AGRICULTURAL AND RURAL DEVELOPMENT PUBLIC EXPENDITURE CHOICES AND MANAGEMENT IN THE TRANSITION ECONOMIES: LESSONS FROM EU PRACTICE AND EXPERIENCE
Agricultural and Rural Development Public Expenditure Choices and Management in the Transition Economies:

Lessons from EU Practice and Experience
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EXECUTIVE SUMMARY

Public expenditure interventions in the agricultural and rural sectors are important in most of the transition economies. Often, however, the choices on both the level and composition of these expenditures lack a transparent rationale. In federal systems there is also often an additional problem of a lack of coherence in the determination and implementation of public expenditure policies between the federal and regional governments. Moreover, the procedures for the monitoring and evaluation of these expenditures are either non-existent, or highly flawed where they do exist. This paper draws some lessons for the transition economies from experience in the EU in addressing these issues. The paper initially proposes a simple but practical approach to the development of a rationale for how public expenditures could be allocated among competing policies in the agricultural and rural sectors. The suggested approach involves using an expenditure typology. Three typologies, that share significant overlap, are put forward and considered as being appropriate for the classification of agriculture and rural development policies, namely, a public finance-based typology; the OECD typology; and the WTO typology. Trends in the evolution of public expenditure in the agricultural and rural sectors are examined and discussed for the OECD typology as this is the only classification system that readily allows for consistent international and intertemporal comparisons. Procedures for the monitoring and evaluation of public expenditure programs that have been used to some advantage in the case of EU Structural and Cohesion Funds are outlined and discussed. Likewise, recent reforms in the Common Agricultural Policy are suggested as a basis for ensuring a greater coherence between federal and regional policies in the transition economies. Finally, the Russian Federation is used as a case study to examine the applicability of the approaches that are suggested to ensure a more strategic approach to the determination and management of public expenditures policies in the agriculture and rural sectors of the transition economies.
ACKNOWLEDGEMENTS

This study was prepared as a supplementary report to the World Bank’s earlier contribution to the policy dialogue of the World Bank with the Russian Federation Ministry of Agriculture (P083842). This report was prepared by Professor Gerry Boyle on the basis of information and findings assembled in preparation of the earlier analytical piece produced for the Ministry of Agriculture of the Russian Federation, leadership of pilot regions and Russian scientific community. This report was prepared under supervision of Bekzod Shamsiev, Senior Agriculture Economist, Sustainable Development Department, Europe and Central Asia Region.
# ACRONYMS AND ABBREVIATIONS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMS</td>
<td>Aggregate Measure of Agricultural Support</td>
</tr>
<tr>
<td>CAP</td>
<td>Common Agricultural Policy</td>
</tr>
<tr>
<td>CSG</td>
<td>Community Strategic Guidelines</td>
</tr>
<tr>
<td>DEL</td>
<td>Department Expenditure Limit</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GSSE</td>
<td>General Services Supports Estimates</td>
</tr>
<tr>
<td>KPI</td>
<td>Key Performance Indicators</td>
</tr>
<tr>
<td>LAG</td>
<td>Local Action Groups</td>
</tr>
<tr>
<td>MPSE</td>
<td>Market price support</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OP</td>
<td>Operational Program</td>
</tr>
<tr>
<td>PBBS</td>
<td>Performance Based Budget System</td>
</tr>
<tr>
<td>PSA</td>
<td>Public Service Agreements</td>
</tr>
<tr>
<td>PSE</td>
<td>Producer Supports Estimates</td>
</tr>
<tr>
<td>REPS</td>
<td>Rural Environment Protection Scheme</td>
</tr>
<tr>
<td>SMART</td>
<td>Specific, Measurable, Achievable, Relevant, and Timed</td>
</tr>
<tr>
<td>SOE</td>
<td>State Owned Enterprises</td>
</tr>
<tr>
<td>SUE</td>
<td>State Unitary Enterprises</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>VPFM</td>
<td>Value For Public Money</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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I INTRODUCTION

Most transition economies face several challenges in the management of scarce public resources. These challenges fall into three broad categories. First, once an overall allocation of resources for public expenditure (including tax expenditures) has been determined for a given function, a strategic and workable mechanism needs to be devised for determining how this allocation can be spent most efficiently. Second, workable procedures need to be laid down for ensuring that the monies that have been allocated to the various activities are in fact generating their intended outcomes. Third, in many large transition economies in particular, the relationships between the center and the regions are not very coherent in terms of budgetary planning and execution.

This paper discusses approaches to the determination and management of public expenditure choices in respect of the agricultural and rural development sectors of the transition economies of Eastern Europe. In particular, the paper attempts to draw lessons from practices in the EU that might be helpful for these economies. We conclude the paper by discussing the Russian Federation as a case study.
II GUIDELINES FOR STRATEGIC PUBLIC EXPENDITURE CHOICES

A typology or classification system is a useful starting point in making strategic public expenditure choices. An appropriate classification system can help to establish priorities and to effectively filter out interventions that do not meet the classification criteria. As public resources, however, are always scarce and have alternative uses, the existence of such a system is only a necessary, and not a sufficient condition, for rational decision making. It is also important to ensure that within the set of public interventions that adhere to the classification criteria, only those measures that deliver the maximum return for the outlay of public resources will be prioritized.

There are a number of different typologies or classification systems that can be advanced in respect of public expenditure and other interventions in the agricultural sector. There is considerable overlap between these formulations and indeed it is possible to “map” from one formulation to another.

The three most widely used typologies are:

1. Public-finance typology
2. OECD typology
3. World Trade Organization (WTO) typology

2.1 Public Finance Typology

The public finance typology\(^1\) of public expenditure is rooted in the notion of “market failure.” Where a “market failure” can be demonstrated there is a prima facie basis for government intervention. This intervention can take the form of regulator intervention or direct public expenditure or tax expenditure intervention. So in a very basic sense, all forms of public intervention should be subject to a single test as to their legitimacy. That test requires the satisfactory answer to the question “where is the market failure?” Market failures can arise in three circumstances:

i. Provision of public goods or services;
ii. Externalities in the form of incorrect product and input prices; and
iii. Targeted interventions designed to address information deficits of various kinds.

2.1.1 Public Goods and Services

The provisions of public goods or services, such as basic education, R&D, generic information on food safety, etc., provide the classic rationale for public intervention. Without government intervention, these goods or services would be either underprovided or not provided at all by the private sector. Due to the relative scarcity of these goods and services, the rate of return tends to be exceptionally high (R&D for example). It should be noted of course that just because an activity can be classified as a public good or service does not ipso facto justify significant public expenditure. It still requires to be demonstrated that the activity generates value for public

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\(^1\) This approach has been widely used in Ireland in recent years in devising national investment-spending priorities in the context of multi-annual investment plans that have been supported by EU Community Structural and Cohesion Funds (see, for example, Economic and Social Research Institute et al 1994, 1999 and 2006).
money, in terms of the quality of the good or service that is provided, as benchmarked against international norms and that it is provided through the prudent and efficient use of scarce public resources.

2.1.2 **Externalities**

Externalities that arise through the incorrect pricing of products or inputs also provide another but perhaps less clear-cut grounds for public intervention in the form of taxes or subsidies. Well-known examples of externalities such as pollution due to excessive fertilizer use may justify taxation of input prices to discourage excessive use. The inappropriate pricing of capital inputs, perhaps because of the underdevelopment of capital markets, may justify the use of credit subsidies. Indeed in some circumstances, certain types of producers, such as, small-scale producers, may be unable to access credit at any price. This may be the case despite their investment projects being basically financially and economically sound. This would justify credit subsidies targeted towards these types of producers.

2.1.3 **Targeted Interventions**

The final category of “targeted interventions” usually arises because of some information deficit or other. Examples might be the need to encourage producers to invest in new technology which, although profit enhancing, the rate of adoption might be stubbornly low due to an information deficit. The nature of these interventions, however, is that of their nature, they ought not to be open-ended. They should have clear time or “sunset” limits.

It is clear from this brief review that the likely circumstances that would warrant significant public intervention in any sector are quite limited. Yet, in many countries, and particularly in the agricultural sector, we observe extensive public interventions, especially in the form of product and input subsidies. Most of these interventions lack any “market failure” rationale. Their impact, however, is to exacerbate underlying economic distortions within economies that inevitably spill over into the international trade arena. These interventions often find favor with governments because they typically lack transparency, both in terms of the payee and beneficiary of these interventions. In virtually all circumstances, the implicit policy aim of these interventions is to achieve some income distribution objective. This is a perfectly legitimate objective of government social policy. However, governments, by trying to achieve essentially social objectives though the medium of agricultural policies, often end up pursuing policies which lack a sound rationale in equity, while at the same time frequently resulting in deep-rooted market distortions and at a cost to taxpayers that is excessive relative to alternative means of effecting income transfers.

