

**CAP UNDER FIRE.
THE BUDGETARY REVIEW AND THE CAP**

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Andrea Elekes – Péter Halmai¹

Abstract

During the process of the budgetary review the CAP faces its greatest challenge of its history: not only the (common) financing of the CAP, but the future of the CAP itself is at stake. It is obvious that the reform steps implemented so far – even though they have several forward-looking elements – do not result in a CAP sustainable on the long run. Further changes are inevitable. Basing our analysis on the theories of fiscal federalism and other political economy approaches, we try to answer the following questions. Is common financing of a reformed CAP justified? Can national co-financing be extended? Is it justified to keep the system of commonly financed direct payments?

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Future financing of the CAP is the “hottest” (quoting the words of Dalia Grybauskaitė budgetary commissioner) *topic* of the budgetary review. The next months will be decisive as regards the financing of the CAP beyond 2013. What is more, we can argue that not only the financing of the CAP but the future of the CAP itself is at stake.

The common budget and especially its CAP related expenditure has been debated for a long time. The possible cancellation of financing the Common Agricultural Policy through the common budget or a radical reduction – the *possibility of ‘the found money’* – piqued interest throughout the Union. Net beneficiaries of the CAP and agricultural interest groups on the other hand would like to maintain the status quo. Our paper aims to examine objectively this sensitive issue. We try to answer: when and how is common financing of the CAP justified.

Fiscal federalism is the most often applied theory in the literature which tries to answer the question: how the responsibility over policies and their financing could optimally be distributed among the EU and the member states. Therefore, when assessing the current CAP we apply the theory of fiscal federalism and other political economy aspects.

Common budget and Common Agricultural Policy² under debate

CAP and cohesion policy are the main expenditure titles of the common budget. Financing of CAP measures is rather particular:

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² Literature of the CAP is very widespread. Here we can not go in details we just try to indicate the significance of the problem.

- market support and direct income payments (first pillar) are fully covered through the common budget in accordance with the principle of financial solidarity;
- rural development (second pillar) is financed in accordance with the principle of additionality (co-financing).

CAP reform introduced in 1992 and then further reformed in 2000 and 2003, and modified as part of the Health Check has not resulted in the reduction of CAP budget. However, *there has been a significant change in the structure of the support*. Especially the decreasing ratio of market support is obvious. At the same time *the ratio of direct payments has increased*, they amount for 70% of the total agricultural support. Their ratio will further increase by 2013. The ratio of rural development expenditure has also increased from the mid '90s. Table 1 shows the share of agricultural support in the GDP.

Table 1: Share of agricultural support (as % of GDP)

	2001	2002	2003	2004	2005	2006	2007
EU15							
1. Common budget ¹	0,50	0,49	0,49	0,46	0,46	0,44	0,39
2. National support	0,15	0,15	0,15	0,12	0,13	0,12	0,09
3. Total (1+2)	0,65	0,69	0,64	0,58	0,59	0,56	0,48
EU10							
4. Common budget ¹				0,46	0,83	0,86	0,97
5. National support				0,35	0,35	0,35	0,20
6. Total (1+2)				0,81	1,18	1,21	1,17
EU25							
7. Common budget ¹				0,46 ¹	0,48 ¹	0,47 ^{1,2}	0,43 ^{1,2}
8. National support				0,13	0,15	0,14	0,09
9. Total (7+8)				0,59	0,63	0,61	0,52

Notes: 1) EA GGF expenditure. 2) Total agricultural area (policy area 05). Authors' calculation.

The common budget differs from the national budgets. Its primary function is to *promote common and Community policies, activities and objectives*, i.e. it is not a miniature of the national budgets for its structure is different. A much higher rate of centralisation compared to the competitors is indicated by the data in *Table 2*. (Note that the high rate of centralisation is not the outcome of the common budget amounting to 1.1 per cent of the GDP.)

Table 2: Expenditure of different levels government in certain federal states (% of GDP), 2003

	Government			
	Federal	State	Local	Total
Australia	22.2	11.7	1.9	35.8
Canada	16.8	18.5	5.6	40.9
Germany	29.4	12.4	6.6	48.3
Switzerland	16.8	12.2	7.7	36.7
US	18.7	10.2	7.8	36.7
EU -15	1.0	34.2	13.5	47.7

Source: El Agra, 2007

The common budget and especially its CAP related expenditure has been debated for various reasons³. Already the budget related disputes (the mid-term financial perspectives for 2007-2013) chiefly focused on *the Common Agricultural Policy*. Several experts considered the CAP related expenditure as money found and the possibility of the ‘found money’ piqued interest throughout the Union.

