

COMMON FINANCING FOR AGRICULTURAL POLICY BUDGETARY QUESTIONS

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Abstract

Can we agree fully with the statement, that “agricultural spending is a major distorting factor in the EU economy and a distinct obstacle to the Lisbon agenda’s implementation”? (Gros, 2008) Is it without question that Europe’s agriculture is in position to become sustainable and competitive without certain kind of common policy with no Community financing? Is it unambiguous in every respect, that the challenges facing the sector – globalization, trade liberalization, climate change, water management, Lisbon process, enlargement, changing preferences – could be answered at national level utilizing exclusively national financial sources?

The answers to these questions are complex. So the purpose of the paper is multiple:

- Exploration of factors justifying community level intervention. – Could be applied the bottom line of the “decentralization theorem” to budgetary questions and needs of the agricultural policy? According to our hypothesis the answer is considered yes.
- Assessing present CAP - taking into account its ability to provide EU wide public goods (multifunctional elements serve in deed significant cross-border externalities) and to create EU value added.
- Making an attempt to redefine EU’s agricultural policy through exploring objectives having a greater impact by being implemented at the supranational level and not at other secondary decision levels. – Making an attempt to outline a Common Rural Policy, a policy promoting the provision of public goods required by the society by means of targeted and decoupled economic policy measures.

In order to attain the objectives of the paper we apply the theory of fiscal federalism, make analysis on EU public finances in a broader context.

Keywords: public goods, fiscal federalism, a new agricultural policy

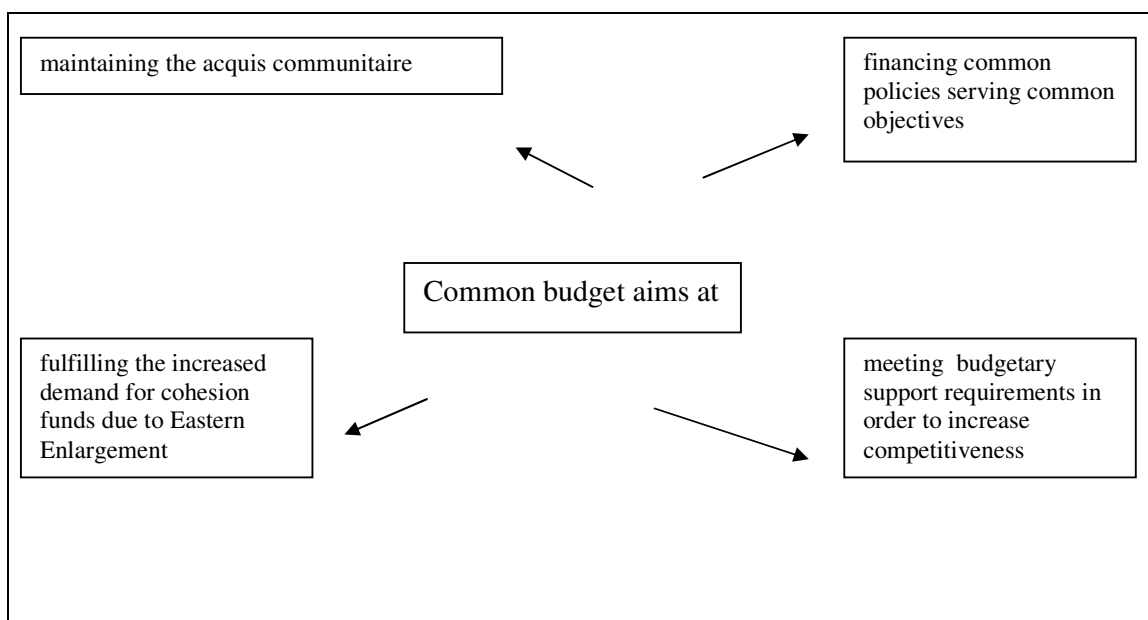
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Introduction

Characteristics of the common budget

Since agricultural policy expenditure mostly burdens the common budget (Figure 1), the rate of agricultural expenditure is relatively high in the common budget. Hence, this rate cannot be evaluated out of context.

