opened against France, Greece, Ireland, Latvia and Spain. In May 2009, this was followed by procedures against Lithuania, Malta, Poland and Romania. With further procedures against Austria, Belgium, the Czech Republic, Germany, Italy, the Netherlands, Portugal, Slovakia and Slovenia in October 2009, 20 Member States are by now being pursued for violation of the Stability and Growth Pact. The IMF even intervened within the EU in 2009, for the first time in three decades, bailing out Hungary, Latvia and Romania.

The crisis adds to pre-existing structural difficulties in the public finances of many Member States. These imbalances will worsen in the long run as European societies age, requiring increased spending for pension, health care and long-term care. DG Economic and Financial Affairs estimates that to keep public debts/GDP down to 60% in 2060, the current balance of public finances would have to improve by 6.5% of GDP on average throughout Europe.4
Assuming that growth will return to its pre-crisis long-term path and that current policies are maintained, public debts in the EU are expected to equal GDP in 2014 and to exceed it thereafter.

[2] See European Commission (2009h).

[3] See European Commission (2009h), table I.1.3.

[4] See European Commission (2009i).

2. FUNDING AVAILABILITY

In order to assess how much funding will be available for the CAP, this section considers the size of the EU budget and its repartition across policy areas.

2.1. Size of the EU Budget

A starting point for thinking about the future size of EU budget is its long-term trend. It reached 1% of community GNI for the first time in 1984, increased slightly during the 90s up to 1.2% and then declined again to around 1% during the last decade.[5] The resistance against a higher EU budget comes from the Member States. The Commission had proposed € 993 billion in total commitment appropriations for the 2007-2013 financial perspectives, but the Council agreed only on € 853 billion. The EP strove to raise the budget in the subsequent negotiations with the Council and obtained an increase of € 11 billion.

Looking at the financing instruments, one can see that the traditional own resources (mostly customs duties plus some agricultural levies) have become less important over time and would further recede with additional trade liberalization. The contributions from the Member States are likely to be remodeled. The value-added tax resource will probably be abolished due to its excessive complexity. The exceptions to the remaining GNI-based resource stand to be removed or, at the least, scaled-back and streamlined.

The idea of introducing a new own resource – such as a tax on telecommunication, financial transactions or aviation – has received mixed reactions in the budget review consultations but support in the budget review conclusions. In particular, the conclusions endorse an own resource based on the auctioning of greenhouse gas emission certificates under the EU Emission Trading System. However, even the Commission seems to see this as a long-term project that would only be progressively phased in during the next financial perspectives.

The budget review consultations and (draft) conclusions say little about the future size of EU budget.[6] In the light of 1) the difficulties in winning public support for enhanced European integration (failed referenda for the European Constitution and the Lisbon Treaty, and low participation in the 2009 elections for the European Parliament), 2) Member States' historic reluctance to increase the EU budget, 3) the lack of agreement on new own resources and 4) the economic crisis and strained public finances, any substantial increase in the EU budget appears unlikely. More likely are very moderate increases in line with expected inflation/GDP growth, with somewhat bigger increases towards the end of the next financial perspectives.

2.2. Agriculture and Competing Policy Areas

Several Member States have committed themselves to a 'strong' CAP, notably in their contributions to the budget review. However, only very few Member States have developed a substantiated vision for the post-2013 CAP.[7] The real debate within the Member States is still to come. Their early statements are heavily influenced by those with a clear interest in

[5] See European Commission (2009f).

[6] The final budget review conclusions are not yet available at the time of writing but the draft version of October 6, 2009 has leaked to the public. In the following, 'budget review conclusions' refers to this draft version.

[7] The most comprehensive stakeholder process has taken place in the Netherlands. See Dutch Ministry of Agriculture (2008) based on SER (2008).

a 'strong' CAP (agricultural ministries, farmers, and landowners), while other stakeholders, and especially the finance ministries, can be expected to gain a greater say over time.

The future position of the European Parliament is equally difficult to foresee. The Parliament was renewed in 2009, most members of the Committee on Agriculture and Rural Development were replaced, and the weight of the political parties shifted considerably. Also, the positions of the European Parliament may gradually change as it acquires additional powers over agriculture with the entry into force of the Lisbon Treaty.

The stance of the next European Commission that will take office in 2010 can be better anticipated. Its president, Manuel Barroso, remains in place and its positions are outlined in the budget review conclusions. The conclusions propose to expand spending[8]

- for sustainable growth and jobs (research and technology development; lifelong learning and mobility; and cross-border cooperation of regions in the context of a more ambitious neighborhood policy)
- for climate and energy (European energy network; low-carbon technologies; performance incentives for investment beyond the binding greenhouse gas reductions and renewable energy targets; climate cooperation with developing countries; and transport and communication infrastructure, with a stronger focus on cross-border interconnections)
- and possibly also for a global Europe (neighborhood policy; fighting global poverty; response capacity to cope with sudden, large-scale conflicts or disasters; migration; and security risks, such as terrorism, organized crime and mass diseases)

On the CAP, the conclusions (p. 17) ask for 'a further significant reduction in the overall share of the EU budget devoted to agriculture'. Several background conditions and developments indicate that the CAP share is indeed likely to shrink – possibly considerably.

Alternative demands: As argued above, substantial increases in the EU budget are unlikely. However, the responsibilities of the EU are constantly growing. This creates pressures to shift money from the CAP to alternative uses. A growing body of research underpins this case.[9] Furthermore, the economic crisis will intensify the impression that the EU has indulged in the luxury of following beaten paths for too long and that a radical, painful departure from engrained compromises is necessary.