In May 2006, the European Parliament, the Council and the Commission agreed that the Commission should undertake a fundamental review of the EU budget⁴. The budgetary review offers an open approach without taboos (a threat for the CAP). Under the consultation process of the budget review most of the contributions were very critical as regards the CAP and its common financing. There is a widespread consensus that further reforms are necessary in order to accommodate the agricultural policy to current priorities. Opinions however, differ on the extent of the reforms. Most of the contributions stress that European agriculture should be competitive internationally and should be able to answer the challenges of climate change, food safety and quality requirements. Current expenditure levels and mechanisms are not based on these requirements. Most of the contributions urge significant reduction of agricultural expenditure and radical reforms especially as regards the first pillar. Several contributors would like to see the first pillar expenditure moving to the second pillar. There is no consensus on the future of direct payments (continue or abolish⁵). Although there are clear expectations for the reduction of agricultural expenditure, total re-nationalization of the agricultural policy has not been mentioned. It is evident however, that the CAP can not be maintained any more in its current form. The CAP should be placed on an entirely new basis in order to make it sustainable (from economic, environmental and social point of view) on the long run.

Common financing in the light of fiscal federalism

Fiscal federalism is the most often applied theory in the literature⁶ which tries to answer the question: *how the responsibility over policies and their financing could optimally be distributed among the EU and the member states.*

Fiscal federalism suggests that there are basically three reasons of government interventions: stabilization, equalization and allocation (Musgravian classification). Stabilization refers mainly to macroeconomic stability however, it can cover security too. The main function of equalization is to manage income inequalities but may extend to risk sharing (insurance) too. Allocation function aims to correct market failures. There are four major forms of market

³ See e.g.: D. Gros: How to Achieve a Better Budget for the European Union. Paper prepared for the Conference on Public Finances in the EU, organised by the Bureau of European Policy Advisers (BEPA), European Commission, Brussels, 3-4 April 2008.

http://ec.europa.eu/dgs/policy_advisers/conference_docs/gros_bepa_conference_final.pdf

⁴ For details of the budgetary review see: http://ec.europa.eu/budget/reform/index_en.htm

⁵ According to the documents reviewed the cancellation or radical reduction of common financing: aims at improving the position of the net contributors; simultaneously the thought of decreasing the cohesion expenditure and the common budget arises; agricultural expenditure would decrease (or disappear) only in the common budget (when agricultural policy is re-nationalized and financial solidarity dismissed, the poorer countries have to face new challenges)

⁶ E.g.: W.E. Oates: Fiscal Federalism. Harcourt Brace & Jovanovich, New York, 1972; W. E. Oates: An Essay on Fiscal Federalism. Journal of Economic Literature. Vol. 37 (3), 1999, p 1120-49; R.A. Musgrave: Theories of fiscal federalism. Public Finance, Vol. 24, 1969, p. 521-532; J. Pelkmans: European Integration – methods and economic analysis. Longman Publishing, New York, 2006; G. Tabellini: The Assignment of Tasks in an Evolving European Union, CEPS Policy Brief No. 10, Centre for European Policy Studies, Brussels, 2002 January

failures which may invoke government intervention: public goods, externalities, economies of scale and information asymmetry.

Based on the above criteria a so called *intervention test* can be made for the EU's different policy areas, examining whether there is a need for government intervention in a specific area. Based on the literature we arrive at the conclusion that *common policy is justified only if it corrects EU level market failures* (with an effect on the whole Union and not only on certain member states) *or contributes to an explicit EU equalization or stabilization objective*.

What is the most efficient level of intervention?

If the intervention test suggests that government intervention is justified in a particular area, the next step is to decide at what level the intervention would be the most effective. The theory of fiscal federalism says that higher level intervention is justified if it aims to internalise externalities or to exploit economies of scale. As regards externalities, higher level intervention is required in case of cross-border externalities, especially if they have positive spill-over effects. When policy dependent sunk costs are high, or there are other central factors which may reduce average costs, centralised policies aimed at exploiting economies of scale may have welfare increasing effects.⁷

On the other hand, if regional preferences show large heterogeneity as regards the solution of a particular problem, decentralised policies should be preferred, because then policies can be differentiated according to local preferences and conditions. In addition, according to the principle of fiscal equivalence, measures should be financed on the same level as they are designed, where the beneficiaries and taxpayers are more or less the same (Olson, 1969).⁸

The trade-off between centralisation and decentralisation has led to the formulation of the functional subsidiarity principle. With the help of the so called *functional subsidiarity test*⁹ we can determine the ideal level at which decisions should be taken: centralised intervention is necessary only if the member states could not credibly cooperate on a given policy issue. The probability of a *credible cooperation* is especially low in case of imperfect information, when the incentives to cheat are strong, when the ability or willingness to impose collective sanctions is perceived as minimal, when efficient provision of public goods should not be expected, Coasian assumptions for efficient bargaining (well defined property rights, no transaction costs) seem to be absent in reality, when free-rider effects may be significant.

