The Common Agricultural Policy of the European Union – the present and the future

EU Member States point of view

INSTITUTE OF AGRICULTURAL
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Contents

3. Is there room for financial instruments in the Common Agricultural Policy? Casus of Poland

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Abstract

A number of new geopolitical conditions, new EU priorities, reform of the euro area with the possibility of establishing a separate budget, fiscal consolidation of most of the EU countries, constitute difficulties in terms of the construction of the EU budget. The aim of the study was to identify the possibility of using financial instruments under the CAP. The analyses concerned mainly Poland. The considerations, illustrated with theoretical and empirical materials, were focused around the following thesis: the permanent domination of the subsidies under CAP and its first pillar radically narrows down the space for using financial instruments. An eclectic approach was applied, using elements of the theory of economics of the public sector, public finances, financial economics and institutional economics. Some justifications of financial instruments do not seem well-founded in theory and probably would not pass the rigorous empirical verification. In order to avoid over-reimbursement and re-promotion of agriculture, it is not advisable to start identifying development barriers to this sector with financial issues. Financial instruments are adjusted mainly to achieve allocation and stabilisation objectives under thr CAP and national agricultural policies. Only larger farms may be interested in financial instruments.

Keywords: financial instruments, agricultural finances, EU subsidies, agricultural credit, Common Agricultural Policy

JEL codes: Q14, Q18, G23

3.1. Introduction

A series of new geopolitical conditions (including Brexit, the US expectations, articulated by President D. Trump, to increase the contribution of the Europeans to the NATO funding), new EU priorities (common defence policy, combating climate change, protection of external borders and the problem of immigrants), reform of the euro area with the possibility of establishing a separate budget, fiscal consolidation of most of the EU countries, constitute significant and noticeable difficulties in terms of construction of the EU budget. Due to the social pressure of farmers in the countries of the fragmented agrarian structure, the change of course in the case of the “agricultural budget” may turn out to be very difficult. Naturally, it would seem that there should be increased interest in financial instruments (FI).

However, previous experience in the application of financial instruments in rural development programmes is very limited, although their use has been possible for several programming periods. A key drawback is the complexity of their implementation related to the need to involve entities from the financial sector, which means a longer process of preparing a given support instrument for implementation. At the same time, the possibilities and the manner of shaping these instruments are very wide. Until the end of the previous programming period, a significant barrier to the development of the use of these instruments lied in their limitation to a given programming period, as there were no mechanisms to change from one programming period to the next without extinguishing the action, which reduced the possibility of generating multiplier effects and was associated with the re-creation of infrastructure for the implementation of the action in the next period.

Although solutions are introduced in each subsequent programming period based on previous experience, which aimed at facilitating the implementation of financial instruments, complicated implementation procedures remain the key problem. Therefore, changes are proposed to simplify the operation of financial instruments, such as more transparent standards for the selection of financial intermediaries or uniform solutions for grants and financial instruments facilitating to combine these two forms in one project.

The aim of the study is to try to identify the possibility of using financial instruments under the CAP. The analyses will mainly concern Poland. The axis of considerations is as follows: permanent domination of subsidies under the CAP and its first pillar drastically narrows down the space for using financial instruments. The authors applied the eclectic approach, using the method of literature studies, documentary studies, case studies, and – in the discussion – elements of the theory of economics in the public sector, public finances, financial economics and institutional economics. The present analysis is a review study.

3.2. Financial instruments versus subsidies – key problems

There is no universally accepted definition of “financial instruments”. Accounting, financial reporting, and securities law have developed different classification approaches. For example, the Polish balance sheet law (Article 3, paragraph 1 point 23 of the Act on Accounting; Dz.U. of 1994 No. 121, item

591) defines financial instruments as “contracts resulting in financial assets being created by one party and financial liabilities or equity instruments on the other”. A financial instrument will, therefore, be a financial contract that documents the title of ownership or the right to provide or receive monetary values. Generally, financial instruments, as indicated by typologies of various financial institutions (e.g. BGK), refer to a broad set of loan guarantees, mezzanine (quasi-equity funds), equity and venture funds, microcredits [BGK, 2014].