Budget negotiations: The fact that the next CAP will be negotiated in the context of a new financial framework favors reform. First, the budget review has strengthened the expectation that the EU budget should follow a rational, welfare-oriented logic rather than being shaped by historical evolution and political compromise. By subjecting all EU spending to the same standards of analytical scrutiny, it reveals that the current CAP cannot be defended on collective welfare grounds. Second, the integration of CAP negotiations into the larger process of defining a new long-term EU budget makes the competition for funding more evident and attracts the attention of stakeholders that usually care little about agriculture.

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[8] Specific issues singled out in the conclusion as deserving more spending are mentioned in brackets below.

[9] See Copenhagen Economics (2009), ECORYS Nederland BV, Netherlands Bureau for Economic Policy Analysis (CPB), and Institute for Economic Research (IFO) (2008) and Sapir (2004).

Third, the negotiating format offers broad scope for interstate bargains across EU spending and financing. For instance, France may be more willing to accept reductions in the CAP budget if the UK rebate and similar exceptions are addressed. Similarly, Eastern European Member States may agree on a smaller CAP budget if, in turn, they receive more structural and cohesion funds. Fourth, CAP reform will be identified as the crucial condition for a 'grand bargain' that ambitiously promotes European objectives and moves beyond the mentality of narrow national interests. This will create strong pressures for reform among pro-European idealists, including probably much of the media.

Farm lobby: Farmers find it increasingly difficult to agree on a common position. The dividing lines are manifold – Swedish farmers have little in common with their French colleagues, 'horn' competes with 'corn', small-scale farmers complain against large-scale farmers who traditionally dominate farm federations, young farmers are more open to change than their elder peers, and organic producers disagree with conventional producers. A resolute subset of farmers, such as the milk farmers, may be able to extract some additional payments under extraordinary circumstances. But they are much less able to resist change in the context of a comprehensive and systematic EU budget re-evaluation and negotiation.

Interest in a large CAP budget: One likely development (addressed in section 4.1) is the change from farm income support to targeted payments for European public goods. In the current situation, the additional cost of abiding by the cross-compliance conditions (that go beyond respecting legal requirements) are mostly marginal. The Single Farm Payment – minus a fraction for administrative costs – translates thus into increased income for farmers and land owners. Perfectly targeted and tailored payments, by contrast, compensate farmers only for the extra costs of providing public goods. Though perfect targeting is impossible, the share of farm income support – whether intended objective or unwanted side effect – will decrease. If the inevitability of such a shift in objectives and instruments becomes clear, farmers will therefore be less interested in investing financial and political capital to fight for a larger CAP budget.

Another development is the expansion of co-financing to all parts of the CAP (as discussed in section 4.2). If Member States have to match EU funding with national resources, a large CAP budget becomes less attractive to governments.

Finally, the distribution of CAP subsidies across Member States will change (see section 7). Member States that benefit significantly from the current distribution key and strongly advocate a large CAP budget are likely to lose. At the same time, several of the Member States that will see their share in the CAP grow will nevertheless prefer to cut the CAP budget. This may be because they are convinced of the benefits of greater market orientation in agriculture and enhanced spending for non-agricultural policies (e.g. Sweden and UK), or because the CAP competes for funding from which these Member States receive an even larger share (potentially the case of structural and cohesion funds for Eastern European Member States).

3. FUNDING NEEDS

While the preceding section has considered external constraints of the future CAP budget, this section examines the needs for EU funding, considering the objectives the CAP should fulfill and the financial burden sharing between the EU and the Member States.

3.1. Objectives of the CAP

The three types of objectives dominating the debate are briefly discussed. The assessment of the intellectual merits of potential CAP objectives is not intended to be normative but shall provide orientation as to the chances of the different objectives to prevail in the upcoming negotiations. It is thus combined with some reflections on how these arguments for or against certain objectives are likely to be perceived by the public in the coming years.[10]

3.2. Farm Income

Four main criticisms have been brought forward against EU-funded farm income support. The first is that social policies should be exclusively linked to household income and wealth (for instance through progressive taxation and social security benefits). Including other criteria, such as agricultural employment or land ownership, as an entitlement for support will necessarily come at the cost of the poor. It means favoring a farmer and disadvantaging a non-farmer with lower income who would otherwise receive more support.

Second, singling out farmers as recipients of preferential income support is especially ineffective for reducing poverty. In some countries, farmers have above-average incomes. Moreover, many farmers are asset-rich: they own machinery, farm buildings, and above all land. It is difficult to justify why people who own a lot should have a privileged access to public money.

Third, poor farm households benefit little from the EU's main income support instrument, the Single Farm Payment. 20% of Single Farm Payment recipients reap roughly 80% of the Single Farm Payment. More than a quarter of the Single Farm Payment goes to farmers with at least € 50,000 Single Farm Payment receipts. In the Czech Republic, the average beneficiary receives almost € 50,000.[11] A related problem is that much of the Single Farm Payment ends up with land owners and not with those who actually farm the land. Fourth, social policies should not be paid for by the EU. European solidarity should limit itself to transfers from richer to poorer Member States (or possibly regions).

