Budgetary Effects of Including the CEC into Dynamic Modulation

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Summary

The EU Commission suggests to exclude CEC from the dynamic modulation mechanism, being part of the MTR package. This article looks at the distributional aspects of including the CEC into dynamic modulation. Under the current accession proposal the CEC would account for only 18% of the rural development budget by 2006. If modulation would be realised with the CEC being excluded this share would drop to 14% by 2010. According to the criteria proposed by the Commission for the distribution of the modulation budget the CEC would get a higher share of the modulation budget if they were included as they account for high shares in agricultural area and employment, and their GDP per capita is relatively low. Based on the assumptions made for this article they would be eligible for about 66% of the modulation budget. As a result of their participation in the modulation mechanism their share in the rural development budget would be at 30% by 2010. The financial net gains for the CEC from participation are estimated to be at 1.7 bln. €.

Key words: Modulation; EU-enlargement; CAP-budget

Budget Auswirkungen einer Einbeziehung der MOEL in die dynamische Modulation

Die Europäische Kommission schlägt vor, die MOEL nicht in die im Rahmen der MTR vorgesehene dynamische Modulation einzubeziehen. In diesem Artikel werden die Auswirkungen einer Einbeziehung der MOEL im Hinblick auf die Finanzflüsse zwischen den Mitgliedstaaten untersucht. Bei einer Umsetzung des gegenwärtigen Verhandlungsvorschlags der Kommission für die Osterweiterung hätten die MOEL einen Anteil von etwa 18% am Budget für die ländliche Entwicklung. Bei einer Umsetzung der Kommissionsvorschläge für die dynamische Modulation würde dieser Anteil bis 2010 auf 14% sinken. Auf Basis der von der Kommission vorgeschlagenen Kriterien würden die MOEL bei einer Teilnahme jedoch einen hohen Anteil an den im Rahmen der Modulation umverteilten Mitteln erhalten, da sie hohe Anteile an der landwirtschaftlichen Fläche und Bevölkerung und ein relativ niedriges Pro-Kopf-Einkommen aufweisen. Auf Basis der hier getroffenen Annahmen hätten sie einen Anteil von etwa 66% an den Mitteln der Modulation. Bei einer Einbeziehung der MOEL würde ihr Anteil am EU-Gesamtbudget für die ländliche Entwicklung bis 2010 auf 30% steigen und es ergäbe sich ein um 1.7 Mrd. € höherer Nettorückfluss aus dem EU-Budget.

Schlüsselwörter: Modulation; EU-Erweiterung; EU-Haushalt

In its Mid-term Review (MTR) the EU Commission suggests to reduce direct payments for the EU-15 by 20% until 2010 and to fully shift budgetary savings to the second pillar of the CAP – measures summarized under the title "rural development". The money saved is to be redistributed among EU-15 members for measures of rural development according to "agricultural area, agricultural employment and a prosperity criterion"[1]). The Commission suggests to exclude Central European countries (CEC) from the dynamic modulation-mechanism (Agra Europe, 2002). This sounds reasonable, as direct payments for the CEC,

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1) For an analysis of distributional effects among EU 15 members see Kleinhanss (2002).

according to the Commission's draft proposal for accession, will be lower than those of the EU-15 in the first years of membership anyhow. But do CEC really profit from this exclusion, and does it make sense in the light of the current distribution of rural development expenditures in the EU-15 and that foreseen under the accession proposal?

Much well-founded criticism about the sense of the modulation-mechanism itself is in place: EU co-financing of measures with mainly local effects is not compatible with sound principles of subsidiarity and fiscal equivalence. Also the link between the financial extension of the second pillar and the dismantling of the first pillar is rather artificial. Furthermore and to a significant extent, the rural development package contains subsidies with an unclear justification just as the first pillar of the CAP. These more fundamental aspects of the modulation mechanism are discussed elsewhere (Grethe, 2002). This article concentrates on the potential budgetary impacts of an inclusion of the CEC into dynamic modulation.