A good example of the consequences of inappropriate policies is the EU Common Agricultural Policy or CAP. The CAP of the EU for several years managed to ensure that product prices were substantially in excess of competitive levels. This policy resulted in excessive food production which inevitably distorted world markets. The policy was also inequitable in so far as it was financed via transfers from consumers to what were, in the main, well-off producers. Also a minority of large-scale producers took the lion’s share of these transfers. For instance, it is estimated that in the EU15 in 2005 about 57% of the transfers went to 6% of the producers and in EU15 about 80% of the transfers went to about 20% of producers (EU Commission, 2006). For several years now the EU has attempted to reform the CAP. The thrust of reform has been to gradually “decouple” support to the sector from production. In other words, agricultural supports have been redesigned in such a way as not to create an incentive for producers to supply more output. EU producers now receive payments based on historical entitlements and not on the basis
of the amount they produce. It should be noted that these transfers are subject to “modulation” over time. In other words, they will decline in real terms. This new departure for the CAP has two other important implications. First, the transfers over the long term will no longer be financed by consumers through the marketplace but via taxpayers. This makes the transfers much more transparent and hence open to much greater political scrutiny. Second, these payments to producers are rationalized not on social grounds but are viewed as payments for the production of public goods\(^2\), such as the preservation of the countryside and rural way of life. Hence, these payments continue to come within the remit of the agricultural budget. However, because of the “modulation” dimension, these payments will diminish in significance over time and indeed the savings are earmarked for the support of rural development expenditure—the so-called “second pillar” of the CAP. Rural development expenditure would also be justified on classic public-good grounds.

A major drawback with the public-finance typology is that no comparable cross-country database is available that utilizes this framework. Any classification would have to be implemented on a country-by-country basis.

### 2.2 OECD Typology

A separate typology has gained considerably currency in recent years as a result of the pioneering work by the OECD (OECD, 2004). This typology distinguishes between General Services Supports estimates (GSSE) and Producer Supports estimates (PSE). Broadly GSSE provide indirect support to agricultural producers because the direct recipients of government expenditure are agencies such as research bodies, educational institutions, etc. The activity of these bodies ultimately, however, but indirectly impact on producers. PSE on the other hand involve transfers that directly accrue to producers. PSE can be further classified into Market Supports estimates (MSE) or transfers that accrue directly to producers via distortion of the market (e.g. intervention purchases, import tariffs, and export refunds) and other forms of support which are funded via taxpayers. The OECD has developed the very useful measure of the PSE or Producer Subsidy Equivalent which is effectively the proportion of producer revenue that is accounted for by Producer Supports.

GSSE tend to overlap substantially with the provision of public goods or services. PSE on the other hand requires examination on an item by item basis to determine whether they conform to the “market failure” requirement. It is manifestly the case that the MSE component does not conform to this requirement. As far as other PSE components are concerned the test that may be advanced as to the soundness of these payments is whether these measures directly encourage additional production or not.

A major advantage of the OECD typology is that comparable international data have been complied by the OECD and these are readily available.

### 2.3 World Trade Organization (WTO) Typology

In recent years the use of the WTO typology of the Aggregate Measure of Agricultural Support or AMS has tended to be widely employed as a supplement and sometimes as a substitute for the OECD typology. This typology classifies public expenditure on agriculture and rural development in terms of whether the expenditure concerned falls into the so-called “Green,” “Amber” or “Blue” boxes. “Green” box expenditures are measures that are deemed not to be

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\(^2\) This requirement is known as “cross compliance”.
market distorting and these measures would essentially include the provision of public goods or services or GSSE measures in terms of the OECD typology. “Green” box expenditures would also include measures that although, involving direct transfers to producers, were deemed not to be market or trade distorting. These measures, would, in the terminology of the EU Commission, include the so-called “decoupled” payments or historically-based entitlements in OECD terminology. The “Blue” box expenditures comprise measures over which there is some doubt as to their market-distorting impact. Debate here centers on the extent of “decoupling” implied by the expenditures. Measures that are classified as “partially decoupled” would fall into this category. Finally, all measures that manifestly involve a market distortion in the form of a stimulant to production fall into the “Amber” box. This would include output-based payments that are administered per head of animal or per unit of crop area. Input subsidies (e.g. fertilizers, fuel, etc.) would also fall into this box.

According to Annex 2 of the Uruguay Agreement on Agriculture Green Box domestic support measures that are claimed to be exempt from reduction commitments “… shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production. Accordingly, all measures for which exemption is claimed shall conform to the following basic criteria:

(a) the support in question shall be provided through a publicly-funded government program (including government revenue foregone) not involving transfers from consumers; and,

(b) the support in question shall not have the effect of providing price support to producers.”

The measures that fall into this Green Box class are summarized in Table 1.

<table>
<thead>
<tr>
<th>Table 1: WTO Green Box Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Services</strong></td>
</tr>
<tr>
<td>· Research</td>
</tr>
<tr>
<td>· Pest and disease control</td>
</tr>
<tr>
<td>· Training services</td>
</tr>
<tr>
<td>· Extension and advisory services</td>
</tr>
<tr>
<td>· Inspection services</td>
</tr>
<tr>
<td>· Marketing and promotion services</td>
</tr>
<tr>
<td>· Infrastructural services</td>
</tr>
<tr>
<td>· General services (not specified)</td>
</tr>
</tbody>
</table>

3 Reproduced in Appendix 1 to this paper.
Direct payments to producers
- Decoupled income support
- Income insurance and income safety-net programs
- Crop insurance for natural disasters
- Structural adjustment assistance provided through producer retirement programs
- Structural adjustment assistance provided through resource retirement programs
- Structural adjustment assistance provided through investment aids
- Environmental programs
- Regional assistance programs
- Others (not specified)

Public stockholding for food security purposes

Domestic food aid

On a *prima facie* basis many of these measures might not appear to conform to the “fundamental requirement” of Annex 2 and indeed many of the developing country members of WTO are concerned that too much scope is available to the better-off members to conveniently re-classify agricultural supports from the “Blue Box” to the “Green Box” (see, for example, Berthelot, 2005). They argue that both individual “Green Box” measures and when considered in their totality, they could well confer competitive advantages on those countries that are capable of funding such measures.

A few of the “Green Box” measures stand out in particular as being difficult to justify on a public-finance basis.

For instance, “Marketing and promotion” of agricultural products would appear to confer a competitive advantage on particular companies. Annex 2 of the Agreement attempts to preclude this possibility by “…excluding expenditure for unspecified purposes that could be used by sellers to reduce their selling price or confer a direct economic benefit to purchasers” (see Appendix 1). This restriction would appear to justify measures of a generic nature, e.g. a marketing campaign to support the consumption of dairy products. Likewise a measure such as supports for “infrastructural services” would appear to be anti-competitive but Annex 2 specifically excludes “… the subsidized provision of on-farm facilities … [and] … shall not include subsidies to inputs or operating costs, or preferential user charges” (see Appendix 1). The intent here is presumably to support infrastructural measures that benefit the industry as a whole rather than individual producers or firms within the industry, e.g. storage facilities for a particular sector.

The measure that is perhaps most open to disputation in regard to the “fundamental requirement” of Annex 2 involves the so-called “Direct Payments” to producers. The intent in the Annex is to limit “Green Box” status to “decoupled payments.” Such payments are deemed to confine eligibility to be determined by a base-year entitlement. Expressly excluded from the “Green Box” are direct payments that depend on the type, price or volume of production that applies in any year beyond the base year. A similar exclusion applies to payments linked to the factors of
production. Moreover *Annex 2* stresses that no production shall be “required in order to receive such payments,”

Income insurance payments are everywhere controversial and *Annex 2* stipulates that payments may be related “… solely to income; it shall not relate to the type or volume of production …”, “… prices” or to “… the factors of production employed” (see Appendix 1). Investment aids in support of structural adjustment are subject to similar restrictions for eligibility as “Green Box” measures. Support must be delinked from production decisions other than where there is a requirement to cease production of a commodity.

Two drawbacks affect the WTO typology. First, the classification system has a legal rather than an economic basis. In other words the typology represents a negotiated outcome. Second, comparable international data are not readily available on the application of the typology.
III TRENDS IN EU AGRICULTURAL EXPENDITURE—OECD TYPOLGY

The OECD typology of agricultural and rural development expenditure is the only one of the three typologies discussed for which international comparable data can be analyzed. Hence, it is useful to consider recent trends in agricultural and rural development expenditure in the EU using this typology.