The budget review conclusions observe (p. 18) that 'decoupled direct payments are subject to substantial criticism for being insufficiently targeted and based on a historic model which becomes more and more difficult to justify.' The public outcry that followed the disclosure of the identity of the CAP subsidy recipients demonstrates to what extent the general public is opposed to current forms of income support. It also showed that many citizens sympathize with small-scale farmers: the Single Farm Payment was reproached not only for

[10] For studies criticizing traditional CAP obectives and instruments and supporting a public goods approach, see Bureau and Mahé (2008), ECORYS Nederland BV, Netherlands Bureau for Economic Policy Analysis (CPB), and Institute for Economic Research (IFO) (2008), Nunez-Ferrer and Kaditi (2009), OECD (2006), OECD (2007), OECD (2008a), OECD (2008b), SER (2008) and Swinnen (2009).

[11] See Velazquez (2008).

wasting public money but also for neglecting small-scale farmers. However, any redistribution in favor of small-scale farmers is likely to encounter multiple difficulties (the opposition from large-scale farmers and from Member States with an important share of large-scale farming; the legal problem that large farms can be split up into several entities; the issue that many small-scale farming households have substantial assets or sources of non-farm income, requiring more complex criteria than economic farm size to determine income support eligibility).

The economic crisis will increase the political sensitivity of farm income support. Unemployment figures will remain high and the social stress of the crisis will continue to be felt throughout society. This will make it less acceptable in the eyes of the public that farmers and landowners obtain income support ('Why not increase unemployment benefits instead?').

Finally, farmers' average incomes have been increasing in recent years in most countries. This trend is likely to continue in the future: output prices are forecasted to move on a long-term upward trend and labor is leaving agriculture, raising the earnings of those who remain in the sector (especially in the new Member States).[12] The current slump in milk prices and milk farmers' vociferous complaints about depressed incomes do not paint an accurate picture of the future of EU farming.

3.3. Food Security in the EU

Food shortages in the EU are extremely unlikely.[13] First, European food production is comfortingly high. For more than five decades, the EU has produced more than enough food to nourish its citizens in every single year. In the future, the European food production potential is likely to grow further thanks to technological progress and improved farming methods, while EU population growth will be negligible: the buffer between supply and the necessary food intake of the EU population is expanding. It is possible that climate change will make food production less stable – but the level of supply is so high that a famine is a most unlikely scenario in the EU.

Second, the EU could cope with severe production shortfalls. Farmers could easily expand cultivated areas, use more intensive farming methods and shift production patterns to increase yields. In particular, curbing meat, milk, and biofuels production could free up capacity for growing basic grains. 51 million hectares were used as pastures and permanent meadows in 2005, compared to 100 million hectares of arable land; in addition, much arable land serves feed stuff production. In other words, the European production potential that could be easily unlocked is reassuring. This would not always be desirable from an environmental perspective, but tolerable under catastrophic conditions.

Third, throwing away less food is a guaranteed way to have more on our plates if food should ever become scarce. In the EU, about one third of the food production is lost after the harvest. Making food processing, transportation and retailing more efficient and handling food more carefully in the household could greatly increase the quantity of food available for consumption, and is exactly what will happen if food prices ever rise so high that we can no longer feed our population.

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[12] See European Commission (2009b), European Commission (2009g) and Witzke, Noleppa, and Schwarz (2008)

[13] This is also acknowledged in the budget review conclusions (p. 18) that note that the EU's 'production capacity and purchasing power will continue to provide it with enough food at all times.'

Fourth, imports would have to be blocked. Some export restrictions abroad – as witnessed in 2008 – drive up world market prices. However, the EU has sufficient purchasing power to fulfill its needs even on a high-price world market. The only threats to food imports are therefore global catastrophic food shortages, or a global war, that bring world food trade to a standstill.

Hence, there is no need to dedicate substantial funds to food security. Those programs aimed at public goods also help to improve food security in the long run (e.g. preserving water, biodiversity, and the genetic variety of plants and animals used in agriculture).

3.4. Public Goods

The budget review conclusions assert (p. 18) that, 'Financing should be provided at the level where it creates real EU added value and the EU budget should primarily be targeted to the provision of public goods.' This is in line with the budget review contributions, the public debate as it has evolved since then, and a host of scientific literature.
The amount of funding needed for the promotion of public goods will depend on many factors. The most obvious one is the definition of what constitutes public goods of European interest. For instance, one may argue that most benefits of a diverse, traditional, well-kept landscape will be reaped within the country – by direct enjoyment, as an advantage to attract qualified human resources or through tourism. But Europeans also enjoy the landscapes of other Member States, possibly justifying some collective intervention by the EU. At issue is where to draw the dividing line (and whether to draw one line, or several, as discussed in the following section).

Once public goods are identified, the next challenge is to determine their value. The scientific evidence is rich but inconclusive, and the fundamental difficulties inherent in these studies suggest that they will only provide very approximate guidance.[14]

Another element of great importance for future financing needs is whether the CAP will treat agricultural and forest area (more) equally and invest resources where the payoff in terms of public goods is greatest. If the CAP moves from marginal to serious support for public goods related to forests, its financial needs will increase considerably.

A further unknown aspect concerns the restrictiveness of future emission targets for agriculture. This depends on the overall EU emission target, developments of emissions in other sectors, structural changes in agriculture (especially in livestock in the case of a WTO Doha agreement), and the marginal mitigation costs across sectors. It needs also to be seen to what extent farmers can receive credits under the Emission Trading System for carbon storage, diminishing the need for subsidies.

Similarly, the legal baseline will influence how much subsidies will be needed. The more effectively regulation, taxes and (potentially) emission trading reduce the negative externalities of agriculture, the fewer subsidies will be required.