Political economics provide further aspects especially as they explicitly integrate self-interested governments. Further arguments for centralization are: complementary policies, corruption, strong lobbying effects and path-dependency (it is difficult to give up a practice with deep roots). Decentralisation should be preferred however, if governments pursue their own interests in contrast to the public interest. If this is accompanied by strong lobbying effects, local preferences can not perfectly be enforced which can result in a welfare loss.

⁷ For details see: A. Alesina, I. Angeloni, L. Schuknecht: What Does the European Union Do? European University Institute Working Paper, Robert Schuman Centre for Advanced Studies, RSC No. 2002/61

⁸ M. Olson, Jr.: The Principle of "Fiscal Equivalence": The Division of Responsibilities among Different Levels of Government. *American Economic Review*, 1969, Vol. 59, p. 479-487

⁹ J. Pelkmans: "REACH": Better Regulation for Europe? Presentation for the Hearing of the European Parliament on REACH, 19 January 2005; J. Pelkmans: *European Integration – methods and economic analysis*. Longman Publishing, New York, 2006; S. Ederveen, J. Pelkmans: *Principles of Subsidiarity*. CPB Netherlands Bureau of Economic Policy, The Hague, 2006

Another argument for decentralization is accountability what seems to be easier in case of decentralized governments. We should also consider the allocation problem of the community resources (common pool). Arguments for centralization and decentralization are summarized in *Table 3*.

Table 3: Level of intervention (political-economic arguments)

CENTRALIZATION	DECENTRALIZATION
Externalities	Heterogeneous preferences
Economies of scale	Self-interested government
Complementary policies	Accountability
Corruption	Allocation problem of community resources (common pool)
Lobby	Lobby
Path-dependency	

Budgetary principles

If the analyses show that centralization is the most efficient form of the intervention, the next question to be answered is: *is it justified to finance the intervention from the common budget*. In order to answer this question, the policies in question should be confronted with the (common) budgetary principles: subsidiarity, proportionality, additionality, value for money, enhancement of the provision of public goods and value added (at European level). (See *Table 4*)

Table 4: Level of intervention (budgetary principles)

(COMMON) BUDGETARY PRINCIPLES	
Subsidiarity	EU intervention only if it is the optimal solution
Proportionality	Intervention should be proportional to that required by the objective
Additionality	EU financing can not substitute national resources
Value for money	Cost-effective intervention
European public goods	Enhancement of the provision of public goods
Value added (at European level)	Income of the benefiting region should be higher than it would have been without the investment

Methods of intervention

Literature suggests basically four methods to address the allocation problems:

- *Rules, regulations and directives (legal approach with administrative measures)*. This is the most cost-effective method, however, its applicability is limited. They are used mainly in case of negative externalities and information asymmetries.

- *Coase-like solutions (legal-economics approach)*: assigning property rights and creating (transparent) markets. (Private bargaining will lead to the internalisation of externalities.)
- *(Semi)governmental production*. Actual provision of certain public goods may take place by private firms (semi-governmental production), since this may be more cost-efficient.
- *(Pigouvian type) subsidies or taxes* (welfare approach) can be applied for externalities. Limits of this solution are the following: marginal utility has to be measured, the subsidy can not exceed marginal cost and the subsidy has to be financed.

Income and risk inequity problems can be addressed by taxation, subsidization, insurance systems and state guarantee. The choice among policy measures should be based on a cost-benefit analysis.

Is common financing of the CAP justified?

In this section theoretical categories are confronted with the reality of the CAP, applying a simple, verbal intervention test for the agricultural policy.

Functional justification

As regards the agricultural policy, allocation and equity functions of the interventions can be stressed. *Table 5* shows the most important allocation and equity functions of the agricultural policy.

Table 5: Allocation and equity functions in the agricultural policy

ALLOCATION	
Public goods	Protection and preservation of natural resources etc. (see <i>Table 7</i>)
Externalities	
Economies of scale	Interregional direct payments
Imperfect or asymmetric information	Crisis and risk management, food safety
EQUITY	
Income	Regional convergence, above average (sectoral, systematic) risk, income disparities
Risk	

The allocation function aims to correct market failures. Agriculture is a special area of the economy, where all the four main forms of market failures can be revealed.

Public goods

As *Table 6* shows, the agriculture, and in a wider sense, the rural areas can provide a wide range of public goods and of (positive and negative) externalities. Several problems may arise however, as regards the evaluation of these public goods and externalities.