Following the OECD typology we can segregate the total estimated cost or expenditure (TSE) on EU agricultural policies into two broad components:

1. Producer Supports estimates (PSE)—estimates of supports that are received directly by producers.
2. General Services Supports estimates (GSSE)—estimates of supports that are received indirectly by producers.

Thus,

\[ TSE = PSE + GSSE. \]

Each of these components can be broken down into their sub-components.

3.1 Producer Supports Estimates (PSE)

1. Market price support (MPSE)—estimates transfers from consumers via market interference (export subsidies and intervention)
2. Output payments
3. Area planted/animal numbers
4. Historical entitlements
5. Input use
6. Input constraints
7. Farm income payments
8. Miscellaneous

Items (2)—(8) are funded via transfers from taxpayers. Item (4) is a relatively novel addition to the EU basket of supports and refers to the so-called SAPS which has now replaced the battery of crop and animal-based payments that existed prior to 2006. As these payments are attached to a historically determined entitlement they are deemed to be “decoupled” and hence not to influence the level of production.

3.2 General Services Supports Estimates (GSSE)

1. Research and development
2. Agricultural education
3. Inspection services
4. Infrastructure
5. Marketing and promotion
6. Public stockholding
7. Miscellaneous
These expenditure items are typically funded via general taxpayer transfers but may also be funded from producer levies.

The main trends in EU agricultural expenditure are shown in Table 2.

**Table 2: Broad Trends in EU Agricultural Expenditure**

<table>
<thead>
<tr>
<th></th>
<th>1986-88</th>
<th>2002-04</th>
</tr>
</thead>
<tbody>
<tr>
<td>TSE €m.</td>
<td>106,372</td>
<td>113,401</td>
</tr>
<tr>
<td>TSE % GDP</td>
<td>2.82</td>
<td>1.24</td>
</tr>
<tr>
<td>Taxpayer transfers % TSE</td>
<td>24.2</td>
<td>48.5</td>
</tr>
<tr>
<td>GSSE % TSE</td>
<td>9.1</td>
<td>8.2</td>
</tr>
<tr>
<td>% PSE**</td>
<td>41</td>
<td>34</td>
</tr>
<tr>
<td>MPSE % PSE</td>
<td>86.9</td>
<td>54.6</td>
</tr>
</tbody>
</table>


* Utilisable Agricultural Area
** PSE as a % of total producer revenue.

A number of features of these broad trends in expenditure are worth highlighting. Relative to EU GDP the overall level of expenditure and transfers to the sector are declining significantly. They now stand at under an estimated 1.3% of EU GDP. The total level of support payments (TSE) per farmer and per hectare have increased slightly and, in 2004, they stood at about €12,000 and €970 respectively.

A major shift in the structure of agriculture expenditure is apparent. Transfers from consumers via the artificial distortion of market prices have fallen significantly as a percentage of total estimated producer supports and transfers from taxpayers have correspondingly increased. This development represents a profound change in the nature of EU agricultural policy. On the one hand it reflects a determination by the EU to eliminate market distortions and to target transfers more effectively. On the other hand it creates very evident tensions of a politico-economic nature. Since taxpayers are now increasingly footing the bill for agricultural expenditures in a very transparent manner, a closer scrutiny is now being rendered both to the scale and disposition of agricultural expenditure by the political system. This level of political attention was not apparent to any significant degree as long as the major policy instrument was the market support of producer prices. As time evolves we can therefore expect to see a build up of pressure from EU taxpayers to reduce the scale of transfers towards the sector.

A related structural shift is also occurring in that producer supports are shifting away from market-based supports to other instruments. This is reflected in a reduction in the share that

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4 EU Commission (2004) estimates the farm population of EU25 at about 10 million and the total utilizable agricultural area at around 126 million hectares.
market supports account for total producer supports. We also note a relatively stable trend in the share of GSSE in the total level of agricultural supports.

Table 3 shows the evolution of the key components of the EU PSE. The major developments here are the overall reduction in the contribution made by direct market supports and the substantial increase in the contribution of area and animal-based payments. These payments are at best only partially decoupled and hence effectively act in the same way in terms of their market impact as do market-based supports. However, these payments are funded by taxpayers and thus raise issues as to the political sustainability of these transfers. The recent installment of CAP reform (EU Commission, 2003) which ushered in the so-called SAPS is reflected in the table by the marginal increase in the contribution of payments of this type which depend on the historical entitlement of EU producers to area and animal-based payments. These payments will assume a much more significant component of total PSE in the future as they will substitute for the traditional area and animal-based payments and the EU continues on its path of agricultural price liberalization. These payments are considered to be completely decoupled from producer output responses and are justified by the EU not on the grounds of income transfers but in order to support the production of environmental public goods that are, it is argued, being demanded by the wider EU public.

| Table 3: Trends in the Main Components of EU PSE, % |
|------------------------------------------|------|------|
| MPSE                                    | 86.9 | 54.9 |
| Output payments                          | 4.9  | 3.5  |
| Area/animal payments                     | 2.6  | 28.2 |
| Historical entitlements                 | 0.0  | 0.6  |
| Inputs                                   | 4.9  | 8.0  |
| Input constraints                        | 0.7  | 4.9  |


We saw in Table 2 that a more or less stable trend is apparent in the share of General Service Support estimates in total expenditure. Table 4 exhibits the trend in the components of GSSE. The winding down of the EU intervention system has released resources that have served to significantly increase expenditure on areas such as “Research and Development,” “Agricultural Education” and “Marketing and Promotion.” It is noteworthy that a third of total EU agricultural expenditure is now estimated to be spent on “Marketing and Promotion.” On a *prima facie* basis this area, assuming that expenditure is confined to generic activity, and the other two areas mentioned, could be seen as constituting expenditure on public goods and services. Therefore, these supports are more likely to survive political scrutiny.
### Table 4: Trends in the Main Components of EU GSSE, %

<table>
<thead>
<tr>
<th>Item</th>
<th>1986-88</th>
<th>2002-04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Res. &amp; Devel.</td>
<td>11.0</td>
<td>17.2</td>
</tr>
<tr>
<td>Agr. Educ.</td>
<td>1.0</td>
<td>10.1</td>
</tr>
<tr>
<td>Inspection</td>
<td>1.6</td>
<td>4.6</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>11.6</td>
<td>23.1</td>
</tr>
<tr>
<td>Marketing &amp; Promotion</td>
<td>25.1</td>
<td>33.4</td>
</tr>
<tr>
<td>Public stockholding</td>
<td>49.4</td>
<td>9.9</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>0.4</td>
<td>1.5</td>
</tr>
</tbody>
</table>


#### 3.3 Summary of Trends in EU Agricultural Expenditure

In summary therefore, the main trends in EU spending on agriculture are as follows:

1. EU agricultural support is in decline both relative to GDP and the level of producer receipts.
2. The structure of overall support is shifting from support provided *via* the market to taxpayers.
3. In the future producer supports will be much more dependent on *decoupled* payments but these are very likely to decline in real terms due to political pressure.
4. Decoupled payments are being justified as payments for the production of public goods (conservation of the rural environment and way of life) rather than the subvention of agricultural activity *per se*.
5. Increased support is evident for General Services, especially R&D, education and marketing and promotion.
6. More resources will be diverted from supporting the agricultural sector to supporting rural development.
IV MONITORING AND EVALUATION OF PUBLIC EXPENDITURE PROGRAMS

The allocation of public expenditures on agriculture and rural development in accord with the principles of public finance is a critically important first step in ensuring that scarce public resources will be used wisely. However, this step will not amount to much significance if the resulting expenditure programs are not monitored and evaluated for effectiveness and efficiency. The EU has devised a system of expenditure program monitoring and evaluation that all Member States in receipt of Community Funding are obliged to implement. The basic elements of this system are now briefly outlined.

4.1 Approaches to Public Expenditure Evaluation

Evaluations of public expenditure programs usually have two purposes. The first is to establish the effectiveness of programs and the second is to establish the efficiency of programs. Effectiveness of a program is reflected broadly when program outcomes are consistent with program objectives. Efficiency on the other hand focuses on the value for public money (VFPM) of the program. From the perspective of the Ministry responsible for implementing a given set of policies this concern may be expressed in terms of whether the Ministry’s activities are maximizing the objectives set for the Ministry by the government. Put another way, could resources be reallocated to achieve a greater quantum of the objectives?

Evaluations can be either quantitative or qualitative in nature. Both approaches have strengths and weaknesses and ideally should complement each other. The qualitative approach has the merit of providing some insight into program outcomes that are inherently difficult to quantify. This is also its main weakness. The approach is anecdotal and it is impossible to draw robust general conclusions on this basis.