Last but not least, the price that the CAP will pay for delivery of each 'unit' of public goods is uncertain. This depends, first, on whether the CAP will be intended to drive down compensation for farmers to the necessary minimum or whether some income support will be considered as a desirable component of public goods payments. Second, it depends on governments' ability to tailor payments to the necessary minimum for the delivery of the

[14] See Jacobs (2008) for a systematic stocktaking of the effects agriculture exerts on society's well-being through non-market channels.

desired quantity and quality of public goods. This includes the use of market-based mechanisms for allocating subsidies, such as auctions for environmental stewardship contracts; the use of outcome oriented compensation; and negotiation of individual contracts with farmers based on locally adapted compensation schemes. It remains to be seen at what point the advantages of greater tailoring are offset by the additional administrative costs. Third, the necessary funds depend on farmers' offer curve for public goods, that is, how much governments have to pay to obtain the public goods even if they are willing and able to perfectly tailor their payments. The answer to this question is hard to give because many parameters that shape the attractiveness of public goods payments for farmers will change: market prices (especially if tariffs are reduced), direct income support, the image of targeted payments, the availability of advice and the orientation of advisors, and administrative costs for farmers (which will decline if they receive larger amounts of targeted payments over longer periods through enhanced delivery mechanisms, including, e.g., less burdensome monitoring thanks to better use of technology).

3.5. Co-financing of the CAP

The 1962 'financial solidarity principle' says that the Member States shall share the financial burden of the CAP. While the first pillar is indeed fully financed by the EU, second pillar expenses are divided between the EU and the Member States. The current rates of EU co-financing are differentiated according to programs and regions (see Table 1).[15]

Table 1: Current EU co-financing rates

	General	Convergence regions
Axis 1 and 3	50%	75%
Axis 2 and LEADER	55%	80%
New challenges	75%	90%

Despite its long pedigree and appealing name, the financial solidarity principle is difficult to sustain as an expression of European solidarity. What would constitute a just distribution cannot be established here, but common perceptions of justice would suggest that a solidarity principle should favor, for instance, the Member States with the lowest GDP per capita, Member States where farmers have the lowest income (possibly in comparison to average incomes), or Member States whose agricultural sector undergoes painful restructuring due to the competition on the single market. Instead, the distribution of CAP funds has favored Member States and regions with substantial output in highly-supported agricultural goods.[16]

More fundamentally, one may question the very idea that the CAP should serve the re-distribution of wealth between Member States or regions. To this end, the EU has two more targeted tools at its disposal: differentiated financing of the EU budget and the structural and cohesion policies. A case can be made for the CAP focusing on its agriculture-related objectives, leaving aside the issue of European solidarity. This argument becomes all the more powerful as the CAP turns towards the provision of European public goods. From this perspective, CAP funds can be understood as investments that should be undertaken where their pay-off is highest, and this logic should not be distorted by other considerations.

[15] See also graph 2.5.1 on p. 50 of European Commission (2008) on average applied co-financing rates across groups of Member States and instruments.

[16] See Shucksmith, Thomson, and Roberts (2005).

It must also be noted that the financial solidarity principle runs counter to the general practice of co-financing according to which the EU and the Member State concerned jointly finance programs. Co-financing has several advantages.[17] First, their financial contribution creates an incentive for the implementing Member States to use EU funds responsibly to fulfill genuine needs (up to the point where marginal public costs equal marginal public benefits). Second, Member States can be expected to administer public funds more efficiently, attaining a greater impact for a given amount of money, if they participate in the costs. Third, co-financing provides the EU with higher leverage for its limited funds, so that it can more comprehensively shape policies in line with a European agenda.

Finally, the expansion of co-financing is desirable if one wishes to shift money away from farm income support to strengthen other objectives within or outside the CAP. If the principle of co-financing all EU expenditure is accepted, Member States that currently defend farm income support (because they expect that their subsidy receipts from the EU budget will outweigh their corresponding contributions to the EU budget) will lose much of their interest in such policies.

Much speaks therefore in favor of expanding co-financing to the entire CAP. While Member States are split on this issue, the budget review conclusions (p. 19) mention that 'a larger responsibility of current CAP spending could be assigned to the Member States, or direct aids could be co-financed by national contributions'.

Ideally, the differentiation of co-financing rates should be developed further in order to maximize the leverage effect of the EU budget. One aspect of differentiation concerns the nature of the supported program. EU contributions in favor of public goods with strong cross-border effects should be higher than those for public goods where most benefits remain within the subsidizing country. The current distinction between three types of programs (Axis 1 and 3, Axis 2 and LEADER, and the New Challenges) is not sufficiently fine-grained, and the range of co-financing rates (50%-75% in general, 75%-90% in the convergence regions) is not sufficiently wide.

Another aspect of enhanced differentiation of co-financing rates relates to the level of development of the Member State implementing the program. It is reasonable to hold that relatively poor regions are less likely to provide the optimal level of European public goods in agriculture and should therefore receive higher EU contributions. However, the current distinction between convergence and non-convergence regions is overly blunt. It does not sufficiently account for regional wealth differentials. Furthermore, it ignores that the costs of co-financed programs that are not born by the EU are generally shared between the regional and the national level. Accordingly, programs implemented in poorer Member States should receive greater EU support. It would therefore be preferable to have a more nuanced set of, or formula for, co-financing rates that is responsive to regions' and Member States' GDP per capita.