Figure 1 Target areas of common budget funding



The common budget differs from national budgets fundamentally. Its primary function is to *promote common and Community policies*, activities and objectives, i.e. it is not a miniature of national budgets, for its structure is different. Comparing the expenditure of certain federative countries to that of the EU, the difference in the structure of the expenditure is obvious (*see Table 1*). 99 per cent of EU common budget expenditure serves different expenditure functions than those of federative states. *The supranational system of agricultural policy in the EU has so far generated a high rate of agricultural expenditure* (though this rate is getting lower). *The rate of agricultural expenditure is, however, insignificant in the national budgets.*

Table 1 - Expenditure of federal governments by chief function (percentage of the total federative expenditure)

	Security	Education	Health	Social security and welfare	Debt service	Other functions
Australia	7.0	7.6	14.8	35.5	6.1	29.0
Canada	5.6	2.3	1.4	44.6	15.1	31.0
Germany	3.9	0.5	18.9	50.0	7.1	19.5
Switzerland	4.6	2.4	19.6	49.1	3.5	20.7
USA	15.4	1.8	20.5	28.2	12.6	21.5
EU15	0.0	1.0	0.0	0.0	–	99.0

Source: El Agraa (2004)

Table 2 compares the level of governmental expenditure of certain federative states with corresponding levels of the European Union. The data shows that the common budget totalled up to 1.1 per cent of the GDP, while in national budgets of EU15 countries this rate amounted to 44.7 per cent of the GDP in 2000.

Table 2 - Governmental level expenditure in federal states (percentage of GDP)

	Governmental level			
	Federal	State	Local	Total
Australia	15.7	15.6	1.9	33.2
Canada	13.3	17.0	7.2	37.5
Germany	30.1	8.6	7.4	46.1
Switzerland	9.9	12.3	8.5	30.7
USA	15.9	7.0	7.2	30.1
EU15	1.1	44.7	–	45.8

Source: IMF (2001), European Commission (2000)

The high rate of CAP expenditure characterises the common budget, while national budgets, which play a decisive role in centralisation, finance agricultural expenditure only to an insignificant degree. It is often noted that too much is spent on the Common Agricultural Policy from the common budget. In 2003, CAP expenditure from the common budget amounted to 0.4 per cent of the GDP of countries of the EU15.

This makes one wonder what level of agricultural expenditure would not be considered 'too much' – perhaps 0.2 or 0.3 per cent of the GDP (Table 3)? According to this logic, most probably 0 per cent support paid from the common budget would represent the ideal level.

Table 3 Agricultural support (as a percentage of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008
EU15								
1. Common budget ¹	0,50	0,49	0,49	0,46	0,46	0,44	...	...
2. National support	0,15	0,15	0,15	0,12	0,13	0,12	...	...
3. Total (1+2)	0,65	0,69	0,64	0,58	0,59	0,56	...	...
EU10								
4. Common budget ¹				0,46	0,83	0,86	...	...
5. National support				0,35	0,35	0,35	...	...
6. Total (4+5)				0,81	1,18	1,21	...	...
EU25								
7. Common budget				0,46 ¹	0,48 ¹	0,47 ^{1,2}	0,41 ²	0,43
8. National support				0,13	0,15	0,14	...	...
9. Total (7+8)				0,59	0,63	0,61	...	...

Note: 1. EAGGF Guarantee and Guidance section – expenditure 2. Total agricultural expenditure (Policy area 0.5) Source: European Commission

The question arises: what justifies the financing (either at Community or national level) of the agriculture at all. Rather than its contribution to the GDP or share in employment, the social and economic role of EU agriculture becomes apparent if one considers the *rate of agricultural land and forest*. This rate exceeds 80 per cent in most EU member states, i.e. *most of the land in Europe is utilized by agriculture (see table 4.)* These areas, including forests, are *significant farmed landscape*, continuously maintained through economic activity. Maintaining the landscape, preventing erosion, planting the land, eliminating allergenic and other weeds, complying with various environmental regulations, and preserving the cultural heritage in the rural areas are *all positive externalities contributing to the provision of public goods*.

