STUDIES

Community versus National Financing How to achieve a sustainable agricultural policy?

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SUMMARY FINDINGS, CONCLUSIONS, RECOMMENDATIONS

Is the Common Agricultural Policy unsustainable? Is agricultural spending a major distorting factor in the EU economy and an obstacle to the implementation of the Lisbon agenda? To answer these complex questions, detailed analysis is required along the following lines of thought:

1. Exploration of factors justifying Community level intervention. – Is the 'theory of decentralization' applicable to budgetary issues and the common agricultural policy? Our hypothesis suggests that it is.

2. Assessing CAP as it currently exists, including its ability to generate public goods at the level of the Community (multifunctional elements which are indeed cross-border externalities) and its ability to create added value at the level of the Community.

3. Making an attempt to redefine the Community's agricultural policy by identifying goals which can be achieved more effectively at the supranational level rather than by involving secondary levels of decision making. – Making an attempt to outline a Common Rural Policy, a new policy intended to promote the creation of public goods required by the society by means of targeted and decoupled economic policy measures.

The concept of the new policy – a new policy requiring both national and Community funding – is in line with the requirements of sustainable development, i.e. sustainable agricultural activities such as sustainable land use, food and feed production, biofuels, forestry and fishing. Additionally, the new policy we outlined may also be an effective approach to meeting challenges arising from globalisation, trade liberalization, climate change and structural reform issues.

SUSTAINABLE AGRICULTURAL POLICY

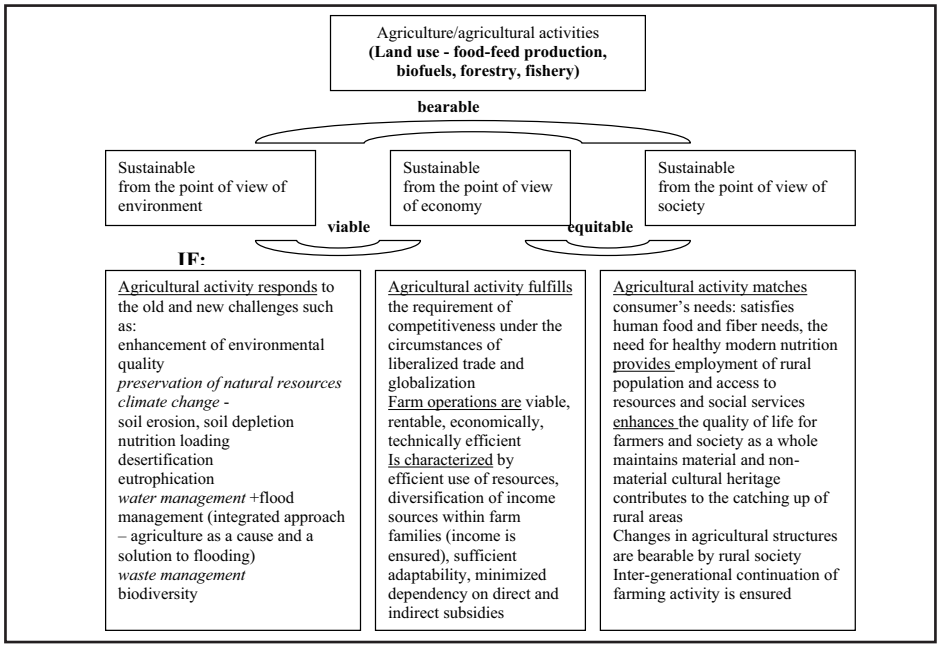
The first crucial aspect attains the definition of sustainability. Sustainable development at sectoral (here agriculture) and territorial (rural areas) level represents a priority objective of the European Union strategy, as it can be derived from many of the most recent documents.

Sustainable agriculture (Fig. 1) has attracted great attention in recent decades.

According to the most widely quoted and generally accepted definition which is included in the *Brundtland report (WCED, 1987)* – a very broad definition – sustainable is the development that meets the needs of the present without compromising the ability of future generations

Figure 1

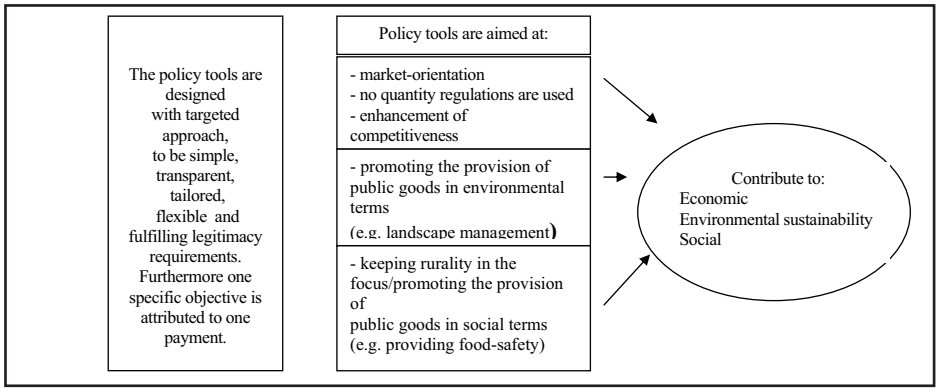
Sustainable agriculture



to meet their own needs. Whatever the adopted definition, the operational interpretation of the concept of sustainability includes three dimensions: economic, social and environmental. And these need to be considered in an interdisciplinary and integrated approach covering also a wide range of spatial and organizational scales that allows an all-round understanding of the issues facing stakeholders. Globalization, trade, policy, supply-chains, business structures and stakeholder preferences, consumer preferences all have profound effects on the sustainability of farming systems. (Furthermore the aggregate effects of decisions in farming systems also have significant spill-over effects into related sectors.)