The quantitative approach is generally to be preferred, but it is not without its own serious drawbacks. First, important program objectives may be inherently unquantifiable. Second, the indicators that are employed in the quantification exercise will be imperfect and sometimes will be misleading. A more serious drawback, however, afflicts the implementation of quantitative evaluation exercises. This concerns the counterfactual problem, or, in other words, what would have happened if the intervention had not taken place. Even if we can establish robust quantitative measures of program outcomes, we can never be sure that these outcomes result from the program under evaluation or from some other factor or factors that are not explicitly considered. The methodological solution to the counterfactual problem is relatively easy to resolve but its resolution raises fundamental issues of an equity nature.

The resolution involves the design of social experiments as an integral part of the roll out of public expenditure programs. This would involve the selection of a “treatment” and a “control” group for a particular program. The “treatment” group receives the benefit of the program and the “control” group do not benefit from the program. Provided both groups are randomly chosen from a population, outcomes can be compared across the two groups and if the “treatment” group scores significantly higher on relevant outcome measures compared with the “control” group, we can safely concluded that the outcome can be attributed to the intervention. The principal objection to the “experimental” approach to evaluation, at least in respect of mainstream programs, concerns the equity of excluding potential beneficiaries from the program. Only in certain limited circumstances this may be deemed to be justified. In the absence of the use of the
“experimental” approach it will be extremely difficult, if not impossible, to establish that measured outcomes reflect the contribution of the program or the impact of some other factor or factors.

If one can successfully and safely establish cause and effect, the evaluation methodology can be pushed a step further by conducting a full-blown cost-benefit analysis. A cost-benefit analysis of an expenditure program involves the quantification of the full program costs and benefits in monetary terms and comparing costs and benefits using various summary indicators, e.g., computation of the benefit-cost ratio, or the internal rate of return to the program.

It is apparent also that the experimental approach will be very costly to implement and thus may only be feasibly applied to small-scale expenditure measures.

4.2 An Overview of the EU Commission’s Approach to Program Evaluation

The EU Commission has championed a simpler quantitative-based approach that has the capacity to evaluate a program’s performance in terms of the quantifiable objectives that have been set for the program over a future time horizon. This approach is much more cost effective that the “experimental” approach and may be applied to the totality of public expenditure. An obvious drawback with the methodology, however, is that it is possible for the program managers to engage in “gaming” behavior by deliberately setting far too unambitious performance targets for particular measures and sub-measures at the inception of the review period. This will have the effect of inflating the actual performance relative to target. This “gaming” strategy, however, will have a short-lived impact and in the long run such behavior should become transparent and thus will tend to be nullified over time.

The approach first presumes that public expenditure allocations for a given functional area are structured on an Operational Program (OP) basis. Each OP in turn may be structured into a series of Measures and Sub-Measures. The Sub-Measures in turn could be structured into a series of Projects which is the elemental unit of the OP. This public expenditure architecture follows naturally the strategic expenditure choices that are determined in the political arena. Ideally there should be a perfect matching between the strategy of public policy and the organization of public expenditure. It should be noted, however, that not all public expenditure allocations in the transition economies are in fact structured along an OP/Measure/Sub-Measure/Project basis. This is usually because the mechanisms for organizing the public expenditure budget are archaic and often employ expenditure categories that have little or no relevance to current-day policy priorities. In addition much expenditure in the transition economies consists of “off-budget” financed items (see Section 7 for a discussion of these and other issues in the context of the Russian Federation).

Given a program-based allocation of expenditure the next step is to identify appropriate Key Performance Indicators (KPIs) corresponding to potentially four different levels of program evaluation: Input-based, Output-based, Result-based and Impact-based. For each of these evaluation levels program managers must identify targets for their KPIs over a given program period, e.g. five to six years. These targets are then evaluated against actual performance and a performance score can be calculated at the end of a given review period, e.g. mid-term or end-of-program.

Program evaluation takes two forms, namely, *ex ante* or *ex post evaluation*. *Ex ante* program evaluation refers to the prior appraisal of proposed OP. This is a vitally important part of public expenditure planning and decision-making. It is well established that once public measures are introduced into the budget it is very difficult to curtail these measures subsequently, let alone see them eliminated. Hence, it is very important to ensure that value for public money is being secured by implementing rigorous prior appraisal or *ex ante* evaluation systems. *Ex post* evaluation takes the form of an evaluation of the historical performance of operational programs.

Program evaluation is usually conducted at the four levels: Input, Output, Result and Impact. The most basic form of evaluation is the Input-based variety. This is the traditional form of evaluation that has been implemented in most economies. It simply involves compiling input-based KPIs, e.g. the numbers of beneficiaries of a farm-machinery purchase scheme. Output-based evaluation is also not very taxing and involves the use of a KPI that captures the outputs of a scheme, e.g., the number of farm tractors that were purchased as a consequence of the farm-machinery-purchase scheme. The Result-level evaluation is somewhat more demanding and tries to establish the direct result or productive consequence of a scheme, e.g. the number of additional hectares of crops that were planted as a result of the farm-machinery-purchase scheme. Finally, the Impact-level evaluation attempts to capture the monetary added-value contribution of the scheme, e.g. the additional farm income generated as a consequence of the scheme. The latter level of evaluation is clearly very demanding as typically it will not be possible to control for all of the factors that are likely to impact on the given sector. Consequently, as a general rule, most public expenditure evaluations that follow the EU evaluation framework either omit the Impact-level evaluation, or, if they do implement it, they usually couch their analysis with several caveats.

This system can be implemented for any desired expenditure aggregate, i.e., Project, Sub-Measure, Measure and Operational Program and Overall Expenditure. Thus performance scores—the actual values of the KPIs as a ratio of their “target” values—may be compiled at lower levels of aggregation (e.g. Sub-measure level) and aggregated upwards to higher levels (e.g. Operational Program level).

An important requirement of this methodology is the development of suitable KPIs for the different evaluation levels. The EU Commission has given very useful guidelines to assist in the identification of suitable KPIs.

### 4.2.1 EU Commission Guidelines on Choosing KPIs

According to the European Commission (1999), an indicator can be defined as “the measurement of an objective to be met, a resource mobilized, an effect obtained, a gauge of quality or a context variable”. The MEANS Collection, which reflects the findings of research by the European Commission into evaluating socio-economic programs, identifies eight such criteria as follows:

1. **Relevance**: The indicator should cover themes and issues which have a significant impact on the development of sustainable tourism;
2. **Availability**: Crucial for an indicator is its actual existence, i.e. it must be quantified at regular intervals and the cost of collecting measurements should not outweigh the usefulness of the indicator;
3. **Meaning:** A good indicator must be clearly defined and understood without ambiguity by everyone who uses it. The indicator should accurately reflect the concept to be measured, i.e. what is called the validity of construction;

4. **Freshness:** The relevant information should be reasonably regularly available and it should be available at the time it is required;

5. **Sensitivity:** The quantity in question should be directly responsive to the activity whose performance is being measured, and ideally changes in the quantity should be directly attributable to the activity in question;

6. **Reliability:** The same measure undertaken by two different people should produce the same indicator;

7. **Comparability:** Ideally an indicator would allow for comparison across a range of different areas, particularly when used for resource and location decisions;

8. **Normativity:** Any value given to an indicator should be comparable to a norm, i.e. it should be amenable to setting of benchmarks against which outcomes can be compared.

### 4.3 The UK’s Performance Based Budget System (PBBS)

At EU member-state level, the UK is the exemplar of what is known as performance-based budgeting which may be considered as the ultimate methodology for ensuring the effective management of program expenditure.

The UK’s PBBS is subordinate to overall macroeconomic policy and adheres to four key principles:

1. consistency with a long-term regime for managing the public finances;
2. a clear focus on policy outcomes rather than inputs;
3. incentivization to encourage multi-annual planning by ministries and agencies;
4. the adoption of accruals accounting principles in the management of public capital assets.

At the core of the PBBS are the so-called Public Service Agreements (PSAs) that all spending agencies enter into with the Treasury (Finance) Ministry. These PSAs effectively amount to a series of quantifiable outcomes relating to Government policy objectives that spending ministries commit to delivering in return for their three-year Department Expenditure Limit (DEL). Each PSA has a value for money (VFM) target and also includes a statement of who is responsible for the delivery of the targets.

The Treasury advises that PSAs should be SMART (Specific, Measurable, Achievable, Relevant, and Timed), and “should not create perverse incentives or encourage staff to massage or misrepresent performance data; encourage staff to focus on easy-win cases above more problematic and important cases; or lead people to compromise quality in order to achieve a measured target,” (Davies, 2004).

