Subsidiarity and CAP reform - who should do what?

*A perspective by Harald Grethe**

Today's CAP is overly centralised. All Pillar 1 (market and income support) expenditure is regulated and administered from a central budgetary resource, while Pillar 2 (rural development) programmes, although to a large extent designed and implemented at national level, remain subject to close EU scrutiny and heavy co-funding. But is there a viable, equitable and more economically beneficial alternative?

One criterion to assess the degree of policy centralisation is the principle of **subsidiarity**, which states that responsibility for policy design and funding should be assigned to the most decentralised level able to internalise all externalities and exploit potential economies of scale.

A recent conference on *Subsidiarity and Economic Reform in Europe*** evaluated various policy areas in light of this subsidiarity principle. The main conclusions reached as regards the three elements of the CAP - market policies, direct payments (DP), and rural development policies (RD) - are outlined in this article.

Too much centralisation

Agricultural market policies (under the CAP's Pillar 1) are currently designed and funded at the EU level. This is of course in accordance with a common market approach which would make independent market policies at member state level either technically infeasible, or competition distorting.

Direct payments were originally granted as compensation for the reduction of institutional prices. As the responsibility for design and funding of price policies lies at the EU level, the responsibility for their successor, DP, is also assigned to the EU. For early DP at the beginning of the 1990s, this made good economic sense: payments were coupled to production much more than they are today, and were thus production-distorting.

But this situation has changed. For the EU-27, on average, DP are more than 90% decoupled from production under the SFP and the SAPS, and the Commission is currently envisaging full decoupling. Thus, the economic nature of DP has changed fundamentally: they have changed from a product(ion) subsidy to a sectoral and personal income policy with very limited competition distorting effects.

But sectoral and personal income transfer policies, such as income tax or social security systems, are generally designed and financed at member state level. As there are neither externalities nor economies of scale involved in granting fully decoupled DP to farmers, the assignment of responsibility for DP and their funding at the EU level is an historical artefact which is in clear conflict with the subsidiarity principle.

Localised impact of rural aid

The responsibility for design and funding of RD is currently shared between the EU and the member states. Most of the RD measures are of a rather local nature as regards their effects and the problems they address, and it is difficult to see why responsibility for these measures should remain at EU level. This is true, for example, for the support of Less Favoured Areas, early retirement, young farmer programmes, and investment subsidies. Moreover, most of the agri-environmental policies address predominantly local or regional environmental problems. This would suggest that primary responsibility for their design and funding should be attributed to the member states rather than the EU.

In contrast, some agri-environmental measures address transboundary environmental goods, such as biodiversity or the pollution of some surface waters. In addition, some agri-environmental policies involve economies of scale, such as the establishment of transboundary habitats. In these cases, EU coordination of policies, or policy design and funding can be justified.

The current system of co-financing, however, is not adequate for most RD measures. This is because of its significant disadvantages. Most important, the system results in overspending on public goods of a local nature if policy design is determined by the intention to generate budgetary flows from the EU rather than by the preferences of local residents.

Financial redistribution

Economic efficiency arguments certainly do not support the current allocation of responsibilities. Its current design can be explained not only by reference to the historical origin of the CAP as a market policy, but also by political economy arguments.

First, the CAP results in substantial financial redistribution among member states. As a consequence, reforms which result in a smaller CAP budget are typically opposed by a coalition of net beneficiaries such as France, Spain and Ireland.

Second, the European Commission may be biased towards centralisation in order to maintain power in agricultural policy design. Indeed, in contrast to the trailblazing role of the Commission in shifting from price support to decoupled DP and RD, there is by and large silence about any kind of nationalisation of core policy fields.

Why is there no analysis from the Commission on the appropriate level of centralisation of the second pillar, where many researchers argue for more decentralisation? Why is there no discussion from the Commission about fully decoupled payments being nationalised?

Moving towards reform

The strong involvement of the EU in agricultural policy design and funding can be explained in historical terms - but is misplaced today. EU involvement should be limited to market policies and agri-environmental policies which address cross border externalities. For other policies, only competition rules need to be monitored on the EU level. Only for market policies should the principle of full centralisation be maintained.

But how can change be effected? The key to reform may be the identification of potential trade-offs to limit redistributive effects and to get buy-in from potential losers.

In the future, the NMS will mainly be the net beneficiaries of the CAP. Therefore, the incentive to block reform may diminish among traditional net recipients such as France and Spain. In order to obtain NMS agreement for a shrinking CAP budget, trade-offs could be sought with cohesion policies, where the NMS are also main beneficiaries. Also a redistribution of second pillar funds, with a higher share being allocated to the NMS, may be an option.

For DP, the full decoupling which may be part of the health check for the CAP in 2008 makes good economic sense. It would allow for nationalisation, as decoupled DP have (almost) no production distorting effects. Furthermore, full decoupling adds to the transparency of these payments – and thus adds to public and political pressure to reduce them.

There is a strong interdependency between the strategies of nationalisation and the reduction of DP. From both efficiency and equity perspectives, the first best option would be to completely phase out DP in their current form. They capitalise into land prices and thus inhibit structural change. Furthermore they contribute strongly to income inequality in the agricultural sector, as they mainly accrue to large and wealthy farmers. If DP could be phased out at the EU level over a reasonable period - say 10 years - there would be no need for policy nationalisation. Also, a reliable phasing out process would enable producers to adjust to a future environment without such payments. If this turns out to be politically infeasible, nationalisation may be an option to at least increase the pace of elimination in many member states due to budgetary rivalry at the national level.

Disentangling responsibilities

For rural development policies, a strong argument can be made for disentangling responsibilities and funding between the EU and the member states. A large part of today's rural development policies should be designed and funded at member state level or below. As an initial step, a modified modulation system may be an option. Instead of savings in the first pillar of the CAP being fully transferred to measures which are co-financed by the EU and member states, part of these savings could be transferred to become the exclusive responsibility of the European Union for agri-environmental policies that address transnational issues - and would not necessarily require co-funding from the member states.

The other part of savings could be transferred to the member states (or converted into a reduction of the EU budget, or used for alternative purposes) and it would be under the member states' responsibility whether the money should be spent on rural development, and for which measures. This modified modulation approach could be a model for the attribution of responsibilities for overall rural development policy. Funds which would be generally co-financed by the EU and member states could be limited to those agri-environmental measures which are clearly linked to EU regulation.

The "health check" in 2008 and the budget review in 2008/2009 are a chance to further develop the CAP in order to better meet efficiency and equity objectives and to address current imbalances in the EU budget.

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** Grethe, H., (2006), "Environmental and Agricultural Policy: What Roles for the EU and the Member States?" http://www.cpb.nl/nl/activ/subsidiarity/papers/keynotes/grethe.pdf