Table 1 presents the advantages and disadvantages of financial instruments against the background of subsidies. It should be emphasised that the positives include the so-called quantitative and qualitative added value, fairly well recognised by the EU institutions (including the European Investment Bank). In turn, the disadvantages refer to the imperfect mechanisms and ineffective institutional frameworks.

Table 1. Advantages and disadvantages of financial instruments – as compared to subsidies

<table>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>Quantitative added value</td><td rowspan="4">▪ imperfect, ineffective organisational model of existing guarantee funds in Poland
▪ creating an institutional, agriculture-oriented and rural SME-based system “from the scratch”
▪ traditional, neoclassical investment assessment, using financial efficiency criteria</td></tr>
<tr><td>▪ the multiplier effect, ME – only credit guarantees
▪ the leverage effect, LE
▪ the revolving effect, RE</td></tr>
<tr><td>Qualitative added value</td></tr>
<tr><td>▪ minimisation of distortions present on the credit market
▪ innovation of the offer
▪ strengthening the potential of some entities with low credit rating
▪ reducing the imperfections of the market typical only for the region or only for the agricultural sector
▪ attracting new sources of knowledge and know-how
▪ supporting the development of “business mentality”</td></tr>
</table>

Source: own elaboration on the basis of EIPA-Ecorys-PwC, 2014, Loriz-Hoffmann 2012; European Commission, European Investment Bank 2016, p. 54-55; Kulawik, Soliwoda, Wieliczko, 2017, p. 76-78.

The neoclassical theory draws attention to the information excellence and completeness of financial markets. However, a deeper analysis has shown that in practice we are dealing with incompleteness and imperfection of financial markets. The institutional theory and its successors distinguished the temptation to abuse and negative selection as two important implications of information asymmetry. The occurrence of credit and liquidity restrictions is a symptom of imperfection and incompleteness of financial markets [Stiglitz, 1994; Stiglitz, 2008]. External credit rationing refers to the policy of financial institutions which allows for the refusal to grant loans to entities that are too heavily indebted. In turn, internal credit rationing results from various types of barriers inherent in the psyche of a potential borrower: excessive level of financial leverage discourages the use of additional amounts of foreign capital [Kulawik, 1997].

Although there have been and still are numerous empirical studies[2], referred to even in the work of Ciaian et al. [2012] concerning the identification of determinants of the farms' demand for loans, the estimates of the demand for financial instruments (e.g. for the EU institutions) have remained quite uncertain. This is due to the fact that at the micro level, credit restrictions may have a varied impact on the farmers' decisions regarding the allocation of resources.

Summing up, the arguments for interventionism constitutes the basis for the use of financial instruments under the CAP (for more on the subject see: Kulawik et al. [2017]). In the case of Poland, many prerequisites apply to countries with medium development (Table 2).

Table 2. Rationale for credit intervention in agriculture depending on the level of socio-economic development of the country – developed countries/countries with medium development level

Developed countries	**Countries with medium development level**
• Imperfection (unreliability, inefficiency) and incompleteness of financial and credit markets • Improving the efficiency of non-financial markets • Social justice and inter-regional equal opportunities	• Mitigation of credit rationing effects • Elimination of underinvesting in agriculture • Counteracting the negative effects of the monopolistic position of financial institutions • Reduction of insolvency costs as well as loss of credit rating by farmers • Subsidising certain groups of agricultural population