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6 For more detailed material, see the UK Treasury website (http://www.hm-treasury.gov.uk)
All ministries also enter into so-called Service Delivery Agreements (SDAs) with the Treasury. SDAs comprise the menu of policy programs that government departments agree to deliver so as to achieve their associated PSAs. Ministries must commit to efficiency improvements and provide details of their administrative budgets.

Failure to achieve agreed outcomes will adversely affect future DELs. Each spending unit’s performance against its PSA is available for public scrutiny twice each year.

As a pertinent example of the PSA system the following are the currently applicable set of PSAs that govern the activities of the Department for Environment, Food and Rural Affairs (DEFRA):

**PSA 1.** To promote sustainable development across the government and in the UK and internationally, as measured by:
- the achievement of positive trends in the government's headline indicators of sustainable development;
- the UK's progress towards delivering the World Summit on Sustainable Development commitments, notably in the areas of sustainable consumption and production, chemicals, biodiversity, oceans, fisheries and agriculture; and
- progress towards internationally agreed commitments to tackle climate change.

**PSA 2.** To reduce greenhouse gas emissions to 12.5% below 1990 levels in line with our Kyoto commitment and move towards a 20% reduction in carbon dioxide emissions below 1990 levels by 2010, through measures including energy efficiency and renewables. Joint with DTI and DFT.

**PSA 3.** Care for our natural heritage, make the countryside attractive and enjoyable for all and preserve biological diversity by:
- Reversing the long-term decline in the number of farmland birds by 2020, as measured annually against underlying trends;
- Bringing into favorable condition by 2010 95% of all nationally important wildlife sites.

**PSA 4.** Reduce the gap in productivity between the least well performing quartile of rural areas and the English Median by 2008, demonstrating progress by 2006, and improve the accessibility of services for people in rural areas.

**PSA 5.** Deliver more customer-focused, competitive and sustainable farming and food industries and secure further progress via CAP and WTO negotiations in reducing CAP trade-distorting support.

**PSA 6.** To enable at least 25% of household waste to be recycled or composted by 2005-06, with further improvement by 2008.

**PSA 7.** Eliminate fuel poverty in vulnerable households in England by 2010 in line with the Government's Fuel Poverty Strategy Objective.

**PSA 8.** Improve air quality by meeting the Air Quality Strategy targets for carbon monoxide, lead, nitrogen dioxide, particles, sulphur dioxide, benzene and 1,3 butadiene. Joint target with DFT.
**PSA 9.** To improve the health and welfare of kept animals, and protect society from the impact of animal diseases, through sharing the management of risk with industry, including:

- a reduction of 40% in the prevalence of scrapie infection (from 0.33% to 0.20%) by 2010;
- a reduction in the number of cases of BSE detected by both passive and active surveillance to less than 60 in 2006, with the disease being eradicated by 2010;
- a reduction in the spread of Bovine TB to new parishes to below the incremental trend of 17.5 confirmed new incidents per annum by the end of 2008.
V A NEW DEPARTURE FOR EU AGRICULTURAL AND RURAL DEVELOPMENT POLICIES

In February of last year, the EU adopted a set of Community Strategic Guidelines (CSG) for the conduct of its agricultural and rural development policies over the period 2007 to 2013 (EU Council, 2006). These guidelines mark the culmination of a reform process that has been in train in the Union now for about 20 years.

The CAP is now structured into two Pillars: the Market Pillar (the “First Pillar”) and the Rural Development Pillar (the “Second Pillar”).

The aim of the “First Pillar” is to create a unitary market by defining a uniform set of rules at central level that are implemented at member state level but subject to monitoring and scrutiny by the center. The Market Pillar comprises an EU-wide harmonized set of rules and regulations embracing: food safety; phyto-sanitary, veterinary measures and standards; agricultural statistics and information systems; producer associations; and farm advisory services, etc., and a common market organization covering grading, market intervention and promotion. The third element of the “First Pillar” is the recently devised SAPS which will gradually come to dominate the CAP budget (EU Council, 2003). This newly adopted framework creates the optimum conditions for the operation of markets. Support for the orderly function of markets is provided through the provision of public goods and services and from this point onwards support to producers will be provided through “decoupled” payments to producers in the form of the SAPS.

The “Second Pillar” of the CAP which focuses on rural development is structured around four axes: competitiveness of agriculture and forestry (Axis 1); land management and environment (Axis 2); quality of life and diversification of economic activities (Axis 3); and the LEADER axis (Axis 4) which emphasizes the contribution to rural development of locally managed, territorially organized, bottom-up structures. Each of these axes contains a set of indicative measures from which individual member states have considerable flexibility in choosing the menu of measures that best suits their particular circumstances and needs.

Indicative measures under Axis 1 comprise means to improve the economic performance of agriculture by, for example, reducing production costs, increasing the economic size of holdings, promoting innovation and enhanced responsiveness to market signals. Specific support measures may include physical and human capital investment (e.g., early retirement, young farmers, training and advisory services).

The measures that are outlined under Axis 2 aim at ensuring the delivery of environmental services by agricultural producers in rural areas, and preserving sustainable land-management practices, including in areas with physical and natural handicaps. Eligible farms receive payments under the Rural Environment Protection Scheme (REPS) in return for the adoption of designated sustainable farming practices.

The aim of Axis 3 is to have a ‘living countryside’ and to help maintain and improve the social and economic fabric of rural areas. Indicative measures that are designed to make rural areas more attractive as places to work and live involve improved access to basic services and infrastructure and a better environment. The aim is to promote sustainable growth and employment and to facilitate enhanced access to up-to-date information and communication technologies. Specific measures may include support for on-farm diversification towards non-
agricultural activities (e.g. rural tourism), assistance for off-farm enterprise activities, and the enhancement of the links between agriculture and other sectors of the rural economy.

The EU authorities aim to ensure the territorial application of the rural development pillar by promoting implementation through sub-regional entities, either developed in close collaboration between national, regional and local authorities or by using the innovative LEADER (European Observatory of Rural Areas, 2006) bottom-up structures (“Local Action Groups (LAGs)” under LEADER parlance) where those exist (Box 1).

Policy is determined overall at EU level and implemented with a large element of flexibility at member state level. This outcome is to be assured by the implementation of co-financing and minimum axis-level expenditure arrangements between the EU and the Member States. These arrangements are designed to ensure that each Member State will focus on commonly agreed EU priorities for the four policy axes, while leaving sufficient flexibility at Member State and regional level to determine a balance between the sectoral dimension (agricultural restructuring) and the territorial dimension (land management and socio-economic development of rural areas). The flexibility given to Member States is in accordance with the long-established EU principle of subsidiarity which holds that policy implementation should be the responsibility of the officially-sanctioned entity that is located closest to the intended impact of policy. At the same time the EU ensures that a set of strategic policies are implemented in outline form by Member States through suitably devised co-financing arrangements.

EU co-financing rates are to be determined at the axis level, with a minimum Community contribution of 20% and a maximum of 50% (75% for those regions—the “convergence regions”—where their per capita GDP is less than 75% of the EU average). For Axis 2, (and also the LEADER initiative) the maximum co-financing rate is 55% (80% for the “convergence regions”), expressing the EU priority attached to these axes. To ensure a balanced implementation of the strategy across the EU, a minimum funding for each thematic axis has been established. The proposed minimum funding percentages of 10%, 25%, 10% and 5% (2.5% for the “new” Member States) for Axes 1, 2, 3 and 4, respectively, are a safeguard to ensure that the implementation of the strategy within each Member State’s will reflect at least the three main policy objectives, but the percentages are set sufficiently low to leave Member States or regions a high margin of flexibility (55% of EU funding) to emphasize the policy axis they wish to prioritize given their situation and needs.

Hand-in-hand with the significant autonomy that is given to individual member states to implement the CSG goes a responsibility that Member States incur to ensure Community resources are spent effectively and prudently in accord with sound accounting practices. Member States will have to ensure that the relevant management and control systems have been set up in accordance with the various detailed requirements involving, inter alia, a clear definition of the functions of the bodies concerned in the management and control of funds and a clear allocation of functions between each body. A reinforced monitoring, evaluation and reporting system based on a common EU framework agreed between the Member States and the Commission is to be introduced, to ensure more transparency and accountability for the use of EU resources. Drawing on the annual national synthesis reports on the execution of programs and the implementation of national strategies, the Commission will report annually on progress in the delivery of EU priorities for rural development.
Since the early 1990s, the EU has devised an innovative program in support of the development of rural areas. This program has been rolled out in parallel with the application of the “Structural” and “Cohesion” funds (Community Support Framework) in support of the peripheral and poorer areas of the EU. LEADER, which roughly stands for links between actions for the development of rural areas, is a so-called Community initiative and as such is designed by the EU Commission for application in selected areas of the Community. Unlike the “Structural” or “Cohesion” funds, where considerable discretion is accorded to the Member States in devising and shaping the various measures that constitute the program of actions, the design of LEADER is very much at the behest of the Commission (Directorate General for Agriculture and Rural Development), albeit influenced by experience in the application of the Initiative in the Member States.