According to the criteria proposed by the Commission, CEC would be eligible to a large share of the rural development budget: They account for about 31% of agricultural area and 57% of agricultural employment, and their GDP per capita is projected to be at 50% of the EU-average by 2010, the year in which 20% modulation will be realized (cf. Table, columns (1) to (3)). A final key for redistributing the savings in direct payments in the 2nd pillar is not yet fixed and will be part of the negotiating package of the MTR. In order to summarize the three criteria proposed by the Commission provisionally a simple average of the shares in area and employment adjusted by the relative GDP per capita has been chosen as a key for redistribution:

$$\text{Share in rural development budget}_{ms} = \frac{\dfrac{\text{area share}_{ms} + \text{empl. share}_{ms}}{\text{relative GDP pc}_{ms}}}{\displaystyle\sum_{ms} \dfrac{\text{area share}_{ms} + \text{empl. share}_{ms}}{\text{relative GDP pc}_{ms}}}; \quad ms = \text{member state}$$

The result is presented in column (5): the CEC would be eligible for about 66% of the rural development budget. Other weighting schemes for the criteria proposed are of course conceivable and would lead to different results. A reduction of the weight of employment versus area would reduce the CEC-share, as would a lower impact of the GDP. The lower limit, as long as no additional criteria are chosen, would be the area share of 31% if employment and GDP are not taken into account.
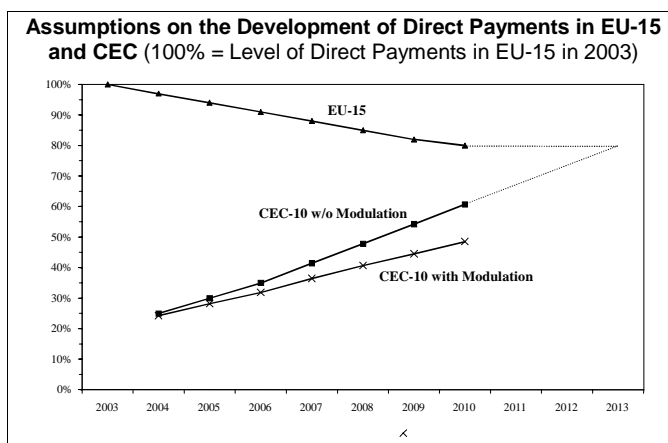
How does this contrast with the distribution of the EU budget for rural development without any modulation? To answer this question the rural development budget under the Guarantee and Guidance sections of the EAGFL as well as the rural development budget proposed by the Commission for the CEC for 2006, distributed according to SAPARD-key, are taken into account, see column (6). Without any modulation the CEC would account for only about 18% of the rural development budget in 2006. In a

Table: **Potential Criteria and Redistribution Keys for "Savings" in Direct Payments into the 2nd Pillar of the CAP and Potential Budgetary Impact in 2010**