Table 4 Rate of agricultural territory and forests in the EU and in individual member states

	Agricultural territory (1)	Forest* (2)	Total (1+2)
Austria	40.1	41.6	82.5
Czech Republic	46.1	34.1	80.1
France	54.1	31.6	85.6
Greece	64.0	22.8	86.8
Poland	52.1	30.0	82.1
Hungary	61.8	19.7	81.5
Great Britain	69.9	11.6	81.5
Germany	47.7	30.2	77.9
Italy	50.1	23.3	73.4
Spain	50.0	33.3	83.3
Sweden	7.0	73.5	80.5
Slovakia	39.3	41.6	80.9
Slovenia	24.2	60.1	84.3
EU25	42.4	-	-
EU15	41.9	38.2	81.1
EU10	44.8	-	-

Source: EU Commission, Directorate-General for Agriculture Note: *data from 2001

Thus, in addition to production, agriculture provides extra services to the society. Therefore, *the European agricultural model is typically characterised by multifunctionality*. The promotion and maintenance of multifunctional characters, however, requires the use of financial tools.

How to promote the provision of public goods, and secondly, to what extent financing this activity can be justified constitute two questions of fundamental importance.

How to promote the provision of public goods?

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.

As a basic principle, the non-product outputs of agriculture should meet the needs of the society as regards their quantity, composition and quality. According to certain OECD countries (including the EU member states) the decrease in support linked to production (coupled payments) and the liberalisation of trade will decrease positive joint non-product output of the agriculture that has no market through the reduction of production. *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 p. 10)

At the same time *the calculation of economic costs of such agricultural externalities is rather difficult.* Such costs may vary depending on the different conditions. It is also difficult to calculate the value of natural resources. Research on preferences related to environmental goods may bring interesting results. (Through for example the examination of a hypothetical market, the intention to pay of those questioned for multifunctional services.)

Not much is known about the actual value and costs of such public goods. Yet we know that these are not free goods; the positive externalities generated as tied output have additional costs. (Eliminating these would result in less cost.)

To what extent community financing can be justified?

There are several factors which justify the community level intervention. Theoretical frameworks ensure the possibility of financing agriculture at EU-level.

According to the *fiscal federalism* theory (Pelkmans, 2001, Baldwin–Wyplosz, 2004, El Agra, 2004) centralised (or Community level in this case) financing may be justified in case of significant, positive and negative *cross-border externalities* and spill-over effects¹ (see Table 5 in case of agriculture). The bottom line of the “decentralization theorem” that centralization is welfare superior when spill-overs are sufficiently high was proved e.g. by Koethenbuerger, 2007.

¹ The question arises, however, how the difference in the utility of centralization and decentralization changes with respect to the level of spill-overs.

Table 5: Certain public goods provided by agriculture

	Public goods	Spill-over effects
Environment friendly agricultural production practices	Protection and preservation of natural resources Stable ecosystem Biological diversity Protection of valuable natural areas Carbon sequestration Waste management	Local, regional, European Regional, European, global Local, regional, European, global 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: Own compilation based mainly on FAO, 2002 and 2007

“Given the present budget structure, several authors like Tabellini (2003) or the Sapir commission (Sapir, 2004) have demanded a higher involvement of the EU in those policies which can be expected to create a European added value². This would imply a shifting of resources from the distributive spending to public goods in areas like international affairs, immigration or security policy (external aid, border controls), as well as R&D and innovation policies, hence areas, where economies of scale or positive external effects prevail.” (Osterloh et al, 2008) It definitely implies a shifting but as agricultural policies are also able to create *European added value*³ EU financing in the agricultural sector cannot be totally eliminated.

² “Reports by the European Court of Auditors, academic studies and even the Sapir report (Sapir et al., 2003) commissioned in July 2002 by the then European Commission President Romano Prodi, also criticize the goals, implementation and added value of the EU budget. Consequently, the contributory solidarity of member states has practically disappeared. Reluctant net contributors agree on a suboptimal policy mix apparently dictated mainly by political pressures and the wish not to cause a breakdown of EU structures.”

³ European value added is dependent on objectives having a greater impact by being implemented at the supranational level and not at other secondary decision levels.