It is important to note that LEADER is a relatively small fund when set against the “Structural” (including expenditures that arise under the CAP) or “Cohesion” funds so its importance predominantly lies in the innovative approach that it brings to rural development.

The LEADER initiative is now in its third generation. The current initiative is known as “LEADER +”, the previous initiative was known as “LEADER II” and the initial one was known as “LEADER I”.

LEADER provides funding to local action groups (LAGs) and these in turn are empowered to allocate these funds for local development projects and are given a wide level of discretion in how the funds are allocated. The projects that are supported range from rural tourism to small businesses with an agricultural orientation. At one level, LEADER might appear as simply another mechanism for the allocation of public funds. However, this view would miss several innovative features of the LEADER model which are:

**Its area-based approach.** Traditionally within the EU most state-funded activities have been structured on a sectoral basis. This is especially true of EU agricultural policies. The challenge of rural development is the development of specific areas. Sectoral policies have a role to play but they need to be harnessed to promote the development of specific areas. A sectoral measure that may work well in one area may need to be re-modelled to work as effectively in another area.

**Its integrated approach.** The development of rural areas requires that policies and agencies that operate in rural areas mesh well together in furtherance of the objective of the development of the given area.

**Its bottom-up approach.** Traditional sectorally-determined policies are usually devised centrally for implementation locally. These policies may not be optimal for particular areas because central planners may lack the knowledge of local needs and opportunities that only locals possess. Moreover, it is well recognized that centrally-planned interventions reinforce a dependency culture among the recipients of state funds and hence undermine initiative. LEADER has extolled the virtues of the “bottom up” approach from its inception and has in many instances identified development opportunities that might not otherwise have arisen.

**Its partnership approach.** Several agencies, both public and private, impact on the lives and livelihoods of people in rural areas. In many cases these agencies operate independently of each other. LEADER has facilitated the emergence of a partnership approach among these diverse agencies that has led to a more concerted and effective identification and implementation of opportunities for development.

**Its commitment to innovation.** The various generations of the LEADER model have evolved in their approach to the promotion of innovation in support of rural development. Innovation is seen as the key to the promotion of the sustainable development of rural areas. The organisational structure of LEADER aims to create the conditions that may allow innovative solutions to emerge at local level.

**Its support for networking and cooperation among LAGs.** Several LEADER-based local-action groups operate within each member state. The structure of LEADER allows for and promotes mutual learning through networking and cooperation both within and between Member States. Through this system models of “best practice” can be successfully transferred from one area to another and, as importantly, mistakes can be avoided.

**Its reliance on local finance and management.** Resources are always scarce in poorly developed rural communities and access to finance can be restricted. These restrictions can reflect relatively high administrative costs that arise when financing agencies have to deal with relatively small entities. Also, highly centralized financing agencies may lack the local knowledge both to avoid potential defaulters and to recognize good development propositions. The LEADER approach can result in a more efficient and effective...
VI LESSONS FOR THE TRANSITION ECONOMIES

This paper has reviewed EU practices in regard to the determination of public expenditure choices in the agricultural and rural development sectors, the monitoring and evaluation of public expenditure in these sectors and the nature of the relationship in the management of these expenditures that applies in the EU between the center (as represented by institutions such as the EU Commission and the Council of Ministers) and the Member States of the Union. In each of these three areas there are a number of lessons that could be applied with appropriate modification as necessary to many of the transition economies.

6.1 Strategically-Based Public Expenditure Choices

The EU has learned an expensive lesson namely, that market distortion, whether it be engineered by direct market interference through protectionist policies or by indirect interference through the transfer of “coupled” payments to producers, is unsustainable. The futility of protectionist policies is so manifest in so many settings that few governments at this juncture would risk even contemplating their introduction. However, the same reluctance may not apply toward the more indirect form of producer supports (e.g. area and animal payments) that are every bit as market distorting as intervention or export support systems. The lesson that needs to be learned here is that public expenditure policies must be strategically determined. That means that governments in the transition economies need to appreciate some basic factors in framing their agricultural spending plans, namely:

1. Taxpayer resources are scarce and must be used where they create the greatest impact on economy-wide growth.
2. Public expenditure should not substitute for private expenditure.
3. Public expenditure policies can only be justified if they address clear “market failures.”
4. Producer subsidies in the form of output and input-based payments do not in general address “market failures” and thus inhibit the sustainable enhancement of growth.
5. Scarce public resources should be predominantly earmarked for general service supports and producer supports should be correspondingly reduced.

6.2 Public Expenditure Management and Evaluation

The EU’s so-called Structural and Cohesion Funds have had an important impact in bringing about convergence of living standards in the European Union, especially in countries like Ireland. However, an important feature of these funds that has largely gone unnoticed has been the requirement on Member States that accompanied these Funds, to implement a rigorous monitoring and evaluation system. This system could be easily modified for application in the transition economies. Practices such as the organization of expenditure on an operational program basis are an important first step towards ensuring the effective management of public expenditure. An operational program architecture will in the first instance enable the allocation of expenditure on a budget basis to be synchronous with the goals of public policy. It also provides the basis that enables a rigorous evaluation system to be created. The EU system relies on the identification of a set of suitable KPIs that in turn allow the performance of an OP or OP component to be determined at periodic intervals. Without a well-structured expenditure program architecture it would be almost impossible to identify a coherent set of KPIs.
The implementation of a rigorous monitoring and evaluation system should provide program managers with an effective tool for the management of expenditure. It should enable them to identify what programs are working effectively and efficiently and what programs are not. This will enable some programs to be curtailed or eliminated and others expanded as well as new ones introduced. The practice that prevails, however, in many transition economies is for expenditure allocations to have only the most cursory of connections to stated government policy and priorities. Programs are introduced with apparently very little prior analysis of potential effectiveness and once adopted are rarely, if ever, significantly curtailed, let alone abandoned.

The EU monitoring and evaluation system falls well short of what might be considered ideal in relation to the ability of the system to identify cause and effect of public interventions. Nonetheless, it has the not inconsiderable merit of causing questions to be raised about the performance of projects and measures and ultimately operational programs which can then give rise to a reconsideration of the programs that do not perform within the framework. The system is also highly transparent and thus enables a public debate to take place on the performance of public expenditures allocated to the sectors under review.

### 6.3 Public Expenditure Allocation in Federal Systems

EU agricultural and rural development policies are determined overall at the EU level and implemented with a large element of flexibility at member-state level. This outcome is assured by the implementation of co-financing and minimum axis-level expenditure arrangements between the EU and the Member States. These arrangements are designed to ensure that each Member State will focus on commonly agreed EU priorities while leaving sufficient flexibility at Member State and regional level to determine a balance between the sectoral dimension (agricultural restructuring) and the territorial dimension (land management and socio-economic development of rural areas). The flexibility given to Member States is in accord with the long-established EU principle of subsidiarity which holds that policy implementation should be the responsibility of the officially-sanctioned entity that is located closest to the intended impact of policy. At the same time Member States are required to implement a rigorous monitoring, evaluation and control system which is subject to audit by EU bodies.

This framework would appear, on the face of it, to be well worth considering as a template for rationalizing the distribution of functional responsibilities between the federal, regional and local governments that characterize many of the larger transition economies. The EU framework may be apposite in the case of the agricultural and rural development sectors. A unitary market is a sine qua non for a resurgence of the agricultural sector. Yet many transition economies fail to achieve this outcome because of the operation of countervailing policies at local and regional level relative to those being championed by the federal authority. There may be more scope for diversity in the operation of broader rural-development policies. Nonetheless the EU approach has much to commend itself to the transition economies. The EU view is that the implementation of a successful rural development policy will require an approach that adheres to a common framework while at the same time allowing a diversity of responses at regional and local government level that reflects their differential circumstances and requirements.

In the case of the transition economies, rural development programs could be sponsored by the federal government under co-financing grants to regional and local governments that, for example, promote public-private partnerships between federally-sponsored programs and agribusiness enterprises that enter into marketing contracts, supply chain arrangements with restructured farms and so on. As in the EU, the financing arrangements between the federal and regional and local governments could allow for minimal expenditure levels and differential co-
financing rates for designated measures. The principle of the convergence of living standards that has been central to EU regional and cohesion policies can also be encouraged by allowing higher rates of central funding for the poorer agricultural regions.