Coutry,	(1) Utilized. Agric. Area (2000) (%)	(2) Agric. Employ (2000) (%)	(3) GDP p.c. (PPP) (2010) (%)	(4) Key for Redistribution EU-15 (%)	(5) EU-25 (%)	(6) Shares in Rural Development Budget w/o any Modulation (%)	(7) Direct Payments (2010) w/o Mod. in CEC (Mill. €)	(8) with Mod. in CEC (Mill. €)	(9) Rural Development (2010) w/o Mod. in CEC (Mill. €)	(10) with Mod. in CEC (Mill. €)	(11) Direct Payment and Rural Development (2010) w/o Mod. in CEC (Mill. €)	(12) with Mod. in CEC (Mill. €)	(13) Net Effect of Including CEC (2010) (Mill. €)
Belgium	0.7	0.5	123.6	1.0	0.3	1.0	230	230	119	103	350	334	-16
Denmark	1.4	0.6	130.1	1.4	0.5	0.7	478	478	107	83	585	562	-23
Germany	9.0	6.1	120.5	12.2	4.1	16.3	2 739	2 739	1 909	1 705	4 648	4 445	-203
Greece	2.7	4.3	81.9	9.1	2.8	2.9	1 421	1 421	533	372	1 954	1 793	-161
Spain	13.4	6.3	95.9	19.1	6.7	7.8	2 634	2 634	1 279	967	3 913	3 601	-311
France	15.7	6.2	114.8	17.4	6.3	10.4	4 256	4 256	1 484	1 204	5 740	5 460	-280
Ireland	2.3	0.8	120.0	2.4	0.9	3.8	620	620	428	390	1 048	1 010	-38
Italy	8.1	7.0	114.5	13.2	4.3	16.5	2 119	2 119	1 954	1 731	4 074	3 850	-224
Luxembourg	0.1	0.0	177.5	0.0	0.0	0.2	14	14	19	18	33	32	-1
Netherlands	1.0	1.5	124.6	2.2	0.7	0.9	246	246	150	112	396	357	-38
Austria	1.8	1.4	123.3	2.6	0.9	5.3	326	326	585	542	911	868	-43
Portugal	2.0	3.9	90.6	7.2	2.2	5.5	278	278	727	599	1 005	877	-128
Finland	1.2	0.9	114.8	1.8	0.6	5.2	205	205	552	522	757	726	-31
Sweden	1.6	0.8	115.0	1.9	0.7	2.1	348	348	251	220	598	567	-31
UK	8.3	2.7	114.8	8.6	3.1	3.0	2 252	2 252	526	390	2 778	2 642	-136
Czech Rep.	2.3	1.2	74.4		1.5	0.8	418	337	76	123	493	460	-33
Hungary	3.1	1.4	61.9		2.4	1.3	615	503	130	205	745	708	-37
Poland	9.6	17.2	48.2		18.3	6.0	1 712	1 689	578	1 146	2 290	2 835	545
Slovakia	1.3	0.8	60.1		1.1	0.6	206	166	63	97	269	264	-5
Slovenia	0.3	0.5	82.5		0.3	0.2	32	31	22	31	54	63	9
Estonia	0.5	0.2	48.8		0.5	0.4	43	41	42	57	84	98	14
Latvia	1.3	0.8	38.5		1.8	0.8	114	110	75	130	189	240	50
Lithuania	1.8	1.7	42.4		2.7	1.1	244	235	102	187	346	421	75
Bulgaria	2.9	2.2	32.3		5.2	1.8	532	499	179	340	710	839	129
Romania	7.8	31.0	39.6		32.2	5.3	2 254	2 170	516	1 517	2 770	3 687	917
EU-15	69.2	43.1	113.7		34.1	81.6	18 166	18 166	10 623	8 958	28 789	27 124	-1 665
CEC-10	30.8	56.9	49.9		65.9	18.4	6 169	5 781	1 781	3 834	7 950	9 616	1 665
EU-25	100.0	100.0	100.0	100	100	100.0	24 335	23 948	12 404	12 792	36 740	36 740	0

Sources: (1)+(2) European Commission (2001a), (3) WEISE et al. (2002), (6) For Guarantee: European Commission (1999), For Guidance: European Commission (2001b), (4), (5) and (7)-(13) own calculations.

situation with dynamic modulation being limited to the EU-15 only, the share of the CEC would decrease further – being in sharp contrast to the criteria proposed by the Commission. How much would the CEC gain under the second pillar, if they would be included in modulation, and to what extent would they lose through the cuts in direct payments?

Assumptions on the Development of Direct Payments in EU-15 and CEC (100% = Level of Direct Payments in EU-15 in 2003)

Graph

In order to assess these questions quantitatively two scenarios have been specified. Under both scenarios dynamic modulation is introduced in the EU-15 according to the MTR proposal, i.e. all direct payments are reduced progressively in arithmetic steps of 3% per year to reach 20% in 2010. The graph illustrates the development of the level of direct payments in the EU-15. Starting in 2004, the EU-15 level of direct payments is gradually reduced and from 2010 on remains at 80% of the 2003 base level. The CEC become full members in 2004 and under the first scenario direct payments are introduced according to the Commission's Draft Common Proposal beginning with 25% in 2004, 30% in 2005 and 35% in 2006 of the EU-15 base-level (cf. graph, line "CEC-10 w/o Modulation"). For the remaining period after 2006, direct payments are increased by equal steps ensuring that by 2013 the CEC reach the support level then applicable in the EU-15. In the year 2010 the level of direct payments in the CEC is at 61% of the EU-15 base-level. As the CEC are excluded from modulation under this option, the amounts saved by modulation will be distributed amongst the EU-15 members only. Under the second scenario the CEC are included in the modulation mechanism, i.e. the same reduction rates as in the EU-15 apply to their direct payments. As a result, direct payments in 2004 start not at 25% but at 24.3% (97% of 25%) of the base level and will reach 49% of the base-level in 2010 (see line "CEC-10 with Modulation" in the graph). The amounts saved by modulation are now distributed amongst the EU-25 member countries.

