THE COMMON AGRICULTURAL POLICY IN RELATION TO INSTITUTIONAL ECONOMICS

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SUMMARY FINDINGS, CONCLUSIONS, RECOMMENDATIONS

The EU’s Common Agricultural Policy (CAP) boasts such a unique system of aims and tools that it assumes and requires the presence of a serious, national institutional background for its implementation. However, if the necessary tools cannot – or can only partly – be utilised, due to an inadequate institutional framework, this endangers the achievement of the proposed aims. The agricultural policy can, therefore, only be fully executed within the appropriate institutional system.

It is an important task to independently analyse the functioning of key elements of the EAGGF Guarantee Payments system responsible for a significant proportion of support: the Payment Agency, and the Integrated Administration and Control System, which is necessary for managing the predominantly direct payments from the Guarantee Department. Beyond this it is necessary that both should be studied in a wider context, in terms of the new institutional economics that draws attention to information deficiencies and transaction costs.

The asymmetric nature of the information provided to Member States’ governments in relation to performing their delegated, payment-related tasks, requires a high level of monitoring, control and enforcement by Community institutions and the Commission. The deficiencies of shared management, which characterise the CAP may be seen as problems to be faced by both Old and New Member States and which can be handled by means of the principal-agent model.

Regarding transaction costs our attention should primarily focus on policy-related transaction costs. This issue has been gaining in importance in the case of the ever-changing CAP of the past 13 years. One significant question is whether in the course of a given policy amendment the implementation of new measures will cost more or less than the previous ones, while another is where to set the trade-off between costs and precision (targeting).

INTRODUCTION

The representatives of institutional economics deal with the establishment and functioning of certain political or economic institutions, and the rules of cooperation among individuals. They study the aims of institutions and their effects on the functioning of the economy. In the framework of the institutional approach it can be explain why economies based on the same model result in different outcomes (Solt, 2005).

The role of institutions in agricultural policy depends on the institutional background of a certain country. “The same
institutional background applies across different economic policies while, between countries, the institutional background differs and is likely to lead to different policy frameworks and different policy delivery systems for dealing with the same problem” (Johnson, 2001). This is obvious in the case of a regional grouping of independent countries such as the European Union functioning with a great deal of policy coordination.

GENERAL DEFINITION OF INSTITUTIONS

In a broad sense informal and formal institutions are to be distinguished. The former ones include behavioural rules, social customs and conventions, and habits among the agents, the latter, organisations, economic agents themselves and law (Tridico, 2004).

The importance of institutions is well demonstrated by the fact that agriculture is not able to produce the right environmental effect required by society and needed for the functioning of the ecosystem, i.e. it is not sustainable. As for sustainability it has become urgent to establish appropriate agri-environmental institutions. Economic and ecological sustainability has to be realised at the same time so that the relationship between humans and nature remains sustainable (Gatzweiler et al., 2001).

NEW INSTITUTIONAL ECONOMICS

The approach of institutional economics differs depending on the view of the Old, New or Neoclassical Institutional Economics. The Old Institutional Economics (OIE) emphasises the role of informal institutions. Their representatives claim that institutions are not necessarily effective in social and economic terms. Regarding the pure Neoclassical Theory the only allocation mechanism and the only institution is the market, and other ones inhibit economic performance (Tridico, 2004).

As for the New Institutional Economics (NIE) its importance and reason for existence is supported by different factors according to Joskow (2003):

- The institutions have important effects on economic performance, thus their analysis should not be evaded. Institutions can be analysed with rigorous theoretical and empirical methods, but the analysis should be interactive.
- The NIE is of interdisciplinary character and it has dynamic historical perspectives.

The NIE is closely linked to the Neoclassical Economics that puts emphasis on individual maximisation and marginal analysis. But at the same time it pays attention to transaction costs, information problems and bounded rationality (Libecap, 1998). North (1990) claims that the institutions represent the way in which different economies cope with market failures. So institutions are efficient in so far as they minimise transaction costs.

According to Kieser (1995) there are three areas of the NIE completing each other: the theory of property rights, the theory of agency and the theory of transaction costs. His two basic questions run as follows: (a) “Which institutional solution produces the lowest costs and the most efficiency regarding single coordinational problems? (b) In what way do the coordinational problems, costs and efficiency of trade connections influence the establishment of institutions and their changes?” (Bárdos, 2004)

THE INSTITUTION – INTEGRATION CONNECTION

Institutional economics has an effect on political integration aiming at the creation of a common policy framework that creates equal conditions for the
functioning of the integrated parts of the economy (Molle, 2005).

