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Andrea Elekes and Péter Halmi*

The “Hottest Topic” of the Budgetary Review: Will the CAP Survive?

Dalia Grybauskaitė, while she was EU Budgetary Commissioner,¹ said that the future financing of the CAP was the “hottest topic” of the budgetary review. The next months will be decisive as regards the financing of the CAP beyond 2013. Net beneficiaries of the CAP and agricultural interest groups would of course like to maintain the status quo while others would prefer to use the funds for other purposes. When, and how, is the common financing of the CAP justified?

The CAP² and cohesion policy are the main expenditure titles of the common budget. CAP measures are financed as follows:

- market support and direct income payments (first pillar) are fully covered by 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).

The CAP reform introduced in 1992, the further reforms of 2000 and 2003, and the modification as part of the Health Check have not resulted in the reduction of the 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, amounting to 70% of total agricultural support. Their ratio will further increase by 2013. The ratio of rural development expenditure has also increased from the mid 1990s. Table 1 shows the ratio of agricultural support to GDP.

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 federal states is indicated by the data in Table 2. (Note that the high rate of centralisation is not the outcome of the common budget, which amounts to 1.1 per cent of the GDP.)

The common budget and especially CAP related expenditure has been the subject of debate for various reasons.³ The budget related disputes on 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 budget.⁵ The budgetary review offers an open approach without taboos (a threat to 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 agricultural policy to current priorities. Opinions differ, however, 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 a significant reduction in 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 abolish⁶). Although there are clear expectations concerning the reduction of agricultural expenditure, total re-nationalisation of agricultural policy has not been mentioned. It is evident, however, that the CAP can

¹ She is now the President of Lithuania.

² Literature on the CAP is very widespread. We cannot go into details but simply try to indicate the significance of the problem.

³ Cf. 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.

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Table 1
Agricultural Support as a Percentage of GDP

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---------------------|------|------|------|-------------------|-------------------|---------------------|---------------------|
| EU15 | | | | | | | |
| 1. Common budget | 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 | | | | 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 | | | | 0.46 ^a | 0.48 ^a | 0.47 ^{a,b} | 0.43 ^{a,b} |
| 8. National support | | | | 0.13 | 0.15 | 0.14 | 0.09 |
| 9. Total (7+8) | | | | 0.59 | 0.63 | 0.61 | 0.52 |

Notes: ^a EAGGF expenditure. ^b Total agricultural area (policy area 05).

Source: Authors' calculation.

no longer be maintained in its current form. The CAP should be placed on an entirely new basis in order to make it sustainable (from an economic, environmental and social point of view) in the long run.

Common Financing in the Light of Fiscal Federalism

Fiscal federalism is the most frequently applied theory in the literature⁶ to try to answer the question as to how the responsibility for policies and their financing could optimally be distributed among the EU and its member states.

Fiscal federalism suggests that there are basically three reasons for government interventions: stabilisation, equalisation and allocation (Musgravian classification). Stabilisation refers mainly to macroeconomic stability but it can cover security too. The main func-

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-nationalised and financial solidarity dismissed, the poorer countries have to face new challenges).

⁶ E.g. W. E. Oates: Fiscal Federalism, New York 1972, Harcourt Brace & Jovanovich; W. E. Oates: An Essay on Fiscal Federalism, in: Journal of Economic Literature, Vol. 37, No. 3, 1999, pp. 1120-1149; R. A. Musgrave: Theories of fiscal federalism, in: Public Finance, Vol. 24, 1969, pp. 521-532; J. Peikmans: European Integration – methods and economic analysis, New York 2006, Longman Publishing; G. Tabellini: The Assignment of Tasks in an Evolving European Union, CEPS Policy Brief No. 10, Centre for European Policy Studies, Brussels, January 2002.

Table 2
Expenditure of Different Levels of Government in Selected Federal States 2003

| | Government | | | Total |
|-------------|------------|-------|-------|-------|
| | Federal | State | Local | |
| 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 |
| USA | 18.7 | 10.2 | 7.8 | 36.7 |
| EU15 | 1.0 | 34.2 | 13.5 | 47.7 |

Source: El Agra, 2007.

tion of equalisation is to manage income inequalities but may extend to risk sharing (insurance). The allocation function aims to correct market failures. There are four major areas of market failures which may invoke government intervention: public goods, externalities, economies of scale and information asymmetry.

Based on the above criteria an 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 equalisation or stabilisation objective.