Differentiated co-financing may also bring about political advantages. Having one rigid co-financing rate would require possibly arbitrary decisions about which objectives and instruments receive support and which do not. By contrast, negotiations about which of say 5 co-financing rates apply to a given objective or instrument would be easier to conduct. A reasoned debate should permit to identify the two rates that could possibly be applied to a

[17] See also the praise of co-financing in the budget revenue conclusions (p. 27).

given program type, so that the negotiable stakes would be minor (not 0% vs. 50% EU co-financing but 20% vs. 30% or 50% vs. 60%).

It will have to be seen how more differentiated co-financing rates are administered best. One difficulty is that many measures serve several objectives (e.g. support to organic farming). Furthermore, the European interest in any objective cannot be condensed in few categories but depends on the specific aims of a given measure. Biodiversity is a good example: the European interest is great in the case of endangered migratory birds but much lower where non-migratory species are protected that are not endangered at European level. Finally, much depends on the quality of program design. Measures that are likely to deliver high value should receive enhanced EU support. Co-financing rates may thus be best determined by DG Agriculture on a case-by-case basis, drawing on a catalog of criteria. They might also be adapted over time according to performance where this is measurable.[18]

In many cases, the European interest in CAP payments is lower than the current EU share. A consistent application of the co-financing principle would thus lead to increased national contribution rates. Theoretically, this should not create a substantial financing problem for Member States. Either their contributions to the EU budget could be reduced accordingly, or the EU could spend more on other areas on which Member States could then reduce their national expenditures.[19] Moreover, total expenditure for agriculture is likely to decline, making its financing (whether through European on national channels) easier. Practically, however, one can doubt whether national agricultural budgets will neither be increased at the same time that the CAP budget is reduced nor in line with the national funding necessary to match all available EU funding.

This shortage of national co-financing capacity has a beneficial side-effect: Member States will likely prefer those objectives and instruments for which national co-financing rates are low, that is, those strongly targeted at European public goods. Nevertheless, it may be necessary to temporarily increase EU co-financing rates until the fiscal situation in Member States improves and national budgets adapt to the new CAP. Accordingly, a sliding scale of co-financing rates could be established that arrives at its final level at some future date.

[18] This would sit well with the performance orientation of EU spending advanced in the budget review conclusions.

[19] This effect will be the weaker the more the national incidence of increased spending on other policy areas will differ from that of the CAP.

4. STRUCTURE OF THE CAP AND INTEGRATION WITH OTHER POLICY AREAS

It is reasonable to expect that the internal structure of the CAP will change after 2013 as several past or expected developments blur the distinction between the two existing pillars. The market intervention mechanisms and the direct aids coupled to production – that is, the part of the first pillar that is most distinct from the second pillar – have been scaled back and might be removed completely.[20] Furthermore, the Single Farm Payment – the only remaining significant policy instrument within the first pillar – may also be phased out. If it is upheld at all, it will more closely resemble the second pillar instruments: it will be more strictly tied to the provision of public goods and probably co-financed. Finally, the Health Check reform has extended the range of instruments eligible for first pillar funding[21], introducing measures traditionally associated with the second pillar (e.g. support to specific agricultural activities entailing additional agri-environmental benefits).

The changes in the objectives, instruments and financing arrangements of the CAP will not only make the current two pillar structure redundant but speak against any new rigid division into few pillars. As argued above, co-financing rates should instead be calculated flexibly according to the merits of each measure based on clear criteria. Accordingly, the options of increased compulsory modulation for new challenges and of a third CAP pillar for charges related to climate change – adduced in the budget review conclusions – appear implausible.

On an even broader level, the question about the relationship of the CAP with other policy areas will emerge. Under the current structure, the overlap between rural development, on the one hand, and structural and cohesion policies, on the other, complicates transparent, efficient and coherent implementation. In addition, the focus on rural areas is misplaced when the policy aims at sustainable land use, which is also threatened in urban and peripheral areas. Finally, the name 'agricultural policy' is misleading. It creates expectations among farmers who resist 'their' money being used for environmental, economic diversification and forestry purposes.

A solution would be to group together all policies related to sustainable land use and rename the policy accordingly.[22] This would enable the removal of measures that overlap with structural and cohesion policies (as they are usually unrelated to land use) and to broaden its reach to all rural and non-rural areas. It would also allow the adjustment of expectations about the objectives of the policy in line with European interests (away from supporting farmers to promoting public goods). Related to such an overhaul of the budget structure is a potential re-definition of portfolios within the Commission.23 To manage a sustainable land use policy, DG Agriculture and Rural Development would have to be renamed and its competencies adapted. It could assume some regulatory responsibilities currently exercised by DG Environment (e.g. the policy areas 'land use' and 'soil') and possibly pass on others to DG Health and Consumers (e.g. food-related consumer information).

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[20] The budget review conclusions state (p. 18) that, 'Market intervention mechanisms could be rolled back further to become a genuine safety net.'

[21] See Art. 68 of Council Regulation (EC) No 73/2009.

[22] WWF (2008) proposes to call this a 'Common Environment and Rural Policy'.

[23] See Sapir (2009) and in particular the current discussion about creating a Commission post for climate change (EuropeanVoice, 29 October 2009).

Several developments enable such a reconfiguration. First, EU agricultural policies are becoming more compatible with other EU policies as they follow similar principles (market orientation, sustainability, subsidiarity, and co-financing). Second, the shift towards environmental objectives makes integration with other environmental policies more important. It also weakens the ability of traditional farm interests to resist such an ever more compelling adaptation to new realities. Third, the structural and cohesion policy is subject to intensive criticism and likely to be reshuffled after 2013.[24] The parallel reengineering of the two policies offers the opportunity to transfer responsibilities. Fourth, the Commission calls for 'a root and branch reform of the EU budget' (p. 5) and suggests (p. 24) that, 'The number of Headings of the financial framework should be limited with a view to adopting an approach that breaks through compartmentalisation of existing policies so as to better respond to cross-cutting challenges at domestic and global level.' Strikingly, the section dealing with the CAP is titled 'land and maritime resources' rather than agricultural policies. Furthermore, it is a sub-section of the priority objective 'climate and energy'.

