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The Case for Co-Financing the CAP

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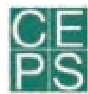

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The Case for Co-Financing the CAP

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1 CAP Objectives

1.1 Overview

The Common Agricultural Policy (CAP) was set up in a time when (a) the memory about post-war food shortage was fresh, (b) Europe was a large net-importer of agricultural products, (c) agricultural production was still highly labour-intensive, (d) food was a major item in a typical consumer basket and (e) significant shares of the workforce received their major income from the agricultural sector. The CAP objectives enshrined in Art. 39 TFEU (see box) clearly reflect this historical situation. When the Treaty of Rome was signed in 1957, it was understandable that the standard of living of the agricultural workforce was a major issue or to that "reasonable prices" for consumers were regarded as a matter of social stability.

Today, Art. 39 objectives appear to some extent outdated given the socio-economic situation of the modern European agricultural sector. At the 60th anniversary of the Treaty of Rome, agricultural production is capital-intensive with a low share of total labour employed in this sector. As a result, the major share of European agricultural production is highly competitive leading to a net-export situation for important agricultural commodities and low food spending share in consumer baskets which have declined dramatically over the decades.

Art. 39 TFEU

1. The objectives of the common agricultural policy shall be:

(a) to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;

(b) thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;

(c) to stabilise markets;

(d) to assure the availability of supplies;

(e) to ensure that supplies reach consumers at reasonable prices.

The popular narratives used to defend the large importance of CAP in the EU budget today have reacted to these changes. The "classical objectives" of Article 39 are no longer prominent when CAP spending is motivated. Other objectives have stepped in to legitimize this policy. The following objectives (no claim to completeness) are important today –

judging on the basis of European Commission documents (e.g. European Commission, 2012, 2013):

New CAP Objectives

1 Food quality

2 Ecological arguments

- Soil and water quality
- Protecting habitat and biodiversity
- Climate change
    - adaptation to new weather conditions
    - mitigation measures, i.e. reduction of greenhouse gas emissions

3 Animal welfare

4 Provision of public goods

- “well-tended countryside”
- preservation of cultural sites and objects

5 Development of rural areas (facing depopulation and economic decline)

6 Structural policy objectives

- Protecting small farms
- Support for generation change and young farmers

1.2 Inflation of Objectives as Immunization Strategy

Before discussing these new objectives‘ relevance for CAP, a general remark is important. Inflating objectives is a standard strategy to immunize a policy against a changing environment and/or a unconvincing performance (Heinemann et al., 2010). A similar strategy has been observed also for Cohesion where authors like Tarschys (2008) have counted about 30 objectives and often very far away from the key objectives assigned in primary law.

A multi-dimensional, comprehensive and constantly changing set of objectives helps to defend the existence of a policy. It allows linking this policy to new popular political trends. Moreover, it makes evaluation difficult. If objectives are manifold and diffuse, it is hardly possible to find objective indicators for success since a clear failure on one dimension can always be qualified by pointing to the many other objectives. This can be illustrated for

CAP income support. The effectiveness of direct payments for guaranteeing a "fair standard of living for the agricultural community" is highly questionable e.g. due to capitalization of subsidies in land prices or often perverse distributive effects (for more details see below 1.4). Defendants have therefore shifted their legitimizing strategies towards very different causes and the above listed battery of new objectives which are to protect direct spending. In the context of the 2013 negotiations a "greenwashing" strategy has been successful. Spectics would judge that "greening" has provided a new alibi to an old and outdated spending policy.

Awareness for this immunization strategy is important. From a constitutional perspective there should be careful checks whether new objectives are really acceptable for a policy which had been set up with very different motives.

1.3 Relevance Checks

A first check whether a new objective is compelling should be legal. Clearly, many of the new CAP objectives are backed by Treaty provisions like "high level of protection and improvement of the quality of the environment" , "economic, social and territorial cohesion", safeguarding of "Europe's cultural heritage" (Art. 2 TEU), consumer protection (Art. 12 TFEU) or animal welfare (Art. 13 TFEU). However, these are general EU objectives and do not necessarily need to play a large role for CAP and its specific budgetary instruments. For example, concerns of regional divergence are explicitly addressed through cohesion policy instruments. A prominent use of CAP for regional development can only be justified if a particularly agricultural perspective on the roots of regional development problems provides added value (which is highly questionable, see below).