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 spillover 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, ac-

⁷ For details cf. 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.

Table 3
Level of Intervention (Political-economic Arguments)

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

ording 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 less the same.⁸

The trade-off between centralisation and decentralisation has led to the formulation of the functional subsidiarity principle. With the help of the functional subsidiarity test⁹ 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 the 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 provides further aspects especially as it explicitly integrates self-interested governments. Further arguments for centralisation 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 cannot be perfectly enforced, which can result in a welfare loss. Another argument for decentralisation is accountability, which seems to be easier in the case

⁸ M. Olson, Jr.: The Principle of "Fiscal Equivalence": The Division of Responsibilities among Different Levels of Government, in: American Economic Review, Vol. 59, 1969, pp. 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, New York 2006, Longman Publishing; S. Ederveen, J. Pelkmans: Principles of Subsidiarity, The Hague 2006, CPB Netherlands Bureau of Economic Policy.

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 cannot 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 |

of decentralised governments. We should also consider the allocation problem of the community resources (common pool). Arguments for centralisation and decentralisation are summarised in Table 3.

Budgetary Principles

If the analyses show that centralisation is the most efficient form of 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). (Cf. Table 4.)

Methods of Intervention

The literature basically suggests four methods of addressing the allocation problems:

- Rules, regulations and directives (legal approach with administrative measures). This is the most cost-effective method; however, its applicability is limited. It is used mainly in the 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. The actual provision of specific public goods may be done 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. The limits of this solution are the following: marginal utility has to be measured, the subsidy cannot exceed marginal cost and the subsidy has to be financed.

Income and risk inequity problems can be addressed by taxation, subsidisation, 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?

We now confront theoretical categories with the reality of the CAP, applying a simple, verbal intervention test. As regards the CAP, the allocation and equity functions of the interventions can be stressed. Table 5 shows the most important allocation and equity functions of the CAP. The allocation function aims to correct market failures. Agriculture is a special area of the economy, where all four main forms of market failures can be found.

Public Goods

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

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 recognise 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, without support, the level of agricultural public goods would fall behind the socially optimal level. At the same time, the current level of support is disproportionately high (from the public goods point of view). Moreover, the current support system is insufficiently targeted.

Economies of Scale

In the case of certain public goods – according to the OECD¹¹ – there may be economies of scale that necessitate provision by large jurisdictions (central government), since it may be impossible to create

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

¹¹ OECD: Policy design characteristics for effective targeting, AGR/CA/APM (2005) 32/FINAL, 2007.

Table 5
Allocation and Equity Functions in the Agricultural Policy

| Allocation | |
|-------------------------------------|---|
| Public goods | Protection and preservation of natural resources etc. (cf. Table 7) |
| Externalities | |
| Economies of scale | Interregional direct payments |
| Imperfect or asymmetric information | Crisis and risk management, food safety |
| Equity | |
| Income Risk | Regional convergence, above average (sectoral, systemic) risk, income disparities |

the right incentives for efficient decentralised provision. For example, Grethe¹² states that preservation of cross-border wildlife habitats is a typical case for economies of scale.

Economies of scale may also arise from the interregional nature of the re-distributive programmes (e.g. direct payments). This stems from the fact that the EU level has the institutional (organisational) capacity to govern and monitor such inter-regional (re)distributive projects.¹³ Furthermore, if the (income) support system is executed by member states, this could distort competition and have a negative effect on the functioning of the Internal Market.

Imperfect or Asymmetric Information

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

¹² 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, organised by the European Commission, the CPB Netherlands Bureau for Economic Policy Analysis and the Dutch Ministry of Economic Affairs, Brussels, 8-9 November 2006.

¹³ W. Moïlle: European Cohesion Policy, London 2007, Routledge.

Table 6
Selected Public Goods Provided by Agriculture

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

Source: Authors' compilation based mainly on data from the FAO.

Food safety is a credence function which can hardly be perceived by consumers. The market itself often cannot provide the socially optimal food safety level, and this calls for public intervention. The literature on 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 a public good; taking into account social costs and benefits; and when there is a difference between the perceived and the real risk.

Equity Function

The 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.¹⁴

¹⁴ 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.

On equity grounds, for example, even the most radical authors recognise a justification for direct payments, although they do so 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 this kind of analysis, and therefore it is not surprising that the 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 this.)