Agriculture does have such expenditure objectives for which spending by a supranational structure are more efficient than national expenditures. Let's name the environmental objectives. "Given the enormous priority of the environment for the future, it is rather unfortunate to see it having such little relevance. Because of the cross-border nature of pollution, environmental actions quintessentially need to be solved at the multinational level. Even admitting that convergence policies and R&D have some environmental aspects and that much of the EU's action is regulatory, spending on the environment is surprisingly low. Given the challenges posed by climate change and the need for adaptive and mitigating practices, there are reasons for substantial budgetary allocation in this area." (CEPS Tasks Force Report, 2007) Let's mention the income support objective as well. Direct payments –as income support tool - could create a value added if low-income farmers benefited and the policy ensured that farming stays in areas where it is socially desirable. In economic terms the desired value added of the impact and the society's willingness to pay to preserve the benefits of agriculture, especially in areas in decline is in line with the cost of the policy. (Núñez Ferrer, J. – Kaditi, E. A., 2007)

Taking into account these considerations and the criticism European added value and the quality of the CAP have to be, however, increased significantly. In this regard the aspects to be improved are the following:

- Targeting
- Widening the scope of intervention to non-farm activities
- Evaluation quality

Direct payments should be:

- restructured and aligned further to their objectives; (There is a need for tightening eligibility criteria to ensure that funds are allocated where needed.)
- based on a cost-based analysis;
- targeted – thus freeing resources which could be used first of all for holistic rural development actions.

Rural development support (payments for rural areas, food safety, food quality standard and environmental protection):

- should be aimed at generating endogenous growth, generating economic development on a 'territorial' basis;
- should be carefully devised and targeted.

In economic terms European value added means that the economic return to recipients after an investment by the EU should be higher than without the investment. For agricultural policies, however, value added is not bound to be quantifiable in economic terms, but substantial and important in political terms. (Danell, – Östhol 2008)

- The eligibility rules for these supports should be refined. (Núñez Ferrer, J. – Kaditi, E. A., 2007)

Provision of public goods supposes public finance: either from the common or from the national budget or both of them. Among others it is to mention, that a relatively large share of environmentally sensitive areas is of international importance. Protection of these areas can not be exclusive liability of member states. It is a common interest to have the landscape in less developed countries and regions meet the requirements of the European model. *Provision of European public goods under common frames can provide compensation for uneven distribution of costs.* Also Gros (2008) suggests, that “one guiding principle for the EU budget: expenditure at the EU level is appropriate mainly to safeguard a *European public good*. Over time, the EU budget structure should reflect this simple principle.” But if we continue to quote him we cannot agree fully with his statement, namely: “There is no justification for spending a major part of the EU’s scarce resources over decades on a declining industry such as agriculture.” As European agriculture is in position to provide EU-wide public goods - *multifunctional elements serve in deed significant cross-border externalities* – financing at EU level is justified. The question – to what extent, however, remains (as mentioned earlier).

Threats arising from eliminating EU-level financing

In case of re-nationalization member states could support their agriculture at different level. Wealthier nations would be ready to spend on their own agricultural producers, and when the principle of *financial solidarity* is dismissed, poorer countries would have to face new challenges. (e.g. *Rural development* would not be able to open up significant modernisation and restructuring opportunities in all regions concerned.) This would threaten the internal market and weaken the social-economic cohesion.

As an increasing share of producers’ income comes from non traditional production activities, competitive advantage becomes more important. Fair competition and transparency of competitive situations has to be insured, thus common frames (involving common financing) are needed.

Due to limited financial resources member states will not prioritise investment in declining areas even if they are valuable socially. But EU contribution can enhance national conservation programs.

The cancellation of financing the Common Agricultural Policy through the common budget or its radical reduction aims at improving the position of net contributors rather than at a parallel increase of cohesion expenditure and involves the possibility of decreasing the cohesion expenditure and also the common budget [for example, R. Baldwin says that the common budget could be reduced to 80 per cent of its previous volume, Baldwin (2005)]

Possible options for the CAP

Taking all these factors into account, let us now review some possible options for the CAP which are closely related to future functions of the common budget and its changing structure.

1. According to the first version, the *CAP would survive*. However, a fundamental assessment of and a significant correction to the reform is possible.
2. Theoretically, the *CAP could be completely refused or renationalised*. In this case the common policy would be replaced by national competences and national financing, with the consequence that the agricultural expenditure of the common budget diminishes, while *the burden on national budgets increases*. Moreover, wealthier countries may provide more generous support to their producers. Stopping the common financing would in itself have an *anti-cohesion effect*: rural disparities between countries and regions could increase to a great extent.
3. *Total liberalisation* is also possible in theory. The common policy would no longer function, and neither would national policies. The implementation of this version would have drastic consequences in regions where agriculture is less competitive. Most of the farmed landscape would lose its maintainers.