A second check should focus on budgetary implications for CAP spending resulting from any of the "new objectives". Accepting a new objective should not lead to a premature acceptance of a budgetary intervention financed from the EU budget. Just tagging a new objective to a traditional spending instrument must no longer be an acceptable strategy.

For that purpose, the following set of questions could give guidance:

- Would objective X qualify as a case for government spending or are there other policy options (e.g. regulation) which are used for similar objectives with respect to other sectors in the economy?
- If there is a case for government spending: Should this spending be national or European? Subsidiarity implies a prerogative for national spending instead of European.
- If there is a case for EU financing: Are the existing CAP instruments best or should spending instruments be used which are more neutral in their sectoral focus?

Applying these questions to new objectives it is difficult to see that they really legitimize a continuation of CAP spending on its current levels.

These new CAP objectives could often be more directly be achieved by using different policy instruments. For example, to address the responsibility of the agricultural production for climate change, strategies as applied for the industrial sector can be employed. The agricultural sector could participate in the emission rights trading system (for the preconditions of such a strategy see Lünenbürger et al., 2013). This would set the right incentives for farmers and also align marginal costs of emission reduction to other sectors and thus contribute to overall efficiency. For other environmental targets (water and soil protection) or animal welfare straightforward regulation can do the job. Safe food is a standard application for the toolbox of consumer protecting regulation. Consumer protection does not involve subsidies to producers for any other sector. Overall, It is astonishing how CAP supporters take it for granted that property rights for polluting the economy or creating risks for consumers are assigned to farmers and that society has to compensate farmers for less pollution or safer food. No other sector in the economy is treated alike. For instance, nobody compensates the chemical industry for its high costs of pollution reduction.

The provision of public goods like well-tended landscapes or provision of cultural sites hardly pass the subsidiarity test of the second question. These emotional public goods are of a rather local type and cross-border effects are small if they exist at all. A nicely kept landscape in Mecklenburg-Vorpommern will not create significant pleasure for citizens in the South of France. Similarly, the preservation of an agricultural village in one Member State as a cultural site raises rarely positive emotions in others. Thus, no significant cross-border externality exists which should be corrected through a European responsibility. If arguments speak for tax financing these local public goods it should be national (or even better sub-national) budgets which provide the finance.

On development of rural areas, there might be a case that Europe needs to stimulate growth in rural areas if they are falling behind. The rural development objective, however, is unlikely to pass the third question. Rural development problems should be analysed and addressed without any prior on the preferred sector for future growth. An agricultural bias in any rural development strategy is not promising in a time when services are key for the future growth potential also of rural areas.

1.4 Direct Payments

Since direct payments still constitute the bulk of CAP spending (three quarters of CAP in 2015) they deserve particular attention. Today, direct payments fulfill two functions. First, they are used to subsidize the income of farmers in line with the traditional objective. Second, they serve as remuneration for farmers for providing agriculture-related local public goods, such as landscape preservation, and as incentive for a reduction of environmental damage like risks for biodiversity.