Based on the EU framework, for this system to work effectively and efficiently it would be essential to establish a strong monitoring, evaluation and reporting system, as outlined above, based on a common federal framework agreed with the regional and local governments so as to ensure transparency and accountability for the use of public resources.
7.1 Overall Trends in Federal Expenditure on the Agri-industrial Complex

The Russian Federation provides a good case study to highlight the issues that arise in the allocation and management of expenditure programs in the agricultural sphere in the transition economies. Most transition economies implement procedures and systems of expenditure planning and management that closely resemble the Russian system and consequently they share many of the issues and problems with this system, albeit to varying degrees.

In recent years there has been a considerable improvement in and rationalization of the agricultural and rural development budget in the Federation. The overall official level of State support for the agricultural and rural sectors in Russia is now well in line with international trends. The consolidated budgetary expenditures for agriculture and rural development accounted for less than one percent of GDP in 2003. The current level of budget expenditure is similar to that found in many OECD countries. For example, US total budget expenditures are estimated to be 0.73 percent of GDP, EU countries average 0.68 percent whereas expenditure in the Russian Federation is estimated at about 0.95%.

While the overall budget, on a per worker or as a share of value of production is lower than in other countries, it is not possible to conclude from these figures alone that the level of support to agricultural and the rural sector in Russia is unambiguously low. First, there is widespread use of “off-budget” expenditures in the Russian Federation (especially at Regional Government level as discussed below) that are not reflected in these data. The other factor to be taken into consideration is the large tax concessions that are provided to agriculture. Therefore, while the overall recorded budget allocation for the agriculture and rural sectors falls within an acceptable international range, the effective level of public support is much greater, but unlikely still to be widely out of line with international norms.

In this section we first benchmark the main expenditure programs against the public finance rationale for public intervention as outlined in Section 2.1. Next we focus on the theme of coherence between federal and regional policies. Finally, we look at the some issues that arise in the budget process itself. For each of these themes we point to how some practices that prevail at EU level are being in fact pursued in the Federation or otherwise could be considered for implementation.

7.2 The Functional Allocation of Expenditures on Agriculture and Rural Development at Federal Level

The shift in supports that has occurred in Russia towards less-market-distorting measures is in line with international developments. The breakdown of Federal expenditure since 2000 by program area reveals a number of positive features. Expenditure on General Services has remained constant over time, while Production Support measures have been declining. Inefficient crop subsidies (including compensation for the cost of mineral fertilizers and flax and hemp production support) have been discontinued. Likewise, some of the less efficient livestock programs (such as wool subsidies, northern reindeer breeding programs and support for livestock

\[\text{This section draws substantially on a World Bank (2006) study on agricultural expenditure policies in the Russian Federation.}\]
feed concentrates) have been discontinued. The seasonal loan program has been discontinued in favor of a more efficient interest-rate subsidy program.

However, there are still some trends that do not fit well with a defensible rationale for public expenditure interventions. In the following we briefly consider the more important of these trends.

7.2.1 Grain Stabilization

Given the large variations in both inter-seasonal and intra-seasonal farm gate prices for grain and the extensive regional differences in grain markets, the existence of a Federal management stabilization program is in principle justifiable on market failure grounds. However, there are problems with the operation of these programs and considerable scope exists for improvement in their efficiency. Interventions tend to be ad hoc; limits were set on both total budget expenditures and volumes available for intervention that were lower than could credibly support the announced prices; public information is often not made available on prices, stocks or intervention procurements; and intervention target prices are often announced after the farmers had made planting decisions. The program also often lacks the appropriate delivery and controls on storage and on stocks. Delays in budget disbursements have often led to a poor timing of interventions, resulting in most of the benefits going to traders rather than farmers, who were the intended beneficiaries.

7.2.2 Leasing Programs

Leasing to the sector is currently the least efficient policy instrument used by the Federal Government in the agricultural sector. The program was designed to encourage private investment in agriculture and facilitate the establishment of modern, competitive farms. Central to this development program are measures to expand and modernize the sector’s capital base by encouraging producer investment in farm machinery and high performing livestock, through subsidized leasing programs.

While the underlying objectives of current government programs to support machinery leasing are legitimate and appropriate, the policies and measures being used to achieve these objectives are not. Producer access to farm machinery has been reduced rather than enhanced in many cases; and the increased private sector activity needed to facilitate greater machinery acquisition (suppliers, commercial banks, leasing enterprises) is being constrained by government intervention in both federal and regional programs. Current government practices associated with leasing and credit probably impede the creation of a level playing field for competition, rather than support it.

7.2.3 Agricultural Insurance

Federal Government expenditures for agricultural insurance have increased rapidly in recent years. Most developed countries subsidize agricultural insurance. Governments consider subsidies on insurance premiums to be a public good because they reduce both the private and public cost of bankruptcy. However, there is also a sound fiscal reason for supporting premium-rate subsidies because they encourage a wider use of insurance, and as a result reduce the government cost of disaster relief. This helps to smooth the time-profile of government expenditures by paying a predictable subsidy on insurance premiums rather than erratic expenditures on disaster relief. Despite a high and growing level of expenditure on agricultural
insurance, the government is still faced, however, with high levels of emergency payments, and there is a low level of insurance coverage.

Subsidies are given to the insurance companies rather than to the purchaser as would be the norm in most other countries. This arrangement is flawed in that it is prone to abuse. The industry is also highly concentrated, especially at regional level. This leads to monopoly pricing behavior. The insurance industry itself is plagued by a weak legal framework, a weak culture of contract enforcement, and pervasive fraud.

7.2.4 Interest-rate Subsidies

While interest-rate-subsidy programs are preferable to traditional forms of credit support they are distortionary in the long run and will be likely to result in an overcapitalization of the sector. Given the current circumstances in Russia, where the banking sector is underdeveloped and the agricultural sector is undercapitalized, the subsidization of interest rates through the commercial banking system is probably the most efficient approach to recapitalizing agriculture and encouraging commercial bank lending to the sector. This program is a significant improvement over earlier credit programs for agriculture where the government provided loans or guarantees on loans directly to agricultural enterprises or banks lending to agricultural enterprises, thus assuming significant risk. Under the current banking environment there is no need for the government to provide liquidity to the banking system and to assume the risk of default on funds lent to banks or agricultural enterprises. The risk under the interest-rate subsidy program is therefore substantially less than if the government were lending funds or providing guarantees.

Nevertheless the preferable, but longer-term, solution is to move to market-determined interest rates and to focus on increasing the supply of credit by developing the capacity of lending institutions that lend to agriculture.

7.2.5 Other Programs

The Federal government implements a large number of acreage or livestock number based programs to support specific crops and livestock types. However, it is phasing out many of these programs. The only remaining programs are supports to pedigree cattle breeding and seed production. Since there is a public good associated with both improving the genetic pool for livestock and in the production of non-hybrid seeds, both of these programs are justifiable public expenditures. In fact they could be viewed more as a general service provided by the Federal government rather than a subsidy program.

There are also some programs that are defensible in terms of public finance and other criteria and which are insufficiently funded at present. Environmental protection programs, for instance, are under-funded, especially relative to the levels prevailing in EU-15 where about 60% of expenditures under the Rural Development or the “Second Pillar” of the CAP are earmarked for environmental and land-management measures. It is worth noting of course that the share of expenditure on these measures across the EU is inversely related to the level of development of the agricultural sectors in the member states.

Expenditures for broad-based rural development in the Federation, including rural infrastructure and health and social services, although they have been increasing recently, are also still under-funded. In this regard, the Federal Targeted Program for the Social Development of Rural Areas Until 2010, is an important addition to Russia’s agriculture and rural policy agenda. This new program provides direct support for public investments in rural areas that are not tied to
agricultural enterprises, and could prove quite effective in facilitating and supporting the restructuring of the farm enterprises. Among several attractive characteristics of this program is the co-financing requirement by regional governments (at a rate of about 80% of the total) which creates the incentive that the program will assume a high priority for the regions. However in practice, despite the best efforts of the Federal government, the matching expenditures from the regions are not always forthcoming at the committed amounts resulting in severe funding shortfalls which the Federal government must make good. The most pressing problem in rural areas is the high level of unemployment, or under-employment. This program could be expanded to directly address some of these issues by supporting the creation of alternative employment in rural areas. This could include specific training programs for small-scale rural businesses, start-up grants for small businesses and small to medium sized farms, improving access to markets, and promoting consumer and producer organizations.

The EU LEADER (Box 1) initiative is an excellent example of a highly successful rural-development territorial-based program that might provide lessons that could be adapted to Russia.