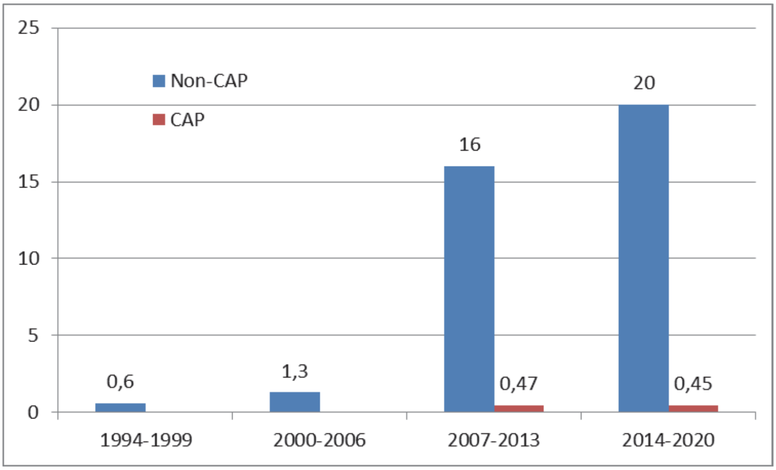
Source: own elaboration based on literature studies.

3.3. The use of financial instruments under the EU policy

Financial instruments, formerly known as financial engineering instruments, are used in the ERDF, ESF and CF funds from the period of 1994-1999, and in the second pillar of the CAP from the 2000-2006 period. There is no significant differentiation between the 'old' and 'new' EU Member States as far as the scale of their application is concerned. In the case of the EAFRD, for the 2007-2013 period, financial instruments amounted to 1.3% of EAFRD resources at that time. Financial instruments may be used for investment activities, i.e. in the case of RDPs to support investments in agricultural holdings and processing sector entities (Figure 1).

[2] Studies conducted in the USA [e.g. Benjamin and Phimister, 2002; Briggeman, Towe and Morehart, 2009] should be mentioned here, as well as in the EU [Petrick and Latruffe, 2003; Latruffe, 2005], referred to by Ciaian et al. [2012]. The set of statistically significant determinants should include: value of own assets, area, profitability, value of fixed assets, level of equity, obtained subsidies (subsidy rate).

Figure 1. Level of funds allocated for the implementation of FI (EUR billion)



Source: own elaboration on the basis of data from the European Commission [2017a] and European Court of Auditors [2015].

The use of financial instruments is still not popular, although the estimated financial gap is significant. In the EU agriculture alone, it amounts to EUR 7.1-18.6 billion, while in Poland it is EUR 788-1732 million [European Commission, 2018].

3.4. Example of the use of FI in the 2014-2020 programming period

French Occitania serves as an example of using a wide range of financial instruments in the current programming period. Based on the previous experience, the scope of application of FI with the use of the ERDF and the EAFRD has been extended. A total support of 5000 SMEs is planned, including agriculture. The budget for this purpose is EUR 143 million (combined resources of both funds, funds from the European Fund for Strategic Investments and public funds from France). It is expected that EUR 900 million will be allocated to entities from the SME sector. The instruments implemented include:

- Loans for seed capital,
- Loan guarantees,
- Co-investment instrument.

With regard to agriculture loan guarantees have been planned for selected measures of the local rural development programme. These activities include: investments in fixed assets; development of farms and economic activity; investments in the development of forest areas and improvement of the viability of forests. Moreover, EUR 27 million of public resources, including EUR 15.81 million in EAFRD funds, will be earmarked for guarantees. It is assumed that on the basis of these funds, EUR 135 million will be generated in the form of loans, which means that the leverage needs to be 5. The guarantees shall reach 80% of the loan amount, but no more than the established ceiling resulting from the regulations concerning State aid in the agricultural sector. The minimum loan amount is EUR 25,000. Guarantees are granted free of charge, and loans are charged with an average interest rate of 0.4% lower than the average interest rate [Robino, 2017].

3.5. How to improve the implementation of FI in the EU?

In subsequent programming periods, changes are introduced in the functioning of the FI to eliminate shortcomings from the previous period. As part of the changes introduced to the 2014-2020 programming period, mandatory *ex ante* inspections have been introduced to determine the actual need for this form of support (Table 3).