Figure 2

Policy tools contributing to sustainability



Agriculture/ agricultural activity is sustainable if it is backed up also by a sustainable agricultural policy (see Fig. 2).

An agricultural policy is sustainable if it is aimed at certain goals and equipped by adequate instruments to help stakeholders to reach these goals.

Goals that should be aimed at by sustainable agricultural policies

In environmental context:

Contribution to

– *conserving resources (e.g.* Farmers should diversify the spatial organization of their fields through the insertion of new patches of natural vegetation well connected with the surrounding habitat. The presence of vegetation (hedgerows) along the farm boundaries reduces windspeed thus minimizing soil loss by wind erosion and water loss by excess of transpiration./Minimum tillage and cover cropping management can be used to conserve soil. In irrigated orchards drip irrigation and irrigation planning can be used to conserve water.);

– *using renewable resources;*

– *adjusting to local environments;*

– *managing ecological relationships* (e.g. Patches of natural vegetation provide important habitats for the propagation and protection of a wide range of natural biological control agents of agricultural pests./In organic olive orchards minimum tillage can be used as well as mulches, minimizing disturbance. Cover cropping and an ecological infrastructure can be used to enhance beneficial biota and beneficial insects. Management of pruning residues, cover crops and animal manures recycle nutrients. Insect pests, diseases, and weeds can be managed with the use of cultural practices, mass trapping methods and biological control.);

– *minimizing toxics* (e.g. use of organic farm regulations/The use of trap crops can drastically reduce the quantity of pyrethroids sprayed in the environment. This broad spectrum insecticide can be used only in a small area and not on the crop. The reduction of the use of insecticides enhances beneficial insects in the agroecosystem. It allows the natural control of other important pests. By not applying insecticides directly on the target crop, there can be a reduction in the amount of insecticides used, which greatly benefits human and environmental health.);

– *diversifying* (e.g. Undisturbed areas of native species encourage the creation of a more complex and diverse agroecosystem with a variety of living organisms.);

– *managing whole systems* (Landscape ecology and geographical information analyses emphasize a whole-system approach of the agricultural landscape focusing the attention on the relationship between farms and natural systems.);

– *maximizing long-term benefits* (e.g. By reestablishing the balance between an exotic weed and its herbivorous pest, certain insects act as a permanent weed management tool.).

In economic context:

Contribution to

– *eliminating market distorting effects* (e.g. distortion of input markets through machinery support);

– *decreasing policy-related transaction costs;*

– *diversifying income sources of farms;*

– *establishing and implementing special design methodologies* (Appropriately designed farming methods are essential for achieving the objectives of sustainable farming systems. E.g. Designing and Disseminating Ecological Production Systems for Perennials.);

– finding the *best-management-practice* options;

– creating instruments to *enable producers* using sustainable practices to market their goods to a wider public.

In social context

Contribution to

– *finding strategies that broaden consumer perspectives*, so that environmental quality, resource use, and social equity issues are also considered in shopping decisions;

– *valuing health* (e.g. use of native medicine, cultural celebration, healthy food education and ecological restoration.);

– *empowering people* (An agri-environmental group can promote an ecological knowledge system in the rural area.).

In order to make sure of reaching the goals aimed at assessment tools have to be used. For sustainability evaluation of production systems, a variety of assessment tools has been developed in the past, including Life Cycle Assessment (LCA), Cost–Benefit Analysis (CBA), Environmental Impact Assessment (EIA) and Sustainability Standards with Principles, Criteria and Indicators (PC&I). These and new ones help measuring the level of sustainability (*Van Cauwenbergh et al., 2007*).

IS THE PRESENT COMMON AGRICULTURAL POLICY SUSTAINABLE?

Although there have been significant changes to the CAP, its current system is still not sustainable. As far as *decoupling* is concerned, which was meant to be pivotal to the reform, progress *has been limited*; the most recent (2003) reform decisions – against the European Commission's more radical proposal on full decoupling – involve only partial decoupling. (Nonetheless, even this compromised solution is a great step forward compared to the earlier situation; in addition each country may decide to introduce full decoupling.)