[24] See the budget revenue contributions and conclusions, as well as Barca (2009), Copenhagen Economics (2009) and Santos (2008).

5. SCENARIOS AND TRANSITION STRATEGIES

Considering the numerous uncertainties discussed above, it is too early to set up elaborate financial CAP scenarios. The uncertainties concern funding availability (size of the EU budget and competition between agriculture and other policy areas), funding needs (the objectives of the CAP and especially the funding needs for the promotion of public goods, as well as the repartition of responsibilities between the EU and Member States with regard to co-financing), and the structure of the CAP as well as its integration with other policy areas (primarily with environmental and structural and cohesion policies). What complicates matters further is that all these aspects are interdependent. For instance, available funding will influence the choice of objectives and instruments. If one wishes to significantly scale back the CAP budget while strengthening targeted public goods payments, the Single Farm Payment needs to be removed. Another aspect of interdependency is that a greater focus on targeted payments for the provision of European public goods will change the politics of the EU budget allocation across policy areas. It will make a large CAP budget more legitimate and defensible but also weaken the lobbying effort in favor of a large CAP of farmers and net-recipient Member States.

Accordingly, it is impossible to predict with a reasonable degree of certainty either the size of the future CAP budget or its allocation to objectives, pillars or instruments.[25]

5.1. Funding Needs in a European Public Goods Scenario

If one believes that the CAP should promote exclusively public goods of European interest (and that these are primarily environmental and possibly also related to animal welfare), one may accept a significantly smaller CAP at the end of any transition period. Comparison with current spending for environmental protection can serve as a reference.

The 2007-2013 second pillar budget amounts to € 90.8 billion.[26] 46.4% of this amount has been assigned to Axis 2. From this, 32% has been allocated to Less Favored Area payments that are not primarily environment-oriented. The remaining amount corresponds to € 5.3 billion per year. Some corrections have to be made. On the one hand, there are some additional, minor environmental and animal welfare payments in Axis 1 and 3, such as payments under food quality schemes to organic farmers. On the other hand, several considerations reduce this value.

- Actual expenditure on the second pillar during 2007 and 2008 has been lower than the 2007-2013 second pillar budget divided by 7 years would indicate.[27]
- Many of the environmental or animal welfare payments are not efficiently targeted at their stated objectives.[28]
- Some subsidies under the first and second pillar have negative effects on European public goods (e.g. by raising price levels leading to more intensive farming or by

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[25] See Bureau and Mahé (2008), Hofer (2009) and WWF (2008) for attempts to put down some numbers.

[26] See European Commission (2008). These numbers are retrospective. They do yet not include the Health Check reform and the European Economic Recovery Plan. Furthermore, the new opportunities offered by Art. 68 of Council Regulation (EC) No 73/2009 have introduced public-goods-oriented spending into the first pillar.

[27] The Reports on Budgetary and Financial Management prepared by DG Budget show € 10.9 billion and € 10.5 billion in expenditures for 2007 and 2008 respectively.

[28] BirdLife International (2009), for instance, criticizes that farmers get more money for fulfilling a few environmentally friendly farming practices that do not impose major costs than for producing according to much stricter organic standards.

subsidizing drainage). If these harmful subsidies are removed after 2013, less money will be needed to create positive incentives.

- Many of the payments focus on the provision of local/national rather than European public goods. EU co-financing rates may decline on average in the long run for EU-supported programs, creating greater leverage.

As a very rough estimate, one could say that, under current financial perspectives, about € 2 billion per year would be needed to maintain the level of incentives for the provision of European public goods provided thus far through the second pillar.

The substantial payments under non-environmental programs that have some positive ecological effects must not be forgotten in such a calculation. The Single Farm Payment is subject to cross-compliance: farmers need to adhere to statutory management requirements (SMR) and to maintain their land in good agricultural and environmental condition (GAEC). However, the ambition of the cross compliance conditions is low and their implementation record is poor.[29] As long as one does not credit the Single Farm Payment for compliance with compulsory law, few environmental benefits can be expected. The Less Favored Area payments are slightly more targeted at public goods, notably the preservation of low-intensity farming with high nature value. But the degree of targeting is still low and the character of a public goods promoted is more local/national than European. As a very rough estimate, one could say that well-implemented, highly targeted payments worth 10% of the current Single Farm Payment and Less Favored Area payment would deliver at least the same level of European public goods.

Taking the environmental payments and the environmental effects of non-environmental payments together, it can be said that € 5 billion would be approximately sufficient to maintain the current provision of European public goods through the CAP.[30] With € 10 or 20 billion for sustainable land use, plus increased funds for research on sustainable farming and forestry management in the research budget, much more European public goods could be provided than is currently the case.

5.2. Transition Strategies

Farmers' legitimate expectations about policy stability could in principle justify an incrementalist approach to phasing out the Single Farm Payment (and other forms of support that is not targeted at public goods). However, the Single Farm Payment is not designed to change farmers' business behavior – such as their investments into farm buildings and machinery or more generally that decision about whether to stay in farming – in order to attain societal objectives. The Single Farm Payment cannot be compared to a policy commitment such as that of the creation of an EU carbon emission market that triggers massive specific investments. In the case of the Single Farm Payment, there are no policy-induced long-term investments that would have to be protected.