Common policies require common institutions. The arguments for centralisation are the following: decrease in the cost of policy delivery (economies of scale), use of the spill-overs, creation of credibility and insurance (Molle, 2005).

In countries that are independent of each other but have common problems and common goals the costs of collective actions are borne by the national governments. However, these costs are to be decreased through the establishment of international or supranational institutions. Joining common institutions will, the partners believe, result in a positive cost-benefit balance. Of course also other conditions are taken into consideration in the decision-making process.

In agricultural policy the supranational institutions don’t reduce the importance of national institutions, as it comes down to the delegation of certain tasks in many cases. The decentralised national institutions controlled by the common institutions (e.g. Paying Agencies) play an equally important role as the supranational institutions themselves. Examining the connection between supranational and national institutions implementing the Common Agricultural Policy one can discover the existence of the principal-agent model.

**PRINCIPAL-AGENT STRUCTURE OF THE INSTITUTIONS**

The proper design of the CAP (design occurs at EU level) and setting of its targets are considered to be very important. But the success of the policy depends on the quality of the implementation as well. It is crucial how the policy is governed and managed at different levels i.e. at Community, country, regional and local level.

The institutions involved in decision-making, design and implementation build a multiple hierarchy system. In this hierarchy system there are principals and agents (Brümmer – Koester, 2003). The principal-agent problem describes strategic interactions between two parties to a contract, between the uniformed principal and the informed agent. The main goal is to get the agent with informational advantage to act in the best interests of the principal and to bridge the information gap despite the fact that certain conflicting interests might exist. The top of the hierarchy, the principal, is the Commission, the decision-maker that sets the goals and delegates different tasks such as implementation, monitoring and enforcement to the governments of Member States i.e. to the agents. This simple hierarchical structure doesn’t remain that simple though, as Member States themselves are forced to implement the policy in hierarchical organisation.

This way the intermediaries of the system become both principal and agent. The only set positions as a principal or an agent is the position of the Commission as ‘top’ principal and the farmer as ‘bottom’ agent. In the case of the delegation of tasks, monitoring, control and enforcement is always needed. The less information received by the Commission regarding delegated tasks the greater the level of control and enforcement it must undertake. The quantity and costs of these activities influence the quality of the results of the policy and depend on several factors (Table 1).

The negative relationship between principal and agent – i.e. the problems caused by deficient governance and shared management – definitively make the implementation of the CAP more difficult. Difficulties may be caused for example by the high intensity of regulation and the lack of incentives to stick to the
regulations. The weak points of shared management are visible with regard to both the Commission and Member States. On the one hand the Member States might fail to check the genuineness and compliance of operations financed by the Community, might fail to prevent and deal with irregularities, or fail to recover sums lost as a result of irregularities or negligence. On the other hand, the Commission might fail to verify the conditions under which payments and checks have been made, might fail to carry out checks on the management of expenditure, or fail to check that pre-financing is reimbursed.

Table 1

<table>
<thead>
<tr>
<th>Factors that have impact on the relationship between principal and agent</th>
<th>Principal</th>
<th>Agent</th>
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<tbody>
<tr>
<td>Intensity of regulation</td>
<td>Incentives to break the rules</td>
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<td>Lack of sufficient staff</td>
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<td>Insufficient inter-service communication in the Commission, insufficient coordination of their work</td>
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<tr>
<td>Costs of controlling the activities of those who break the rules</td>
<td>The likely costs of breaching or bending the rules</td>
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<tr>
<td>The interest of the principal in monitoring and enforcing contracts</td>
<td>The probability of being caught if the rules have been broken</td>
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<td></td>
<td>The penalty that has to be paid for breaking the rules</td>
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<tr>
<td>The importance of embedded institutions (e.g. morals) for society</td>
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Source: based on the study by Koester, Brümmer 2003

There is a price to pay for deficient governance. More transaction costs, more irregularity and fraud in terms of agricultural payments from the Community, and more money to be recovered. The amounts in question can be regarded as significant when one takes into consideration that the European Union spends a significant part of the common budget annually on the Common Agricultural Policy.

Almost all payments under the CAP are made by Paying Agencies (PAs) in the Member States (MSs). This fact makes it clear that it is very important to focus on the PAs, their tasks and relationship with the Commission. (The role of the co-institutions of the Paying Agencies – Competent Authority, Certifying Body, Coordinating Body – is of great importance as well.)