Table 6: Certain public goods provided by agriculture

	Public goods	Spill-over effects
Environment friendly agricultural production practices	Protection and preservation of natural resources Stable ecosystem	Local, regional, European Regional, European, global Local, regional, European, global

	Biological diversity Protection of valuable natural areas Carbon sequestration Waste management	Local, regional, European European, global Local, regional, European
Ethical agricultural production	Food safety Animal welfare	Local, regional, European Local, regional, European, global
Socially sustainable agriculture	Buffer function on the labour market Cultural diversity – maintenance of material and non-material cultural heritage Contribution to the catching up of rural areas	Local, regional, European Local, regional, European, global Local, regional, European
Land management	Stable ecosystem Biological diversity Carbon sequestration Water management +flood management (integrated approach - agriculture as a cause and a solution to flooding)	Regional, European, global Local, regional, European, global European, global Local, regional, European, global
Preventing deforestation	Forest biodiversity Stable ecosystem Wildlife Reduction of greenhouse gas Carbon sequestration	Local, regional, European, global Regional, European, global Local, regional, European, global Local, regional, European, global European, global
Combating desertification and drought	Carbon sequestration Watershed protection Biodiversity conservation in drylands	European, global Regional, European, global Local, regional, European, global
Sustainable mountain development	Stable ecosystem Hydrological stability Carbon sequestration	Regional, European, global Local, regional, European European, global

Source: Authors' compilation based mainly on FAO, 2002 and 2007

Most of the public goods involve some kind of stock feature¹⁰ (stocks of pollution, stocks of knowledge, biological or genetic stocks etc.). By their nature, stocks accumulate, often very slowly, so that it may be difficult to recognize the symptoms of the disease until it is too late to cure. Moreover, because stocks accumulate slowly, stock externalities often have long-lasting consequences and are irreversible or near-irreversible. One of the major difficulties with managing public goods (that have stock features) is that they impose costs on the current generation while the benefits may come far in the future. From a political point of view, this implies that any bargain is a negative sum game (i.e.: there is no Pareto-improving solution) for the current generation.

In sum, we can arrive at the conclusion that the level of agricultural public goods without support would fall behind the socially optimal level. At the same time, the current level of support is disproportionately high (from public goods point of view). Moreover, the current support system is insufficiently targeted.

Economies of scale

In case of certain public goods – according to the OECD (2007) – there may be economies of scale that necessitate provision by large jurisdictions (central government), since *it may be impossible to create the right incentives for efficient decentralized provision*. E.g. Grethe

¹⁰ For details see W. D. Nordhaus: Global Public Goods and the Problem of Global Warming. Annual Lecture, The Institut d'Economie Industrielle (IDEI), Toulouse, France, June 14, 1999.

(2006)¹¹ states that preservation of cross border wildlife habitats is a typical case for economies of scale.

Scale economies may arise also from the inter-regional nature of the re-distributive programmes (e.g.: direct payments). This stems from the fact that the EU level has the institutional (organizational) capacity to govern and monitor such inter-regional (re)distributive projects (Molle, 2007)¹². Furthermore, when the (income) support system is executed by Member States, this could distort competition and may have a negative effect on the functioning of the Internal Market.

Imperfect or asymmetric information

As it is known, agricultural activity is accompanied with higher average *risk* (weather, diseases etc.) than that of other branches of the economy. Risks higher than average (which are in general systematic) necessitate state/Community level intervention. In this respect, there are two possible ways of Community level intervention. On the one hand public intervention should encourage training on the field of market-oriented risk management tools of which use is still very limited. On the other hand, subsidies are needed to counterbalance the fact that, due to the extremely high systematic risk that is typical in the agricultural sector, insurance companies only undertake insurance against an excessively high premium. Because of the above average risks producers can not remain without protection: economic crises must be managed at Community level.

Food safety is a credence function which can hardly be perceived by consumers. Market itself can often not provide the socially optimal food safety level, and this calls for public intervention. The literature of the economics of food safety distinguishes four factors, which as a source of market imperfections can evoke public intervention: asymmetric information on risk; food safety as public good; taking into account social costs and benefits; when there is a difference between the perceived and the real risk.