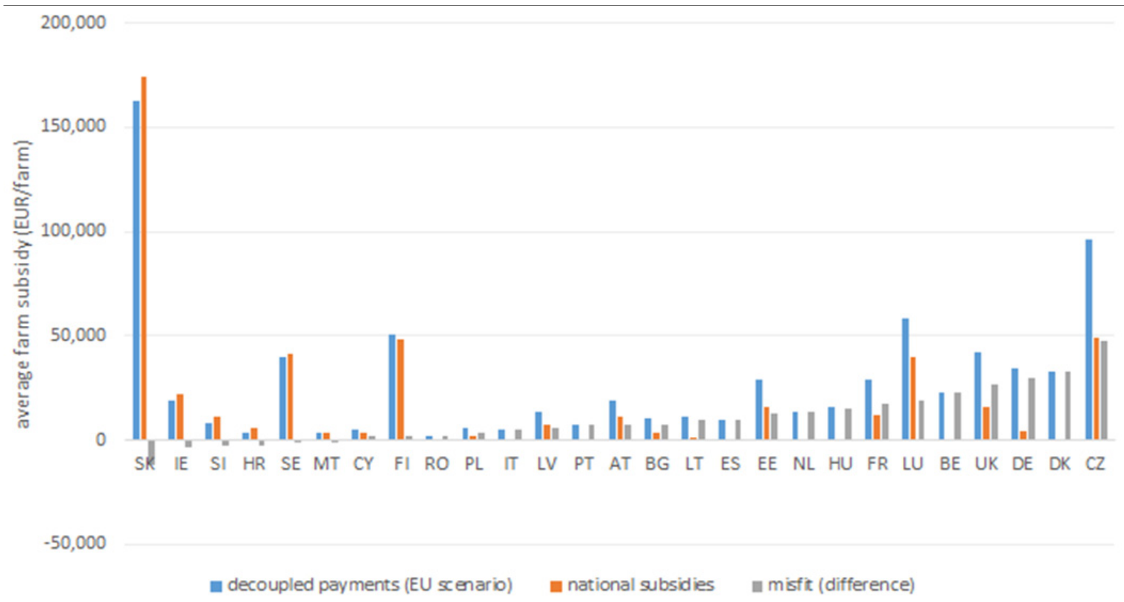
The history of the direct payments dates back to the MacSharry reforms from 1992. Thus, at the beginning of the next MFR the reform which has legitimized cash income support already dates back almost 30 years. This implies that compensations are paid today for a structural reform which current farmers' parents have experienced a generation ago. This clearly is far beyond any reasonable and acceptable time horizon compared to other cases of structural change with comparable social hardship. Moreover, from the perspective of new EU Member States, a compensation is paid for a price reduction which they have never experienced.

Given that the new objectives hardly provide a convincing alibi for the continuation of direct payments (see below) it is worth considering their income protecting function.

One inherent problem of direct payments in this regard (apart from capitalization in land prices) is their low degree of precision. An efficient income protection system should concentrate support on those in need. Given the huge diversity of income levels across Member States, need can only meaningfully be assessed by the use of national reference points. In an ongoing research project in cooperation with Bertelsmann Stiftung, ZEW has quantified to which extent direct payments implicitly provide protection levels for national average farms in line with national reference points.[1] The results indicate a low precision (see figure below). For the average farm, income support through direct payments lifts gross wages (market income plus direct payments) per hour above national low income levels (defined as two thirds of the national median hourly wage) in 21 Member States. In six Member States the hourly compensation (before GAP support) already exceeds national low income thresholds. In 15 Member States direct payments lift the effective hourly compensation of an average above the national protection level. Thus, from an income protection perspective consistent with the national welfare states' standards, direct payments are highly imprecise and excessively expensive. In this sense, their net European added value is negative. The European solution is pushing up costs compared to a national responsibility.

[1] The underlying FADN database provides farm averages. Only a microsimulation approach based on a the full distribution of farm data could precisely quantify the extent of the misfit.

Figure 1: Farm Support Level Direct Payments Compared to Farm Support Level Consistent with National Income Levels



Source: FADN database and Eurostat (own calculations), reference year: 2013. Note: For Member States without an orange bar, implied hourly compensation in farming exceeds national average wage in manual industries, meaning that these member states would refrain from subsidizing the income of their farmers.

2 Opportunity Costs

Europe is facing numerous major challenges ranging from global migration pressure to fundamentally new security concerns up to the impact of digitalization. Against this backdrop, the large role of the CAP in the EU budget appears more and more a leftover from a past stage of economic development. It is revealing that “agriculture” or “CAP” are not mentioned at all in any of the five scenarios on the future of Europe in Juncker’s White Paper.

This also implies strongly increasing opportunity costs of the status quo bias. Money spent for direct payments or rural development programs is unavailable for urgently needed alternative uses. Some simple quantitative relations between spending on CAP and (non)spending on other items clearly signal how poorly the current budgetary composition matches political priorities.