**TRANSACTION COST – POLICY RELATED TRANSACTION COSTS**

General statements regarding transaction cost economics (TCE) theory could be listed on several pages quoting Commens, Coase, Hayek, Baumol or others who dealt with this topic in the 20th century and have been dealing with it in particular to a greater extent since the early 1980s.

But as for applications to agriculture *Masten (2000)* wrote: “agricultural transactions provide a rich and largely unexplored area for application and refinement of transaction cost theory”.
Transaction costs (TC) are to be divided into the category of
- non-policy-related transaction costs: costs which are incurred by parties to voluntary transactions,
- policy-related transaction costs: costs which are associated with the implementation of policies.

When applying these two categories it is obvious that the latter has been gaining in importance recently, regarding the Common Agricultural Policy (CAP) of the European Union. Changes in a certain policy and the implementation of new types of measures produce either more or less costs.

The replacement of the traditional policy instruments and the establishment of completely new measures are, however, pretty costly. The reason is that the switch from a broad to a targeted approach: from broad income support to a need-based system, from generalised area payments to targeted landscape maintenance create significantly higher implementation and monitoring costs. These costs, however, can be justified by the possibility of overall benefits to the economy (Cahill – Moreddu, 2004).

**DEFINITION OF POLICY-RELATED TRANSACTION COSTS**

Transaction costs (TCs), implementation costs or policy-related costs (Cahill – Moreddu, 2004) are used to mean all the costs incurred in the design, implementation, execution, monitoring and evaluation of policies or payments, including the costs incurred by farmers and their organisation (Figure 1).

The latter – costs incurred by farmers and their organisation – means costs imposed on farms when complying with information obligations stemming from government regulation i.e. administrative burden (Ladegaard, 2005). Farmers participating especially in voluntary measures can be regarded as an important part of the system. Farmers have to bear different types of costs when meeting the requirements of a certain policy measure/regulation and a lot depends on their participation regarding the success of a measure and so the amount of participation costs can’t be neglected. In order to understand the positioning of the administrative burden let us have a look at Figure 2.

**MINIMISATION OF POLICY-RELATED TRANSACTION COSTS AT DIFFERENT LEVELS**

In any case the main goal is unambiguously to estimate TCs measure by measure and then to minimise them at different levels (Cahill – Moreddu, 2004): 1. at the outset, 2. at the level of design, implementation, and control, 3. at the institutional level.

1. At the outset one should invest in political and social acceptance, exploit existing information about the target group and reduce the number of agencies playing a role in implementation. These are important tasks because TCs depend on factors such as farm size, farms’ participation in different measures, organisational differences between regions, and environmental influences (Buchli – Flury, 2005) i.e. factors one should have detailed information about.

2. At the level of design, implementation, and control one should focus first of all on the legislative aspects. Simple, clear legislation contributes to efficient implementation, management, and control implying less scope for fraud. (Besides, frequent, ongoing amendments to the regulations cause additional costs, e.g. in the case of IT development.) Simple and clear legislation creates some formal requirements (accessibility; transparency in the decision-making process; dissemination of law; legal drafting) and
substantial requirements (test of subsidiarity, proportionality; estimation of duration and intensity of the intended instrument; consistency with previous measures, cost–benefit analysis; impact analysis on other policies, e.g. regarding transaction costs in agri-environmental policies; limiting rules to those which are essential and practicable).

Figure 1

Subcategories of policy-related transaction costs

![Diagram of transaction costs]


Figure 2

Categories of costs borne by farmers under policy measures

![Diagram of categories of costs]

Source: OECD International working group on administrative burden, The Standard Cost Model, A framework for defining and quantifying administrative burdens for businesses, 2004
In addition to the important legislative issues there is a need for simplified procedures for eligible, but not key, target groups: simple forms and controls, the use of modern technologies, and avoiding frequent changes in programme terms and conditions. The sharing of experiences across agencies, regions and countries might prove useful and the trade-off balance between tighter targeting (precision) and costs needs to be found. This latter point is as significant as the legislative one. Efficiency depends on this trade-off; a tighter (more precise) target may “look good” but could cause additional costs that exceed the marginal benefits \textit{Romstad} (1998). When precision increases the marginal utility of that increased precision is likely to fall and the marginal transaction costs are expected to grow. Assume that there is one special landscape feature in a given country while in another country the same feature is present multiple times. Decision makers of the first country should have indifference curves similar to $\beta_1$ and $\beta_2$ and decision makers of the second country should have indifference curves similar to $\alpha_1$ and $\alpha_2$. The reason is that in the first case a more precise policy (B) is preferred over the less precise one (A) as decision makers are likely to be willing to pay more (B) in order to preserve that landscape. In the second case it is not necessary as the landscape feature is not unique (Figure 3).