Equity function

Economic and social strengthening of rural areas forms an integral part of economic growth. Interventions aimed at regional convergence (interregional re-distributive policies) could therefore be justified (Ferrer, 2007)¹³. On equity grounds e.g., even the most radical authors recognise a justification for direct payments, although, they do it from a perspective of path dependency. Before implementing a support system, cost-benefit analyses should be carried out. *The current income support system of the CAP (price support, direct payments etc.) has not been based on these kinds of analyses, and therefore it is not surprising that transfer efficiency of these payments is relatively low.* The current support system favours the owners of production factors and production entitlements instead of the needy. (*Full decoupling and targeted policies could prevent doing this.*)

¹¹ H. Grethe: Environmental and Agricultural Policy: What Roles for the EU and the Member States? Keynote paper for the conference Subsidiarity and Economic Reform in Europe, organized by the European Commission, the CPB Netherlands Bureau for Economic Policy Analysis and the Dutch Ministry of Economic Affairs, November 8-9, 2006, Brussels

¹² W. Molle: European Cohesion Policy, Routledge, London, 2007

¹³ N. J. Ferrer: The EU Budget: The UK Rebate and the CAP Phasing them both out? Centre for European Policy Studies, CEPS Task Force Report, Brussels, December 2007

Level of agricultural and rural intervention

Theory suggests that only the management of public goods based support systems and externalities with significant spill-over effects can be justified at central level. These objectives however, may have important regional (spatial) and benefit dimensions. Focusing on the spatial and benefit dimensions of public goods has the advantage of making the principle of *subsidiarity* applicable: community level intervention (centralization) may be justified in the following cases:

- regional (European) and global public goods (because of self-interested governments);¹⁴
- vertical cooperation in case of core activities (e.g.: research)¹⁵;
- economies of scale;
- risk reduction and direct utility (their benefits can usually be enjoyed in a wider range than that of capacity enhancing activities)¹⁶;
- joint production.

We can speak about *joint production* if the production of two or more outputs is interlinked in some way (e.g.: through technical interdependencies or non-allocable inputs). For agricultural public goods, jointness is mainly related to the existence of non-allocable inputs, where it is difficult to determine a non-allocable input's contribution to each output. In agriculture, land is the most obvious non-allocable input since land enters into the production of both landscape preservation and food security, as well as agricultural products¹⁷.

The enlarged Union shows significant differences as regards income, population density, climate, land quality etc. It is not surprising therefore, that preferences for the objectives to be supported are rather heterogeneous too. The *strongly heterogeneous preferences take us in the direction of decentralization*.

Instruments available

Instruments of public intervention and their possible implementation areas (having regard to the aspects discussed earlier) are shown in *Table 7*.

Table 7: Instruments of public intervention available for the agricultural policy

	Area of implementation
Rules, regulations, directives	Negative externalities, standards
Coase-type solutions	Certain environmental issues
(Semi)governmental production	Crisis and risk management
Pigou-type subsidies or taxes	Public goods, multifunctionality, positive

¹⁴ For details see: OECD: Financing Global and Regional Public Goods Through ODA: Analysis and Evidence from the OECD Creditor Reporting System. Working Paper No. 232, 2004 www.oecd.org

¹⁵ For details see: O. Morrissey, D. Velde, A. Hewitt: Defining International Public Goods: Conceptual Issues. In: M. Ferroni and A. Mody (eds) International Public Goods: Incentives, Measurements and Financing. Dordrecht: Kluwer Academic Publishers, 2002

¹⁶ For details see: Morrissey et al. (2002).

¹⁷ R. J. Brunstad, I. Gaasland, E. Vardal: Optimal provision of public goods. Implications for support to agriculture. Discussion paper, INSTITUTT FOR SAMFUNNSØKONOMI DEPARTMENT OF ECONOMICS, 2007. They concluded that joint production of public goods (landscape and food security in their case) require less support than separate production.

The current system is based on regulations and support measures. When selecting the most efficient instruments social, environmental and economic aspects have to be taken into account. Here we have to stress the importance of proportionality, what can be seen as a social cost benefit analysis that examines what policy measure to use.

Agricultural policy in the light of budgetary principles

This section examines how the current CAP meets the budgetary principles and what kind of change is necessary.

Subsidiarity

When examining the spending side of the EU budget, the study of the Ecorys et al. (2008)¹⁸ made the *subusidiarity* test for the CAP in an enlarged form. They took into account not only the three most important relevant criteria of fiscal federalism, but also political economy and public choice aspects. Their main conclusions are the following:

- Path dependency seems to be the main argument for the current existence of direct payments and market interventions.
- As price support and coupled payments distort markets, they have clear externalities. Therefore, there is a case for centralising the implementation of market interventions, although this remains a second-best option. (The first best solution would be to abolish them altogether.)
- Both normative and positive analyses argue for decentralisation of income support policies.

Proportionality

Without support, the levels of rural public goods would fall short of the socially optimal level. However, we can state that *the current support level is well above the level that can be defended by the public goods argument.*

The origins of this problem go back to the *objectives of the CAP* set out in the Amsterdam Treaty (modernization, income security, market stabilization and food security). Although these agricultural policy objectives have remained important, there has been a significant change in emphasis. In recent years objectives related to the environment, rural development and food safety (or in generally: provision of public goods) have also become important. These latter objectives have important spatial and/or benefit dimensions, therefore, in their cases traditional broad-based policies do not necessarily address current societal interests, and are often wasteful and inefficient¹⁹.