In 2015, the EU spent EUR 55.3 bn on both pillars of CAP. Over the 2014-2020 MFF period, the total CAP envelope amounts to EUR 408 bn. This implies that

- … 40% of one annual CAP budget would have been sufficient to finance the full reception costs including the asylum processes for all refugees that have entered the EU in the crisis year of 2015 (costs are estimated for that purpose at EUR 22.3 bn, Heinemann, 2017),
- … 15 to 20% of the annual CAP budget would be sufficient to compensate for the loss of the UK net contribution (estimated to be around EUR 7 bn by Nunez Ferrer and Rinaldi, 2016),
- … CAP spending amounts to 27% of total defence spending of EU Member States (estimated at EUR 203,1 bn EUR in 2015, IISS Military Balance, cited from Stanley-Lockman and Wolf, 2016),
- … the EU and its Member States spent EUR 74 bn on development aid in 2015 (White Paper 2017) amounting to 0.50% of EU GDP (EUR 14.711 bn); 52% of the annual CAP budget would be sufficient to fully close the development aid spending gap to the UN spending target of 0.7%,
- … the EFSI which wants to mobilize EUR 315 bn additional investments is based on a mere guarantee of EUR 16 bn from the EU budget which is not more than 29% of one annual CAP budget;
- … 29% of the CAP 2014/2020 envelope would be sufficient to largely defuse the Greek debt problem and to cut back the Greek debt from its current unsustainable level of 182% (EUR 343 bn) by one third to 120% which could kick-start the Greek economy,
- … the spending ratio of CAP versus Horizon 2020 in the EU budget in 2015 was 5.8 to 1;
- … the spending ratio of CAP versus the Asylum, Migration and Integration Fund in 2015 was 134 to 1;
- … the spending ratio of CAP versus Environment and Climate Action in 2015 was 162 to 1.

All these calculations impressively demonstrate that the weight of CAP in the budget is way out of proportion with the field's relative importance for the future of Europe.

3 The Case for Co-Financing of CAP

The considerations above are highly sceptical about the arguments in favour of either of the two pillars. Rural development funds could better be merged into sectorally unbiased regional policy instruments. And there is a very strong case for a gradual phasing out of

direct payments. Thus, CAP is probably the clearest candidate for cuts in the context of a strategy to rebalance spending towards true European public goods.

An uncompensated phasing-out of CAP seems reasonable but is hardly a realistic perspective given strong resistence of receiving countries and interest groups (for details see section 4 below). Therefore, co-financing is the way forward. From the perspective of farm lobbies co-financing is also obviously more acceptable than outright cuts of spending. It allows for a substantial reduction of agricultural spending in the EU budget and shifts parts of the financial burden to the national level. This is highly appropriate given that many of the common CAP justifications relate to local or national public goods. Also the indicated massive inaccuracy of income support in the light of its inconsistency with national income levels calls for cofinancing. The income protecting privileges for farmers compared to workers in other sectors should not be fully financed from European money but from national money. This would initiate an overdue cross-sectoral fairness debate on the national level.

Finally, a noticeable national financial burden from this policy would set an incentive for better voter information. So far, CAP subsidies tend to be popular among voters. The public associates these subsidies with a likeable assistance to small farmers in existential needs. However, this public perception is often not based on any significant knowledge of CAP instruments and their true effects. So far, there are no incentives for national voters for better information given the distant European financing. In none of municipal, state or national budgets, visible conflicts between CAP subsidies and other spending items exist. Co-financing would change this stage towards more rationality. With national co-financing, direct payments to farmers would be traded-off against spending for the education system, the welfare state etc. in national budgets. This would fundamentally change the way voters and politicians reflect on CAP.

A frequently used but non-compelling counter-argument against co-financing is that a “renationalization” of CAP would threaten to kick-off a destructive race of national subsidies. In this sense, a European regime serves the function to contain any such inefficient dynamics (see Cramon-Taubadel et al., 2013, for a comparison of the level of agricultural subsidies in Europe with a counterfactual situation of national autonomy). However, co-financing is fully consistent with the continuation of a single market for agricultural products. Co-financing is a mere financing tool and does not imply any changes to the rules of the European agricultural market.

Co-financing could be phased in and best be used to eliminate EU financing of direct payments altogether within a decade.

4 Political-economic Considerations

4.1 CAP Net Balances

All these arguments are not new and CAP has nevertheless proven to be of remarkable resilience. Are the chances better the next time?