\textbf{Figure 3}

\begin{figure}
\centering
\includegraphics[width=0.5\textwidth]{-trade-off_precision_cost.png}
\caption{Trade-off between costs and precision}
\end{figure}

\textit{Source: Romstad, 1999}

Note that a different approach should be applied to private and public agricultural outcomes. TCs related to policy measures directed directly at public goods provisioning are expected to be high (In the case of payments attached to private goods/inputs the TC amounts to some few tenths of a percent of payments. When the payments are attached to easily observable non-traded goods/inputs (proxies) the TC amounts to a few percent of the payment. When the payments are attached to the public good more directly the TC amounts to some/several tens percent of the payment.) When the public good is produced jointly with the private good, it is least costly to provide the public good by paying via the private one \textit{(Vatn, 2005)}.

3. At the level of institutions one can set the following requirements to be fulfilled. Each institution and individual
should have some common and specific incentives to minimise costs. It is of great help if there is a close relationship between policy design and implementation. Actually implementation should be considered as part of the policy-making process. In the policy cycle (Figure 4) the role of Paying Agencies is of great importance, as they carry out the day-to-day management of the CAP, assess and redefine the CAP and they are the first to notice implementation problems. Separate agencies have to consult. The costs have to be measured and compared. The estimation of policy-related TCs (PRTCs) is a set of crucial tasks: one should define PRTCs to be measured, identify precisely the individual tasks, measure the number of transactions, identify who carries them out, attach a cost to each task: (time spent*number of staff*labour and overhead costs). All these tasks have to be done at different levels: EU, state, region, control organisation, farm level (Morediu, 2005), but sometimes it is quite difficult because of the absence of transparent data and the lack of common methodology.

**Figure 4**

Policy cycle

ATTEMPTS AT NUMERICAL EXPRESSIONS

Problems relating to PRTCs occur inevitably in certain cases. Frequent changes of policy and short time frames for implementation lead to higher costs, certain measures are very costly anyhow and the costs are always the highest in the initial phase of implementation. Due to the absence of transparent data and the lack of common methodology (as earlier mentioned) and the complexity of TCs – (as TCs at different levels have to be taken into account at the same time) it is difficult to draw an overall picture of the total amount of PRTCs, i.e. it is difficult to determine PRTCs at each public level and at the level of individual farmers. The details provide us, though, with some useful clues.

According to Dutch information the rate of implementation costs as a percentage of EAGGF expenditure increased significantly between 1990 and 2003 (Table 2). The same situation can be assumed in the other Member States as they implement the same CAP and more or less the same measures.

Some kind of a lesson could be drawn from a comparison of studies carried out in some of the Member States and non-member states. The differences
among Member States are great. Einarsson (2005) took for example three countries: England, the Netherlands and Sweden. According to his conclusions the administration costs between 1997 and 1999 expressed as a percentage of total payments ran to 1% in England, 6.8% in the Netherlands and 2.7% in Sweden.

### Table 2

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<tbody>
<tr>
<td>Measures in relation to the common organisation of markets and agricultural prices</td>
<td>4.9%</td>
<td>10.0%</td>
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<tr>
<td>Measures in relation to direct payments</td>
<td>6.6%</td>
<td>4.4%</td>
<td></td>
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<tr>
<td>Measures in relation to rural development</td>
<td>3.9%</td>
<td>4.5%</td>
<td></td>
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<tr>
<td><strong>Total Average</strong></td>
<td><strong>1.1%</strong></td>
<td><strong>2.3%</strong></td>
<td><strong>4.0%</strong></td>
<td><strong>5.2%</strong></td>
<td><strong>6.3%</strong></td>
</tr>
</tbody>
</table>