¹⁸ ECORYS Nederland BV, Netherlands Bureau for Economic Policy Analysis, Institute for Economic Research: Study on EU spending. Final Report, Nederland BV Rotterdam, 2008. http://ec.europa.eu/budget/reform/library/issue_paper/study_EUspending_en.pdf

¹⁹ For details see e.g.: OECD: A matrix approach to evaluating policy: preliminary findings from PEM pilot studies of Crop policy in the EU, the US, Canada and Mexico, COM/AGR/CA/TD/TC(99)117/FINAL; OECD: Improving the environmental performance of agriculture: Policy options and market approaches, OECD, Paris, 2001b; OECD: Income transfer efficiency of farm support measures. [AGR/CA/APM(2001)24], 2001d.

An OECD study²⁰ concludes that *in case of policies which aim to correct market failures* (e.g.: landscape preservation or biodiversity) *targeted support* (being it decoupled or not) may prove to *be the most cost efficient solution* (especially if the savings through targeting are high). The study mentions also the *exceptions*: widespread market failure, which limits the savings from targeting; high policy-related transaction costs; decoupled measure where there are high costs of separating the production of commodities from that of non-commodities (joint production).

Value for money

This is perhaps, the most complex area of the analysis. The aim of intervention is generally to correct market failures (public goods, externalities, asymmetric information etc.) because the market of a particular “product” does not function well or there is no market at all. Therefore, it is difficult to calculate the market value. There are several other factors which make calculation more difficult. E.g.: there are different types of values (user, option, existence and bequest) and there is no uniquely approved measurement method. The most commonly applied methods (mainly for environmental services) are the following: contingent valuation, travel cost and hedonic price method. Calculation of value on this area requires further research.

European value added

It is highly debated that the Common Agricultural Policy generates value added for Europe. Ecorys et al. (2008) argues, that presently, the support measures of the Common Agricultural Policy score badly in terms of EU value added due to a lack of efficient targeting and ensuing excessive opportunity costs. According to the definition by Sapir (2004)²¹ of (European) value added, the CAP would have to be abolished and completely renationalised.

European public goods

In addition to production, agriculture provides extra services to the society, the European agricultural model is typically characterised by multifunctionality²². The key elements of this multifunctionality are as follows:

- multiple product and non-product output produced jointly in the agriculture (joint output)
- creating non-product output with characteristics of externalities or public goods.

All of these (maintaining the landscape and viable rural communities, providing environmental and ethical goods etc.) can be jointly classified as *European public goods* (Table 6). These accomplishments add to the quality of life in the EU member states while, at the same time (because of the additional costs involved) are considered to be competitive disadvantages compared to the overseas competitors.

The above mentioned multifunctional elements serve essential, cross-border externalities and provide significant European and global public goods. It is a common interest that even in

²⁰ OECD: Policy design characteristics for effective targeting. AGR/CA/APM(2005)32/FINAL, 2007

²¹ A. Sapir, P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. K. Rosati, J. Vinals, H. Wallace, M. Buti, M. Nava: An Agenda for a Growing Europe: The Sapir Report. Oxford University Press, 2004

²² One has to bear in mind that the term multifunctionality in this economic concept has another meaning than the term multifunctionality as it is often used by agricultural interest groups in defence of the status quo.

poorer member states and regions, landscapes correspond to the requirements of the European model. Furthermore, common financing avoids the distorting effects of possibly different national support systems on the internal market and on competitiveness. It must be emphasised however, that the magnitude of current CAP subsidies has not been determined based on the proper assessment of the above functions. The size of agricultural subsidies in the EU essentially depends on historic amounts. Accordingly, *the scale of these agricultural subsidies is debatable.*

The multifunctional factors result in economic policy action, if there is no private market for certain welfare increasing or decreasing joint outputs. If there is a need for political action in such cases for the internalisation of externalities, the characteristics of the affected activity will have an impact on planning and the application of the corrective measures.

In case of the joint production of private and public goods efficiency will require that private goods are produced, used and traded governed by market mechanisms. In addition, for the production of public goods required by the society targeted and decoupled economic policy measures are necessary. The eventual goal is to establish principles of good policy practice “that permit the achievement of multiple food and non-food objectives in the most cost-effective manner, taking into account the direct and indirect costs of international spill-over effects.” (OECD, 2001d)

Questions to be answered during the process of the Budgetary Review

Here we try to answer some sensitive questions, which should be answered during the process of the Budgetary Review.