Level of Agricultural and Rural Intervention

Theory suggests that only the management of public goods based support systems and externalities with significant spillover effects can be justified at a central

level. These objectives may, however, 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 (centralisation) may be justified in the following cases:

- regional (European) and global public goods (because of self-interested governments)¹⁵
- vertical cooperation in the case of core activities (e.g. research)¹⁶
- economies of scale
- risk reduction and direct utility (their benefits can usually be enjoyed in a wider range than that of capacity enhancing activities)¹⁷
- joint production.

We can speak of 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 products.¹⁸

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 decentralisation.

Instruments Available

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

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

¹⁵ For details cf. 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.

¹⁶ For details cf. O. Morrissey, D. Velde, A. Hewitt: Defining International Public Goods: Conceptual Issues, in: M. Ferroni, A. Mody (eds.): International Public Goods: Incentives, Measurements and Financing, Dordrecht 2002, Kluwer Academic Publishers.

¹⁷ For details cf. O. Morrissey et al., op. cit.

¹⁸ 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.

Table 7
Instruments of Public Intervention Available for 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 externalities |

stress the importance of proportionality, which can be seen as a social cost benefit analysis that examines what policy measure to use.

Subsidiarity

We now examine how the current CAP meets the budgetary principles and what kind of change is necessary.

When examining the spending side of the EU budget, the study by ECORYS et al.¹⁹ applied the subsubsidiarity 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 in favour of the 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 (modernisation, income security, market stabilisation and food security). Although these agricultural policy objectives have remained important, there has been a significant

¹⁹ 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.

change in emphasis. In recent years objectives related to the environment, rural development and food safety (or in general: the provision of public goods) have also become important. These latter objectives have important spatial and/or benefit dimensions, and therefore in their cases traditional broad-based policies do not necessarily address current societal interests, and are often wasteful and inefficient.²⁰

An OECD study²¹ concludes that in the case of policies which aim to correct market failures (e.g. landscape preservation or biodiversity) targeted support (be it decoupled or not) may prove to be the most cost efficient solution (especially if the savings through targeting are high). The study also mentions 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 in this area requires further research.

European Value Added

It is highly debated whether the Common Agricultural Policy generates value added for Europe. ECORYS et al.²² argue that, presently, the support measures of the Common Agricultural Policy score badly in terms of EU value added due to the lack of efficient targeting and the ensuing excessive opportunity costs. According to the definition of (European)

value added by Sapir et al.,²³ the CAP would have to be abolished.

European Public Goods

In addition to production, agriculture provides extra services to society, and the European agricultural model is typically characterised by multifunctionality.²⁴ The key elements of this multifunctionality are:

- multiple product and non-product output produced jointly in agriculture (joint output)
- creating non-product output with the 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 (cf. 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) they are considered to be competitive disadvantages vis-à-vis 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 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 welfare-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 the case of the joint production of private and public goods efficiency will require that private goods are produced, used and traded according to market mechanisms. In addition, for the production of public

²⁰ 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, Paris 2001; OECD: Income transfer efficiency of farm support measures, AGR/CA/APM(2001)24, 2001.

²¹ OECD: Policy design characteristics, op. cit.

²² ECORYS Nederland BV et al., op. cit.

²³ 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 2004, Oxford University Press.

²⁴ It has to be borne in mind that the term multifunctionality in this economic context has a different meaning from that in which it is often used by agricultural interest groups in defence of the status quo.

goods required by 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”.²⁵

Is Common Financing of a Reformed CAP Justified?

We shall now try to answer some sensitive questions which should be dealt with in the process of the Budgetary Review.

Negative positions regarding the CAP 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 be completely disregarded. It is commonly agreed that they contribute to local/regional/national/EU/global welfare, but their value is not added to GDP.

Growth should be measured with an extended form of GDP, including the value of public goods. What is more, we should also take into account the intergenerational nature of certain public goods. Further problems 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 directly favour 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 in 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 utilise 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 market or only a limited one.

²⁵ OECD: Income transfer efficiency of farm support measures, op. cit.