*Source: de Groot (2005)*

### Table 3

<table>
<thead>
<tr>
<th>Policy measures</th>
<th>Administrative TC as a percentage of payments to farmers (1996*-1997)¹</th>
<th>TC (running costs) as a percentage of subsidies/tax (2000)²</th>
<th>TC as percentage of payment (2003)³</th>
</tr>
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<tbody>
<tr>
<td><strong>Switzerland</strong></td>
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<tr>
<td>Canton Grisons</td>
<td></td>
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<tr>
<td>Area payments</td>
<td>0.63%</td>
<td></td>
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<tr>
<td>Payments for keeping grazing farm animals</td>
<td>1.21%</td>
<td></td>
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<tr>
<td>Payments for keeping livestock under difficult conditions</td>
<td>0.94%</td>
<td></td>
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<tr>
<td>Payments for farming on steep slopes</td>
<td>2.52%</td>
<td></td>
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<td>Payments for ecological compensation</td>
<td>6.75%</td>
<td></td>
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<tr>
<td>Payments for extensive cereal/rapeseed cult.</td>
<td>16.57%</td>
<td></td>
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<tr>
<td>Payments for organic crop farming</td>
<td>9.74%</td>
<td></td>
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<tr>
<td>Payments for animal stabilizing systems</td>
<td>8.32%</td>
<td></td>
<td></td>
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<tr>
<td>Payments for regularly exercising animals outdoors</td>
<td>5.02%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1.80%</strong></td>
<td><strong>2.80%</strong></td>
<td><strong>7.80%</strong></td>
</tr>
<tr>
<td>Canton Zurich</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: ¹ Eklund – Only the public/state transaction costs are considered (1999), ² Vatn, (2005), ³ Buchli and Flury (2005)*
As the data is only average data, it might be more helpful to have a look at Table 3 where TCs related to certain measures are listed. The percentages pertain to different years however, and they cannot therefore really be compared, but one can see the great differences between the measures listed. It is apparent that agri-environmental measures, i.e. measures related to some kind of public good, cause higher PRTCs. But PRTCs also differ due to the fact that they are measure-specific and dependent on regions (e.g. in the case of the Swiss Cantons Grisons and Zurich).

As agri-environmental measures cause higher PRTCs it is worth scrutinising these measures a little bit more. The higher the level of targeting is – i.e. the higher the informational needs are – the closer the relationships arising between farmers and government agencies. A stronger linkage between the payments a farmer receives and his obligations in terms of the information he must provide and the rules he must respect implies higher implementation costs/more administrative burden. That is the case regarding several agri-environmental measures but – it is worth mentioning – not all of them. The reason is that there is a wide range of agri-environmental measures with both general and targeted measures.

The measures include budgetary payments to provide environmental services or to reduce damage; cross-compliance mechanisms attached to support payments; taxes and charges on polluting activities; regulations to limit point source pollution (e.g. controlling the quantity of manure produced, the quantity spread and how the manure is spread); financing research, development and education; providing seed money for voluntary groups; facilitating tradable permit schemes; and designating zones for specific forms of agricultural practice” (Jones, 2005). By comparing the taxes (e.g. fertiliser tax) and agri-environmental support for spring tillage one can state that taxes have the advantage of not placing administratively determined restrictions on farm activities, while agri-environmental support has the advantage of targeting regions and crops where leaching is a problem (Norell – Sjödhal, 2004).

Although the level of transaction costs is very important, one should bear in mind that it is to be placed into a broader context as after all, TCs and PRTCs constitute a part of overall costs. By using general/broad measures all farms – irrespective of their needs or capacity to enhance the landscape or produce any other agricultural public goods – are subsidised equally resulting in higher overall costs in comparison to the level of the support that is provided only where it is needed. Let’s take as an example pasture support in Sweden. It is proven that pasture support is much more efficient than e.g. livestock payments regarding the following variables: relative area per ammonia emission, relative area per nitrogen leaching, and relative area per budget cost. The reason is that livestock aid is granted for all animals not depending on whether they graze on pastures or not. Generally speaking targeted policy instruments causing higher transaction costs could be much more efficient and don’t necessary lead to higher overall costs.

The main goal is to form a set of general and targeted agri-environmental measures that meet economic and environmental needs at the lowest possible transaction costs. The first thing to do is proper identification of the problems that is of the environmental needs of the society and the degree of willingness among farmers to solve these problems.
Secondly, we require answers to a number of questions. Is a financial incentive needed? What type of policy would engage people in a positive way, a general or a more targeted one? How high should the amount of the incentive be? Different issues need to be taken into consideration when providing the answers, such as the degree of asset specificity (variation of the quality of a good), the frequency of similar transactions – economies of scale, and the cost and availability of information.

REFERENCES


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