Is common financing of a reformed CAP justified?

Negative CAP positions are usually based on the assessment of European value added. However, they do not take into account the value of public goods provided by the rural areas. As we have already mentioned, it is very difficult to calculate the value of public goods. However, this does not mean that they should completely be disregarded during the calculation of value added. It is commonly approved that they contribute to local/regional/national/EU/global welfare, but their value is not added to the GDP.

Growth should be measured with an extended form of the GDP: including also the value of public goods. What is more, we should also take into account the intergenerational nature of certain public goods. Further problem may arise from the fact that the value of certain public goods do not directly appear in the agricultural sector. Biodiversity, landscape and several other benefits of rural public goods favours directly the tourism.

We argue that the challenges Europe faces *require EU level agricultural and rural policies.* Regulation may help in certain cases, while in other cases financial resources are required to correct market failures. *Regulation and financial frameworks should be developed at EU level,* because:

- Europe is one of the largest food producing regions of the world. From the perspective of *global food security* it is essential to keep production factors in a “stand-by” position, to improve competitiveness and to enhance innovation.
- *Land is a strategic input.* Agriculture and forestry utilises more than 80% of the European land surface. Food production is only one of the several services of the

ecosystem. Perfect competition (without intervention) would push the other (welfare) services (competing for land as an input) into the background, as they have no or only limited market.

- Management of regional and global *environmental problems* (e.g.: climate change) is justified at EU level. Climate change is one of the most important priorities of the EU. Hardly exists another sector which is more affected by climate change than agriculture. Agriculture has not only to accommodate to climate change, but it can also combat against it (alternative energy, carbon sequestration etc.).
- *Quality and management of the nature, the environment and the landscape requires cross-border approach*, as neither the ecosystem, nor the environment and pollution respects national borders.
- Ethical aspects (e.g.: animal welfare) and (human, plant and animal) health requirements make *supranational* approach necessary from trade perspective.
- *Sustainable development* is a European interest and in a way not to pass the burden on the environment, on developing countries or on future generations.
- From the perspective of *competition policy* it is important that at least the European competition be fair. (E.g.: binding ecological efficiency should not weaken economic efficiency – only richer member states could afford support based on ecological reasons.)

Certain level of common budgetary contribution seems to be justified in the above mention cases (even if it is made in a co-financed form). However, current level of support is well above the level justified by public goods. The policy should be reformed along the basic principles of public expenditure (see *Table 8*), efficiency should be improved through targeted policies (principle of value added) and alternative costs should be minimised.

Table 8: Basic elements of a reform reflecting the budgetary principles

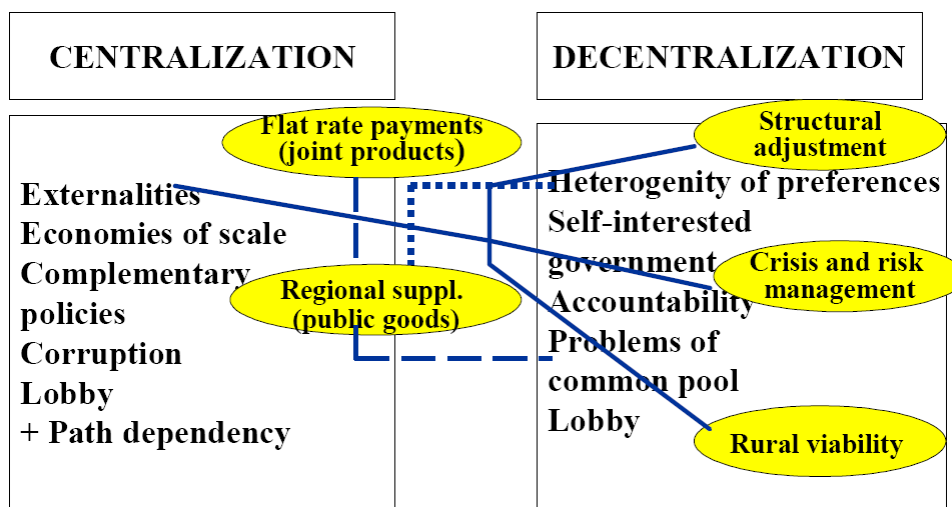
(COMMON) BUDGETARY PRINCIPLES	
Subsidiarity	Rising level of decentralization
Proportionality	Targeted policies, cost-benefit analysis, project-like approach
Additionality	Co-financing, except for flat rate payments for joint products
Value for money	+ Calculating value of non product outputs
European public goods	Support system based on public goods
Value added (at European level)	Targeted support, positive externalities with European or global spill-over effects

Can national co-financing be extended?