Table 8
Basic Elements of a Reform Reflecting the Budgetary Principles

| (Common) Budgetary Principles | |
|---------------------------------|--|
| Subsidiarity | Rising level of decentralisation |
| 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 output |
| European public goods | Support system based on public goods |
| Value added (at European level) | Targeted support, positive externalities with European or global spillover effects |

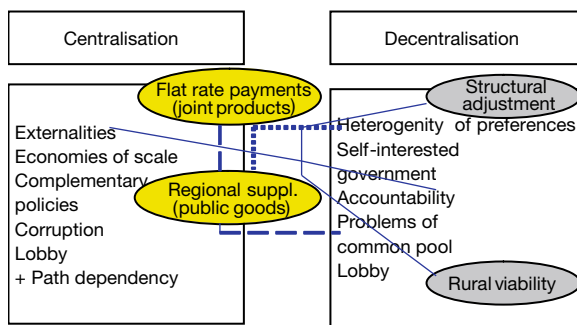
- Management of regional and global environmental problems (e.g. climate change) is justified at EU level. Climate change is one of the most important priorities of the EU. There hardly exists another sector which is more affected by climate change than agriculture. Agriculture not only has to adapt to climate change, it can also combat it (alternative energy, carbon sequestration etc.)
- The quality and management of nature, the environment and the landscape requires a cross-border approach, as neither the ecosystem nor the environment and pollution respect national borders.
- Ethical aspects (e.g. animal welfare) and (human, plant and animal) health requirements make a supra-national approach necessary from a trade perspective.
- Sustainable development is a European interest; the burden should not be passed on to the environment, to developing countries or to future generations.
- From the perspective of competition policy it is important that at least European competition be fair. (e.g. mandatory ecological efficiency should not weaken economic efficiency).

A certain level of common budgetary contribution seems to be justified in the above-mentioned cases (even if it is made in a co-financed form). However, the 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 (cf. Table 8), efficiency should be improved through targeted policies (principle of value added) and alternative costs should be minimised.

Can National Co-financing be Extended?

Based on the theories of fiscal federalism and political economy we argue that full centralisation – com-

Figure 1
Arguments for Centralisation/Decentralisation



mon financing, implementation and monitoring – is justified only in the case of joint products (cf. Figure 1). In all other cases a certain level of decentralisation should be considered: national and regional authorities should take more financial liability.²⁶

Is it Justified to Keep the System of Commonly Financed Direct Payments?

Direct payments were originally introduced as compensation for the income loss suffered because of the reduction in price support. Originally they were coupled to production and distorted the markets so they clearly had (negative) externalities. These externalities justified the centralisation of the policy and its financing. Nowadays, most of the payments are decoupled and have no, or at most minimal, distorting effects. Fis-

²⁶ For simulation results see e.g. F. Heinemann, P. Mohl, S. Osterloh: Reform Options for the EU Own Resources System, 2008 Springer, p.178, here pp. 74-78.

Figure 2
Reasons for Common Financing in the Old and in the New System

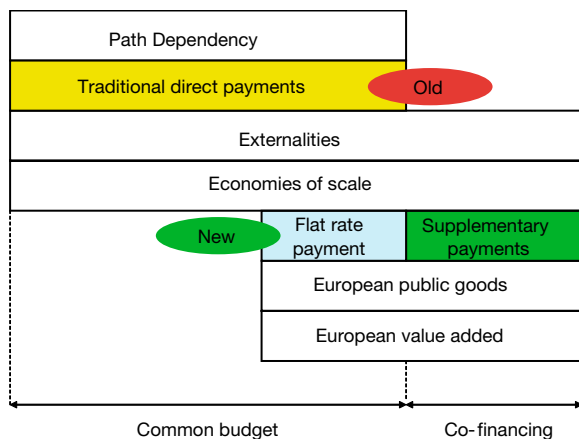
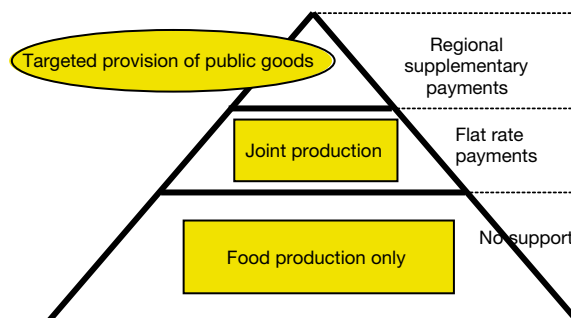


Figure 3
The System of Direct Payments After the Proposed Reforms



cal federalism suggests that direct payments should be totally 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 (cf. Figure 2). Income support cannot be a central task. Neither economies of scale, nor the internalisation of externalities justifies central financing.

Based on the theories we can again argue that full centralisation is justified only in the case of joint products (cf. 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 whose provision can be expected from all European producers, and whose value is more or less independent of the location of production.

It is important to stress that even if economies of scale justify the 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 decentralisation 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 the 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).