Besides, when farmers were granted the Single Farm Payment in 2003, they had to know that this subsidy would not last forever. The preceding two decades had seen repeated reform attempts, which had regularly fallen short of the reformers' ambitions, and the next CAP reform had already been scheduled for 2008. Both in 2003 and 2008, the Commission tried to shift far more money from the Single Farm Payment to rural development and

[29] See European Court of Auditors (2008). See also Brady et al. (2007) and www.ccat.wur.nl on environmental effects of the Single Farm Payment.

[30] This figure will rise if one believes that the removal of income support will lead to significant land abandonment and that land abandonment has significant negative cross-border effects.

environmental payments than the finally agreed amount. Between these two reforms lurked another threat to the Single Farm Payment: the negotiations of the financial framework for 2007-2013 which could very well have led to drastic cuts in the CAP budget. More generally, compensation payments necessary to facilitate reform at one point in time usually have a deadline. The fact that this deadline was not specified in the 2003 and 2008/09 reforms should not give reason to believe that they would go on forever. The budget review discussions are sending a clear message that farmers need to prepare for times of no, or much lower, income support. In this sense, the transition period started in 2008 at the latest.

Nevertheless, it appears probable that transitional income support will be deemed desirable for social and political reasons by many policymakers. The necessary funds for such support will depend strongly on policy design.

One approach would be to apply a linear reduction to the Single Farm Payment. Much more effective in social policy terms, and thus less expensive, would be a targeted transition payment. This payment could be based on Single Farm Payment entitlements (with a strongly degressive formula, paying less for every additional hectare), households' income and assets levels (paying less to relatively well-off households) and households' dependence on farming (paying less to households with significant non-farm income). Beyond a certain threshold of eligible area, income and assets levels, and non-farm income shares, no payments would be effectuated.

Another measure that would reduce the burden of transitional payments on the CAP is to allow governments to top up such payments up to a certain level. Given the current inequities of the system, such differential treatment during a limited time span would not unduly distort competition on the internal market.

6. DISTRIBUTION OF THE CAP BUDGET ACROSS MEMBER STATES

The allocation of subsidies across Member States will certainly change after 2013. First, current distribution is highly uneven. Many Member States urge a thorough redistribution and this idea is generally supported by the Council and the European Commission. Second, the current distribution is shaped by the EU enlargement process. New Member States have received a much larger share in the second than in first pillar payments. After 2013, a genuinely European approach that removes the old/new member state divide is due. Third, current national envelopes are largely determined by past payment patterns rather than by rational criteria reflecting the CAP's objectives (see Annex 1). As the reference periods date further and further back, they become ever harder to justify. Also, the progressive and, after 2013, probably complete removal of the link between subsidies and past production on the farm level will undermine such linkage in the distribution across Member States.

One can assume that future distribution will be guided by more rational criteria. Any change on the scale to be expected is hard to imagine without a principled approach that can guide negotiations and be defended in public. The structural funds are also assigned according to a distribution key determined by policy objectives.

Possibly, there will be a transition period during which a decreasing part of the subsidies will be allocated according to past (e.g. 2013) entitlements. This could be explained by the need to avoid hardship among farmers in Member States whose share will fall. It may also be useful to appease farm protests and facilitate agreement in the Council.

Which criteria will be used depends on the future objectives of the CAP. The criteria will have to be easily applicable and resistant to abusive claims. Highly targeted allocation to the Member States that have the greatest need or that are undertaking the greatest effort to advance European public goods is thus not workable. For instance, one might believe that high nature value areas deserve additional EU funding. The problem with such a criterion is that it would be poorly defined and open to abuse, leading to inextricable negotiations and resulting in a distorted allocation.[31] The past experience of an EU average of 57% of agricultural area declared as Less Favored Area should serve as a warning. A list of potential criteria can be found in Annex 2.

Using a distribution key that combines several criteria (2013 entitlements; agricultural, forest, Natura 2000, and organic farming areas; GDP per capita), Zahrnt (2009) finds that a substantial re-distribution of CAP subsidies may occur. In the most change-oriented scenario, Sweden would increase its share in CAP payments by 159%, Latvia by 138% and Finland by 133%, whereas the Netherlands and Ireland would lose 36% and Malta would see its share diminished by 82%.

[31] See Institute for European Environmental Policy (2007) on the challenges inherent in indicators for high nature value farmland.

CONCLUSION

Let us make three assumptions. First, policymakers redefine the CAP into a coherent policy for sustainable land use. This would, in particular, mean shedding large parts of rural development and paying increased attention to forest areas. Second, policymakers agree that the CAP should exclusively serve to enhance European welfare by promoting the provision of public goods through land use and curbing the negative effects of land use on society. Third, policymakers endorse the principle of subsidiarity and reserve EU subsidies to measures where European action is superior to national action. The last two points would imply the removal of all intentional income support for farmers.

Although this would transform the CAP, even detailed planning of the future use of agricultural policy instruments could be undertaken without having to wait for greater clarity about funding availability. € 20 billion for European public goods related to land use, leveraged through substantial national co-financing, would look like a reasonable upper limit for future financing needs. If policymakers in charge of agriculture propose a sound policy for sustainable land-use at such a price, they can be confident of winning the support of decision-makers in other policy areas, including for an additional targeted transition package that avoids hardship among farmers. The CAP budget would then decrease over time as the transition payments are melted down and as national agricultural budgets grow in response to the policy changes at European level.