In order to quantify the amounts saved in the first pillar by the reductions of direct payments the quantitative framework of ESIM (European Simulation Model) was used[2]. The € 5000 franchise proposed by the EU-Commission is taken into account by adjusting the reduction

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2) For a detailed description of ESIM see MÜNCH (2002).

rates for the share of small producers as an approximation for the share of producers falling within the franchise. For example, if the share of small producers is 33% the annual reduction of the sum of total direct payments under the modulation-mechanism is only 2% instead of 3%.

Columns (7)-(13) of the table display the results of both scenarios for the year 2010, the final year of the implementation of dynamic modulation. All amounts are in real prices of the year 2000. Under the first scenario, where the saved amounts of modulation are only distributed amongst the EU-15 countries, 10.6 bln. € will be available for rural development in 2010 within the EU-15 countries, see col. (9). The largest shares are for Italy (18%), Germany (18%), France (14%) and Spain (12%). After accession the new member countries will receive 1.8 bln. € for rural development. Out of that amount Poland will receive 32% and Romania 29%. The CEC as a group would have a share of about 14% in the total EU-budget for rural development.

The introduction of modulation in the CEC would reduce the total amount of direct payments in the CEC from 6.2 bln. € to 5.8 bln. €, which is equivalent to -6.3%, see col. (7) and (8). This relatively small reduction in direct payment is caused by the high share of small producers in the new member countries, which fall within the € 5000 franchise. While the amount of direct payments for the EU-15 remains constant if modulation is introduced in the CEC, the amount available for rural development decreases significantly. In the EU-15 the budget of the 2nd pillar is at 9 bln. € instead of 10.6 bln. €, see columns (9) and (10). The EU payments for rural development in the CEC more than double from 1.8 bln. € to 3.8 bln. €, compared to a situation with the CEC being excluded from dynamic modulation. The CEC as a group would have a share of about 30% in the total EU-budget for rural development. It is important to note, however, that the full increase in the second pillar for the CEC is conditional on the complete use of the budget available. If parts of the rural development budget are not used by member states, they remain with the EU.

Adding the budget for direct payments and rural development the countries of the EU-15 lose 1.6 bln. € if the CEC are included in the system of modulation, with Spain (-310 mill. €), France (-280 mill. €), Italy (-224 mill. €) and Germany (-203 mill. €) losing most, see column (13). The losses for the EU-15 are a net surplus for the group of new member countries. However, looking at the individual CEC, the Czech Republic, Hungary and Slovakia will receive less money for direct payments and rural development under the rules of modulation.

What conclusions can be drawn from the above calculations?

1. From a financial point of view, it is in the clear interest of the group of CEC to take part in the modulation mechanism if the distribution of the modulation budget is based on the criteria proposed by the Commission and if the CEC have the capacity to absorb available funds.

2. If agricultural area and employment as well as prosperity are considered the "right indicators" for the distribution of the budget for rural development, CEC should be included in the modulation mechanism. According to these indicators, they should get at least 31% of the rural development budget (area criterion only), or more (66%

according to the assumptions made in this article). Taking part in the modulation mechanism would increase their share from 14% to 30% - thus coming closer to the "right distribution".

3. Seemingly, the current implicit criteria determining the future distribution of the rural development budget between the EU-15 and the CEC are very different from the criteria proposed by the Commission for the distribution of the budget under dynamic modulation. One gets the impression that they are only to a very limited extent of any economic or social nature, as are those for the future distribution of direct payments. Distributional aspects are at the foreground.

4. There is an urgent need for more transparent and well founded criteria for the distribution of the rural development budget. The relevance of the size of the agricultural sector, being covered by the area and employment criteria in the current proposal, is evident. The justification of a prosperity criterion is less clear: Is there more need for rural development measures in poorer countries? Does it make sense to cover this kind of distributional aims by agricultural policy instead of broader cohesion policies?

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