Table 3. Changes in the functioning of the FI as part of Cohesion Policy in the 2014-2020 programming period in relation to the 2007-2013 period

Specification	2007-2013	2014-2020
Scope	Support for enterprises, urban development, energy efficiency and renewable energy in construction	Support for all thematic objectives implemented under the programme
Before creation	Voluntary analysis of the size of the financial gap for enterprises and at holding fund level	Mandatory *ex ante* evaluation
Deployment options	FI at the national or regional level – tailor-made	FI at the national, regional or international level. Individually designed or ready, loans/guarantees from the managing authority Addition to instruments at the EU level
Payments	The ability to declare to the Commission 100% of the amount contributed to the fund – not related to payments to final beneficiaries	Periodic payments related to the payment to final beneficiaries. National co-financing may be included in periodic payment applications.
Management costs, fees, interest rates	Legal basis defined in subsequent amendments to regulations/ interpretations specified in three subsequent notes	Detailed solutions available in EU regulations from the very start
Reporting	Mandatory reporting only from 2011. Only selected indicators	Mandatory reporting from the very start. A wide range of indicators

Source: European Commission [2017b], p. 183.

Still, many solutions applied to FI are not conducive to their widespread use. In connection with this, further changes are proposed regarding various areas of FI functioning (Table 4).

Table 4. Issues that need simplification and proposals for change

Area	Proposals
Financial intermediaries and their selection Public procurement rules hinder implementation. The selection process is too long and excessively regulated. Transparent standards for the selection process are necessary.	Direct indication in Regulation No. 1303/2013 and amendment of the Public Procurement Directive to unambiguously exempt FI from public procurement rules. Simplification of rules when implementation is entrusted to national financial institutions that implement national policy instruments. Selection procedure containing minimum requirements without the need to apply public procurement rules.
State aid rules applicable to FI The rules on State aid are applied despite their complexity, which often leads to illogical results. Different application of State aid rules to individual parts of the same project or similar financial projects from the EFSI to centrally managed programmes. Unresolved question of repayable assistance – which rules of State aid should be applied when repayable assistance is not FI *per se*, but does contain some elements of FI and grants?	Simplified State aid rules for FI, modification of block exemption regulation. Same rules for grants and FI implemented at the national level.
Combination of grants and FI Difficulties in linking grants to FI in a single operation. Different level of costs and fees, various rules regarding State aid and the requirement to maintain separate registers.	Simplified system for two separate operations or allowing a combination within one.

Source: Committee of Regions [2016], pp. 7-8 and 12-13.

3.6. Summary and conclusions

Key conclusions from the current application of FI and the possibilities of their wider and more effective use and application in Poland are as follows:

- Some justifications of financial instruments do not seem well-founded in theory and probably would not pass the rigorous empirical verification.
- In order to avoid over-reimbursement and re-promotion of agriculture, it is not advisable to start identifying development barriers to this sector with financial issues.
- Before actions are initiated aiming at wider application of financial instruments under the CAP, it should be checked whether the private financial sector will offer at least some of them more effectively. This case is taking place in Poland.
- Financial instruments are adjusted mainly to achieve allocation and stabilisation objectives under the CAP and national agricultural policies. On

the other hand, their direct impact on the degree of implementation of environmental objectives of these policies is debatable.

- Only larger, market-oriented and development-oriented farms may be interested in financial instruments. Also only such farms are able to efficiently handle the foreign capital offered to them in this way.
- Simplification of the procedures for the application of financial instruments is an important element to increase the demand for such financial instruments. This applies to both the procedures of public administration and financial intermediaries as well as final beneficiaries.
- Previous experience with the implementation of FI under the RDPs is limited, however, all of them (similarly as in the case of other EU funds) indicate that much more time is needed to launch the FI than in the case of grants (subsidies).

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