Finally, one recommendation for the CAP (budget) debate: the ultimate objective of the future CAP/land use policy should be better kept apart from the issue of transitional policies. This would permit greater boldness with regard to the ultimate objectives and more flexibility with regard to transition policies.

ANNEX 1: EXPLANATION OF CURRENT CAP SUBSIDY ALLOCATION ACROSS MEMBER STATES

When the Single Farm Payment was introduced in 2003, the money that was freed up by removing subsidies that had hitherto been coupled to production was transferred to national Single Farm Payment envelopes in accordance with Member States' previous receipts of coupled subsidies.[32] Payments were to be reduced by 3% in 2005, 4% in 2006, and 5% in every year thereafter. The money generated through such modulation was to be transferred to the second pillar of the CAP. The way the money was to be allocated to countries was supposed to take account of agricultural area, agricultural employment, and GDP per capita in purchasing power. However, at least 80% of the money should remain in the country where it has been generated. The 2008 Health Check maintained this approach. The additional money freed up through reinforced modulation (gradually rising to 10% in 2012 for payments above EUR 5,000, plus an extra 4% for amounts exceeding EUR 300,000) was again shifted to rural development.[33]

The guidelines for the distribution of rural development payments under the second pillar are vague, pointing to regional convergence objectives, historic levels of rural development payments, and undefined particular situations and needs as determinants.[34] The actual distribution of rural development payments for 2007-2013 largely reflects Member States' 2000-2006 payments. In the EU-15, these payments were made under the European Agricultural Guidance and Guarantee Fund. Their level is itself based on rural development payments and commitments in the period 1994-99 (under various schemes, e.g. the EU's regional policy objective 5b). The new Member States received separate payments until 2006 under the Special Accession Programme for Agriculture and Rural Development (Sapard). These were calculated according to farming population, agricultural area, gross domestic product (GDP) per capita in purchasing power, and specific territorial situation.[35]

[32] See Council of the European Union (2003).
[33] See European Commission (2009c).
[34] See Council of the European Union (2005).
[35] See Commission Regulation (2004) and European Council (1999).

ANNEX 2: POTENTIAL CRITERIA FOR ALLOCATING CAP PAYMENTS ACROSS MEMBER STATES

What follows is a discussion of potential criteria with regard to commonly proposed policy objectives.[36]

Agricultural Area

One justification for this criterion is that differences in support levels per hectare across farmers threaten to distort competition. Even if distortions are considered to be small, the argument that agricultural area should be rewarded similarly across Europe appeals to basic ideas of equality and the spirit of European integration. In addition, agricultural area is loosely related to the need for funds to promote all the European public goods. This relationship is most straightforward when it comes to enhancing the amenity value of landscapes but also reasonably close for climate protection, biodiversity preservation, and water management measures. Agricultural area can similarly serve as a proxy for the funds needed to ensure food safety and animal welfare.

Forest Area

The importance of responsible forest stewardship is increasingly being recognized.[37] Member States with significant forest areas can make a strong case for obtaining payments to enhance the environmental value of their forests. Furthermore, excessively penalizing forest area compared to agricultural area, given the contribution of forests to fighting climate change, should be avoided.

Natura 2000 Area

The size of Natura 2000 areas is a suitable criterion for four reasons. First, it is clearly designated and registered.[38] Second, Member States that designate Natura 2000 areas pay a price as they have to fulfill strict EU requirements that limit land use. It is thus fair to reward such efforts. Third, the compliance costs make it unlikely that Member States grant Natura 2000 status at an excessive scale to bias CAP allocations in their favor. If the impact of Natura 2000 areas on CAP allocation nevertheless disposes Member States to extend their Natura 2000 areas, this would be a desirable development.

Organic Farming Area

Organic farming is preferable with regard to all environmental public goods listed above (climate, biodiversity, amenity value, flood control). It also ensures higher animal welfare than traditional farming and possibly produces healthier food. Importantly, the EU-level definition of minimum requirements for organic farming, together with a sophisticated certification and monitoring system, avoids abusive declarations.[39]

[36] See also Zahrnt (2009) and, for partly different criteria, Mantino (2003).

[37] See Schulze et al. (2009).

[38] See http://ec.europa.eu/environment/nature/natura2000/index_en.htm.

[39] See Council Regulation (EC) No 834/2007.

Agricultural Employment

Agricultural employment is not a suitable candidate for guiding future subsidy allocation. Most importantly, it is not related to any reasonable policy objectives for the CAP. Furthermore, Romania and Poland each hold close to twenty percent of the EU's total of 'agricultural work units'. They would thus seize significant shares of CAP funds from other Member States. Since these two countries do not wield sufficient bargaining power in the EU to push through such a result (especially as they are strong net beneficiaries of the CAP and the EU budget in any case), inclusion of agricultural employment as a determinant of subsidy allocation is unlikely. A final obstacle arises over measurement issues.

GDP per Capita

In richer Member States, wages in non-agricultural jobs that are comparable to agricultural employment are higher. So a higher level of income support is needed to ascertain a fair standard of living for farmers and prevent land abandonment. Higher payments are also necessary to establish sufficient incentives for agri-environmental schemes. Furthermore, flattening income support across Europe without taking account of differences in GDP per capita would lead to excessively high support in poor Member States and thus increase distortions in the economy. The inclusion of GDP per capita may be resented for contradicting the principle of European solidarity. But agricultural policies should not become a tool for accelerating economic convergence in Europe. Structural policies are more effective to this end.

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