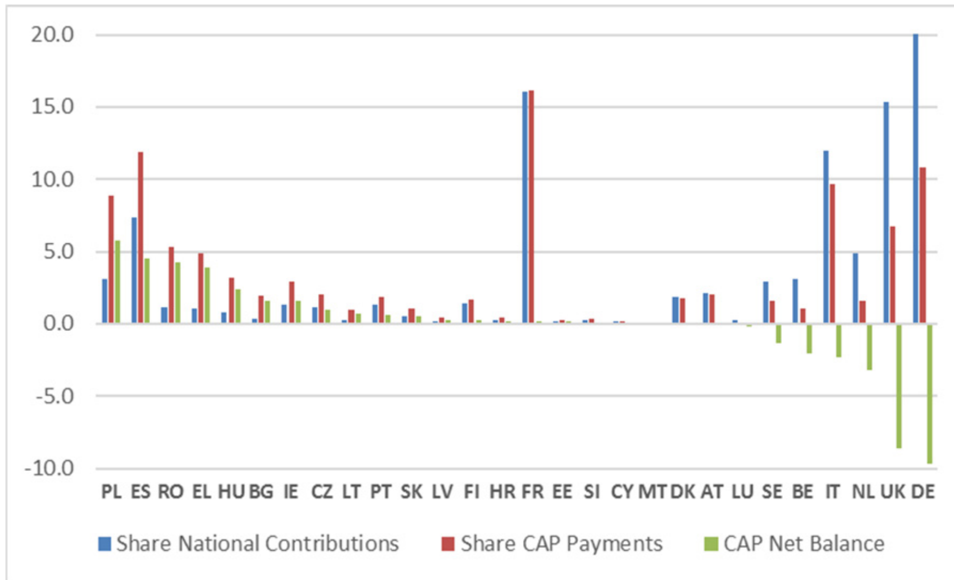
Although net balances are regularly rejected to be a methodologically sound compass for national self-interest they, nevertheless, remain of amazing predictive power to forecast Member States positions and inclination for reform. This also relates to co-financing which is financially costly/beneficial for net recipients/payers.

The specific CAP net balances (see both figures 2 and 3 below) indicate that today only a few Member States pay the price to the benefit of a majority of countries. For the reform inclination of the majority this is a bad result. Reform support is further weakened by Brexit with the United Kingdom as the most prominent and determined CAP critic leaving the European Union. It is hard to imagine that Germany together with Italy and some small like-minded countries in the remaining EU-27 can successfully reach reform steps which it was unable to achieve in coalition with the United Kingdom.

The French situation is special in this context: Although this traditional proponent of CAP has ceased to be a net recipient, the country is still, by a wide margin, the largest absolute recipient of CAP transfers.

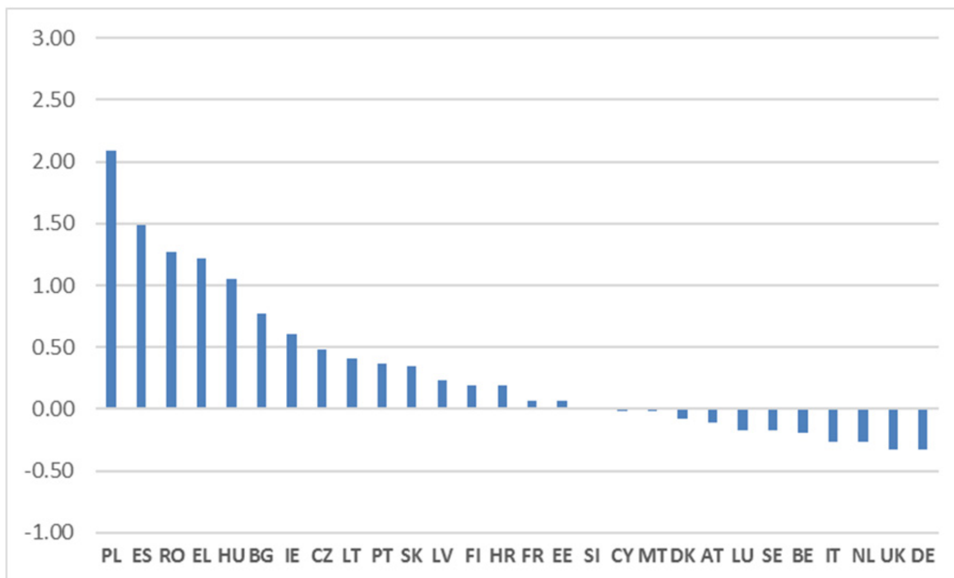
Poland is the largest net recipient of CAP. In many respects, Poland is a crucial country in the coming negotiations. It is the top absolute beneficiary from EU spending both for CAP and cohesion; it is one of the strongest opponents against more EU solidarity in refugee reception; it refuses to apply the agreed rules of the European Common Asylum System; it is under scrutiny in respect to its offenses against freedom of the press and the rule of law (possibly making an Article 7 TEU procedure necessary). The question how to deal with such an uncooperative Member State is complicated, touches upon difficult legal and political issues and is beyond the scope of this paper. It must be stressed, however, that there are significant financial stakes involved for Poland.