Based on the theories (fiscal federalism, political economics) we argue that *full centralization* – common financing, implementation and monitoring) *is justified only in case of joint products* (see *Figure 1*). In all other cases certain level of decentralization should be considered: national and regional authorities should take more financial liability²³.

²³ For simulation results see e.g.: F. Heinemann, P. Mohl, S. Osterloh: Reform Options for the EU Own Resources System. Springer, 2008 p178 (pp 74-78)

Figure 1: Arguments for centralization/decentralization

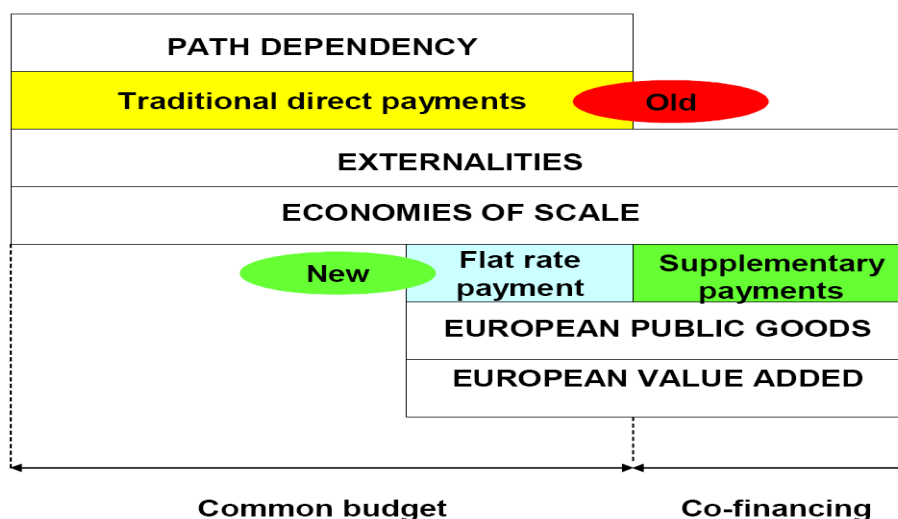


Is it justified to keep the system of commonly financed direct payments?

Direct payments were originally introduced in compensation for the income loss suffered because of the reduction of price support. Originally they were coupled to the production and distorted the markets so they clearly had (negative) externalities. These externalities justified the centralization of the policy and the financing. Nowadays, most of the payments are decoupled, they have no, or at most minimal distorting effects. Fiscal federalism suggests that direct payments should totally be abolished. However, path dependency encourages us to find a second best solution. Also the former reforms show that the necessary changes can only be made gradually. As a first step, *it is necessary to reduce the rate of general support and increase the level of targeted payments.*

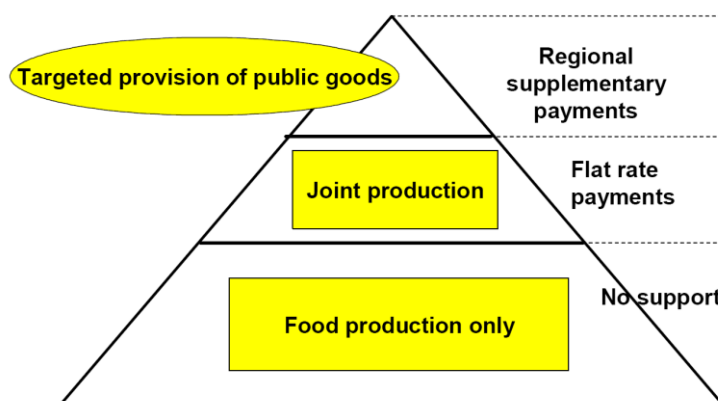
Changing the “content” or base of the payments is a more complex process and requires more time (see *Figure 2*). Income support can not be a central task. Neither economies of scale, nor internalisation of externalities justify central financing.

Figure 2: Reasons of common financing in the old and in the new system



Based on the theories we can again argue that full centralization is justified only in case of joint products (see *Figure 3*). This suggests that *flat rate payments can be made if the non product output is a joint product of the agricultural activity, for public goods of which provision can be expected from all European producers, and of which value is more or less independent of the location of production.*

Figure 3: The system of direct payments after the proposed reforms



It is important to stress, that even if economies of scale justify central financing of the provision of public goods, other functions can effectively be accomplished at lower governmental levels, depending on the nature of spill-over effects. In these cases decentralization should be considered.

Public goods may show significant regional differences. These differences (specific social and environmental conditions of the member states) justify the *regional supplementary payments* aiming at enhancing targeted provision of public goods. Targeted regional payments could ensure that support adjusts better to the actual additional costs (proportionality) and contribute to a more balanced cost-benefit ratio (cost efficiency, value for money).