Other critical notes that are to be drafted:

Present CAP doesn't back up economic sustainability because:	Market distorting effects of the system on the way to decoupling has significantly weakened, still a great proportion of *direct payments* may capitalize in land prices and land lease fees, i.e. it *may distort input markets* and the transfer rate of agricultural subsidies (i.e. the rate of one unit of subsidy received by the agricultural producer) may worsen. Paradoxically, the reformed system is *more complex and bureaucratic* than the original model. The reform of 2003 promised the simplification of the system; however, the compromise (a system of different national implementations including various possibilities of coupling) disrupts the existing unity of the system, and endangers the implementation of the "single market" principle. Furthermore, this could lead to significant redistribution; while the regulation of cross-compliance and the implementation of the rules result in even more complex conditions, thus more transaction costs. The elements of *quantitative regulations* may still cause disorder, the mandatory set-aside is still in force and the elimination of the milk quota may be placed on the agenda only after 2013. Difficulties can be expected as regards the financing of direct payments and the budget review may further limit the CAP's financial possibilities. Conclusion of the WTO Doha round and the resulting new agreement(s) may challenge the CAP too.
Present CAP doesn't back up social sustainability	Regardless the declarations the role of *rural development* is still limited. It has to be noted that in 2004 the CAP system was expanded by ten new member states. As far as support is concerned significant *disparities* have evolved making the new member states handicapped: while the producers in wealthier member states receive high amount of payments falling in the scope of the first pillar fully from the common budget, the poorer countries' share is much smaller. Direct payments are *based on historical payments*, reflecting neither social aims, nor the value of public goods provided. The system is very complicated and lacks of transparency so it is difficult to get the society approve it.
Present CAP doesn't back up environmental sustainability	Direct payments are *based on historical payments*, reflecting neither social aims, nor the value of public goods provided.

MULTIFUNCTIONALITY – PROVISION AND FINANCING OF PUBLIC GOODS

A remarkable aspect needs to be focused on: Namely in addition to production, agriculture provides extra services to the society. Therefore, *the European agricultural model is typically characterised by multifunctionality.* The maintenance of multifunctionality contributes to the sustainability of agriculture. The promotion and maintenance of multifunctional characters, however, requires adequate policy instruments among them 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.

Prior answering these questions the characteristics of the common budget and within that the characteristics of the agricultural expenditure has to be studied.

Characteristics of agricultural expenditure

Since agricultural policy expenditure mostly burdens the common budget (Fig. 3), *the rate of agricultural expenditure is relatively high in the common budget.* Hence, this rate cannot be evaluated out of context. 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.*

Figure 3

Target areas of common budget funding

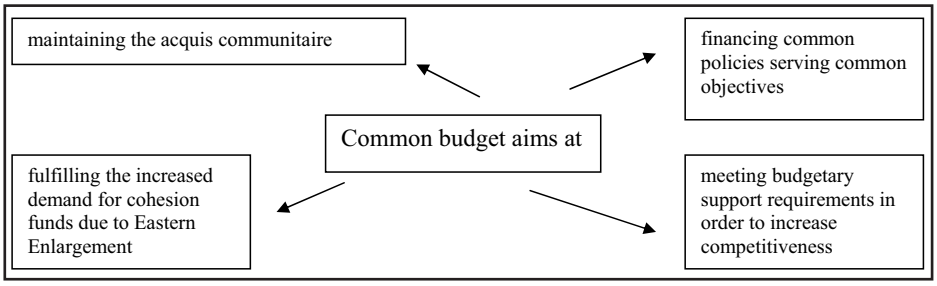


Table 1

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? According to this logic, most probably 0 per cent support paid from the common budget would represent the ideal level.

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 3) 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 3

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

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 Agraa, 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 effects[1] (see Table 4 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.*

"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 value[2]. 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. 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

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

[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.
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*).

to pay to preserve the benefits of agriculture, especially in areas in decline is in line with the cost of the policy (*Núñez Ferrer – Kaditi, 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;

– the eligibility rules for these supports should be refined (*Núñez Ferrer – Kaditi, 2007*).

Table 4

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: Elekes – Halmai – Vásáry, 2008

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 (2005)* says that the common budget could be reduced to 80 per cent of its previous volume].

The deepening of the European integration is possible through the preservation of the acquis communitaire 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 – such as the Common Agricultural Policy – 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[4]

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 elements with their new contents.

There should be a switch from direct payments to a flat rate payment based on public goods and fully decoupled plus complementary subsidies on regional base 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.)

Another tool with co-financing should be aimed at promoting and strengthening the viability of rural economy and society. It would serve on the one hand 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. On the other hand its objective would be 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 (Fig. 4).

Figure 4

Common Rural Policy?

VISION: Common Rural Policy (?)			
Incentives for provision of rural public goods		***Strengthening the viability of rural economy and society***	
Flat-rate subsidies based on public goods	**Complementary subsidies on regional base** (targeted support for the provision of public goods)	**Improvement of competitiveness of agriculture, forestry, aquaculture** Structural adjustment Risk and crisis management	**Economic/ Social Strengthening of rural communities**

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[4] This concept was elaborated on in the study prepared by *Halmai – Udovecz et al., 2008*.

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