Figure 2: CAP Net Balance Structure 2015 (in % of CAP Spending)



Source: Data EU Budget Financial Report, own calculations

Figure 3: CAP Net Balance Structure 2015 (in % of GNI)



Source: Data EU Budget Financial Report, own calculations

4.2 Reform Drivers and Obstacles

The literature on the political economy of CAP offers interesting further insights beyond this simple net balance perspective. Swinnen (2010, 2015) has compared the conditions which led to the far-reaching Fischler reforms in 2003 with the disappointing outcome of 2013 when the status quo of the CAP was defended.

According to this analysis, 2003 was successful because of a strong individual Commissioner, external pressure (WTO), the imminent Eastern enlargement, and last not least food crises like BSE which had damaged the reputation of CAP. By contrast, 2013, reform support did not benefit from similar factors. Moreover, since 2003 a change in the institutional procedure has occurred through the Lisbon Treaty introducing co-decision in CAP legislation. This implies more power for the European Parliament which is not – as some might have hoped for – equal to more power for reformers. According to Swinnen (2015) and Roederer-Rynning (2015), farm interest have had a strong say in the Agriculture and Rural Development Committee (COMAGRI) of the European Parliament. More power for the Parliament has effectively strengthened the forces defending the status quo: With respect to COMAGRI Roederer-Rynning (2015, p. 343) summarizes: "Thus it appears on the basis of these preliminary data that COMAGRI in the post-Lisbon era was not a different committee from what it was before the introduction of co-decision. It had close connections to the farming world; Its centre of gravity lay, politically, around centre-to-right farmer-friendly parties, and, geographically, around a group of countries traditionally favouring an interventionist interpretation of the CAP."

Finally, sequencing of reform decisions played a role. In 2013, a reform strategy based on "budget against reforms" had failed due to an unfortunate sequence of decisions. The decision on budgetary envelopes within the MFF came first and negotiations on the precise contents of policies second. Hence, from the perspective of CAP supporters, budgets were already politically safe when detail negotiations on the contents of the policies (greening details, public good approaches) started. Readiness to reform the content was no longer conditional for keeping a substantive budget. This drastically reduced the inclination for compromises on the side of status quo defendants.

5 Conclusions

Applying all these insights to the upcoming negotiations the following aspects will be decisive whether a substantial cutback of CAP can be achieved.

Intellectually, the environment, animal protection, public good or income protection narratives must be dismantled as what they are: flawed and misused arguments which do not legitimize current CAP instruments and spending levels. In 2013, the ideas was prominent to make the continuation of direct payments conditional on a closer link to ecological objectives ("budget for reforms"). It is highly questionable whether this approach is appropriate given the need to mobilize funds for very different spending purposes. A new green or social disguise for a continuation of genuinely anachronistic subsidies is no progress. The most urgent reform to CAP is not a re-labeling but cutting it back.

The largest reform impulse should result from the existential crisis of the EU and the urgent need to prove the benefits of EU membership. This should provide a reform

impetus at least as powerful as WTO pressure prior to the Fischler reforms. CAP defendants will try to convey the message that CAP cuts would be another boost to anti-EU populists. Here, a strong different message is necessary which points out that the EU should use tax payers' money in a responsible way. The message must be: CAP in its current size is part of the problem and no element of a solution. The opportunity cost argument is crucial and could develop impact in the upcoming negotiations.

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