The agricultural policy of the past cannot be continued. It should be noted, however, that agricultural policy as such is not necessarily a representative of the past. As a maintainer of the European landscape it produces public goods and through further reform it can produce even more. Consequent reform could facilitate a sustainable Common Agricultural Policy, serving the goals of maintaining environmental values and increasing competitiveness. At the same time, its complete refusal and a re-nationalisation of the Policy is also a viable options. *Nevertheless, the deepening of the European integration is possible through the preservation of the *acquis communautaire* and the reform process promoting sustainability.*

In order to achieve these goals, it is also necessary for the common budget to operate as an instrument of the effective implementation of common policies and objectives. If member states focus narrow-mindedly only on improving their net budgetary position, common policies would become of secondary importance and the process of the European integration would come to a halt after decades of development, or stagnate at the present level.

A draft of changes in CAP proposed by the authors

The European Union is not able to maintain CAP in its current form any more: radical reform is unavoidable. Current review of the CAP (Health Check) may help to reach a healthier CAP, but the proposed changes are not enough to overcome the difficulties. The future CAP meeting abovementioned criteria – such as providing European added value –

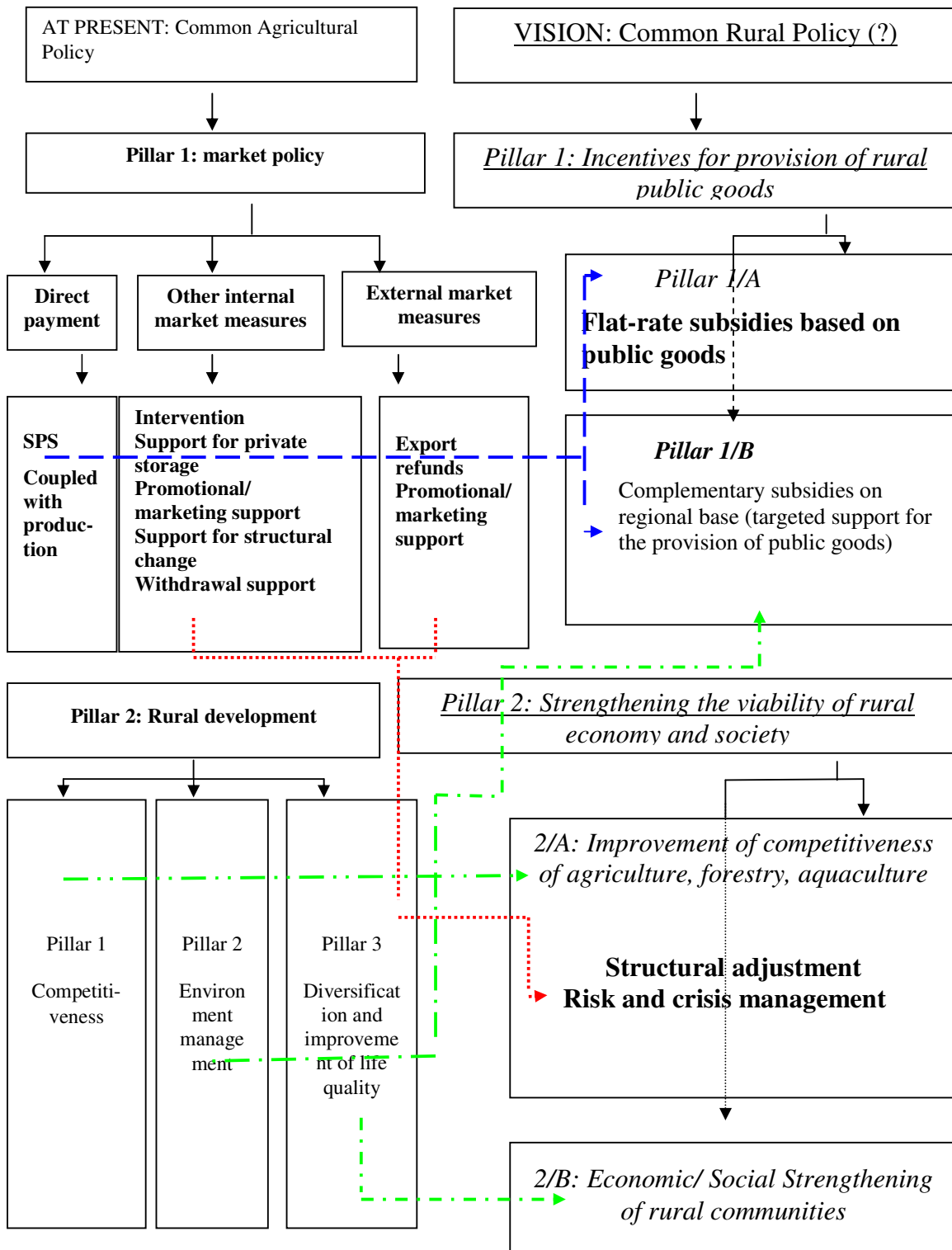
could contain the following new pillars with their new contents.

The Common Agricultural and Rural Development Policy depicted in Figure 2 shows that also the new policy is based on two pillars. But these are totally different ones. In the new pillar 1 there is a switch from direct payments to a flat rate payment based on public goods and fully decoupled - pillar 1/A - plus complementary subsidies on regional base – pillar 1/B, that is considered indeed to be targeted support for the provision of public goods. (Community financing is proposed but in the last resort co-financing is possible, the share of national contribution has to be, however, agreed upon.)

Pillar 2 with co-financing is aimed at promoting and strengthening the viability of rural economy and society. Pillar 2/A serves structural adjustment - in the framework of which EU contribution in poorer countries is higher and in richer member states the national share of support is greater – and new integrated risk and crisis management. The objective of pillar II/B is the developing, strengthening of rural communities (improvement in the quality of rural life, support for local communities, maintenance of landscape are of higher importance).

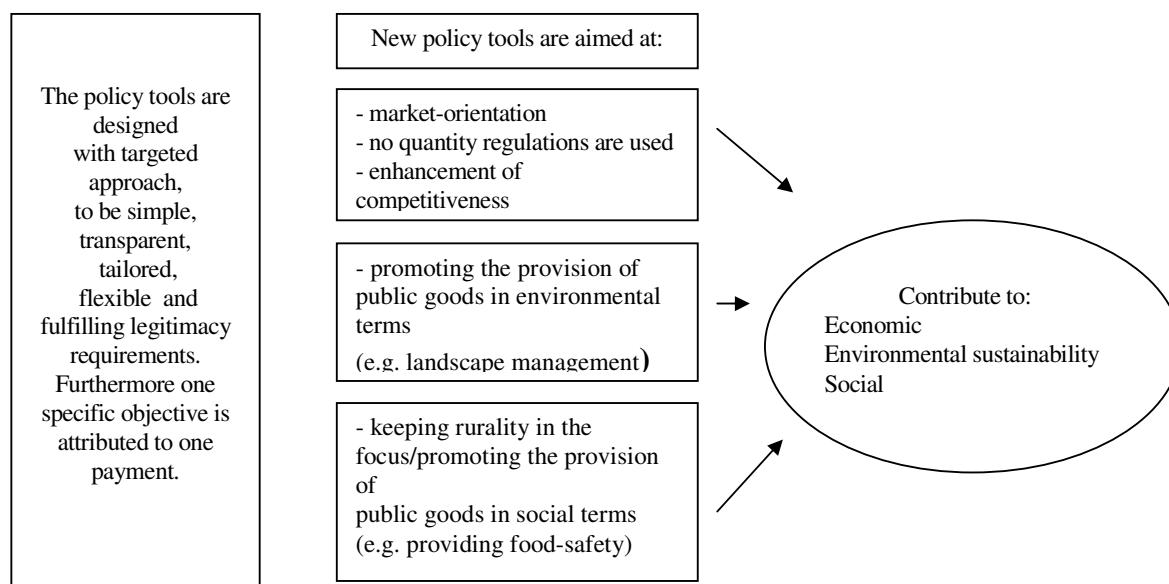
The vision – as a paradigm shift – proposes and describes rather a Common Rural Policy than a Common Agricultural Policy.

Figure 2 Structural change in Common Agricultural and Rural Development Policy



The conception of the new policy – a new policy requiring both national and Community funding - is in line with the requirements of sustainable development, thus sustainable agricultural activities – sustainable land use - food-feed production, biofuels, forestry, fishery.

Figure 3 Policy tools contributing to sustainability



Furthermore, the new policy requiring national and Community funding might have the appropriate approach to deal with globalisation, trade liberalization, climate change, new sources of demand and structural reforms issues.

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