7.2.6 Non-transparent Tax Expenditures

Federal and regional governments provide significant amounts of indirect support to the agricultural sector through the application of differential tax rates for agricultural enterprises. In 1992, a revised tax code was introduced that relieved agricultural producers from several taxes (e.g., profits tax for marketed agricultural produce, including farm processed goods; tax on property held by organizations; road user taxes; vehicle owner taxes and vehicle purchase taxes (currently the transport tax)). Agriculture also does not pay for the use of water resources. Private farms are exempt from land tax for five years from the date the farms are established. Agriculture also enjoys benefits on deductions for payments to the social insurance fund, medical insurance fund, and pension fund. In addition to the Federal level tax exemptions, regional governments also provide various tax breaks.

Some of these tax expenditures could be justified as a transitional measure (or a “targeted intervention”) to encourage capital investment in the agricultural sector that has suffered from years of capital outflow. However, rather than provide tax breaks to agriculture on a blanket basis, it may be more efficient to allow cost deductions for capital investments rather than all expenditures. In time these highly differential tax rates will need to be changed in line with other industries, or they will result in long-term investment distortions in the economy.

7.2.7 Periodic Debt Write-offs

A major source of effective subsidy with consequential significant public expenditure implications in Russia in the past has been the periodic bailout of bankrupt agricultural enterprises. Due to the government bailout of agricultural enterprises in 1994-95 and again in 2003-04, there is an embedded expectation that the government may repeat this process in the future. The build-up of debt at the farm level therefore creates a contingent liability for the government that is not reflected in the regular budgetary process.

The debt write-off in 1994-95 was largely a write off of accumulated debt issued by the Federal government. This was a blanket write-off of all government-owed debt, and as a result rewarded the worst defaulters. This program largely failed as a restructuring exercise, but led instead to increased defaults following the write-off and reduced financial discipline at the farm level. The lack of a hard budget constraint also allowed many agricultural enterprises to continue operating
inefficiently. Following the 1994-95 write-off of debts, farms continued to accumulate large
debts and tax arrears to the State as well as penalties on these overdue loans and tax arrears.

While periodic debt write-offs may have been necessary during the transition period to save the
agriculture sector from complete collapse, debt write-offs are not a sustainable policy instrument
for supporting agricultural development as it creates the expectation of repeated write-offs and
rewards the inefficient.

7.3 Lack of Coherence between Federal and Regional Spending Programs

Most of the positive developments in agricultural expenditure policies that we have noted have
been confined to the Federal budget. The problems and challenges of agricultural policy reform
arise predominantly at regional level. Regional level expenditures are still primarily focused on
inefficient production support measures and there are wide variations between regional
governments in the level of expenditure and the types of instruments used for agricultural
producer support and rural development interventions. The policy instruments used by the
regions are diverse, ranging from instruments that support highly centralized government grain
procurement and state machinery procurement to market-oriented interventions of a public-good
nature, such as, rural public infrastructure, science and education, environmental protection and
food safety. In 2003 the share of spending on agriculture and rural development as a percentage
of total regional expenditures ranged from 0.1% to 7%. This variation reflects both the wide
variation in the tax base of the regional governments and also the wide variation in agricultural
policies. Evidence suggests that as a result of this diversity, trade is highly distorted both across
regions and products because of input subsidies, in particular, and regional trade barriers.

For instance, many regional governments also have their own grain market intervention
programs. These are usually managed through the so-called “Food Funds.” These interventions
are effectively non-cash procurement schemes and are inimical to the development of an
integrated well functioning national market for grain; they tend to discriminate in favor of the
large farm enterprises; adversely affect the emergence of a more vibrant private-farming sector;
and impede the emergence of an efficient marketing system.

Some regional governments procure the minimum food needs for public institutions, such as
hospitals and schools, while other regional governments monopolize grain purchases in their
regions and thereby cause severe distortions in local and national markets. In many cases these
interventions are financed “off-budget” through state-owned enterprises. These enterprises are
often given privileges which other companies do not have, such as access to government credit or
grants, or, they act as agents for the delivery of credit to farmers by regional governments. Their
privileged position discourages the development of private trading and causes the fragmentation
of the national market.

In the long term, price support programs are fiscally and economically expensive and are not
sustainable. A move towards measures that underpin the long-run productivity and
competitiveness of the sector would be a preferable policy. Ultimately in order for a Federal grain
market interventions to work effectively, it is important that regional price intervention programs,
which range from creating regional grain purchasing monopolies to grain export bans from the
region, should also be phased-out and eventually outlawed or strongly regulated. In the long
term, price intervention programs are not only fiscally costly but they carry large economic costs
such as agricultural surpluses, an increasing disconnect from market demand, reduced
competitiveness, adverse impacts on the environment, and consumer welfare. If there is a need to
support farm incomes it would be preferable to move directly to income-based support programs
or programs that promote competitiveness-enhancing investments at the farm, marketing or agro-processing levels, rather than repeat the expensive lessons learned by many OECD countries in their implementation of price-support programs.

The Federal price subsidy on mineral fertilizers was eliminated in 2004, after it was demonstrated that the program was ineffective. Due to strong international demand for fertilizer, and almost no new investment in plant and equipment, Russia’s fertilizer factories have been operating at near capacity. As a result, increased demand resulting from the subsidy on fertilizer led to an increase in domestic fertilizer prices. Consequently, most of the fertilizer subsidy was captured by the fertilizer manufacturing sector and not by the farms that it was intended to support.

Many regional governments, however, still supply agricultural inputs directly to agricultural enterprises, usually on credit or through a barter/credit arrangement. This is often done by a single agent selected to administer the fertilizer supply and subsidy program for the region. International experience has shown that direct input subsidies are inefficient as a policy instrument for agricultural sector support and, in effect, are equivalent to output price support measures, especially in the grain sector.

Contrary to best international practice, Russia has opted to decentralize the operation of producer supports and to centralize the delivery of general services. The policy of the Federal government is to decentralize both the funding and management of producer supports to regional governments and to centralize the funding and management of general services support, such as veterinary services, etc. This is counter to trends in several OECD countries. Agricultural support programs are usually managed and financed centrally to ensure uniformity of delivery at the producer level. On the other hand, the implementation of general services support is normally decentralized in order to bring the management of these services closer to the service recipients.

The recent installment of CAP reform with its clear delineation of the scope of policy interventions between the center and member countries could be a model for rationalizing the respective roles of the central and regional governments (Section 6.3). The Federal government should have the sole responsibility for managing unitary markets for agricultural products and regional governments should be subordinate to it in respect of policies that impinge on the orderly functions of markets. On the other hand, rural development policies could reflect a much greater degree of diversity. The Federal government could encourage “best practice” by instituting co-financing arrangements. While the regions would have a much greater autonomy in respect of such policies, the quid pro quo is that they assume become much more accountability for the implementation of these policies.

In order to achieve better coordination of regional and Federal policies and expenditures, it would be important that the same budgeting and monitoring system and system of budget classification be used at both the Federal and regional levels. Currently this is not the general practice.

7.4 The Management of Public Expenditure Programs

Several reforms in the management of public resources can enhance the value obtained for public monies that are invested and there are a significant number of practices that can be borrowed with benefit from EU experience. Traditional modes of expenditure management have yet to completely adjust to the emergence of a market-based model of resource allocation. The management of public expenditure can be enhanced considerably through ensuring coherence between Federal and regional policy design and implementation; reform of the budget process; and by addressing the issues created by “off-budget” expenditures and the functioning of State
Owned Enterprises (SOEs) and State Unitary Enterprises (SUEs). The successful implementation of these reforms will release much needed resources that can address aspects of the public policy agenda that are presently only being inadequately funded and in some cases, not at all.

7.4.1 Reform of the Budget Process

Budget discipline would be improved significantly if considerably more detail and information were available on the structure of General Government Services. In 2004, General Services constituted about 55% of the total Federal budget allocation for agriculture and rural development. About 45% of this allocation is classified as “General administration and maintenance of subordinated agencies.” Another large share, 33%, is allocated to “education,” and at 9% “science” is also prominent. Based on the nature of the budget data that are available, it is very difficult to determine how efficiently these expenditures are being employed, except in broad terms. First, it is not possible to differentiate between capital expenditures, operating costs and personnel expenditures. Second, information on the extra budgetary fees collected by many of the organizations providing these services is not available. Third, it is not possible to map these expenditures to the quality and quantity of the services provided.

The budget process in the Russian Federation is not meeting the needs of the agriculture and rural sectors in that there is a marked lack of coherence between the determination of strategic policy interventions and their funding. A key deficiency is the failure to synchronize the annual budget allocations to the agriculture and rural sectors with medium-term strategy for the development of the sectors. The current system thus encourages budget requests that fit the existing budget classifications, regardless of whether or not they support current policies.

The policy-making process could be more closely tied to the budget process by, for example, the adoption of a program-based approach to the framing of public expenditure decisions as is implemented, for instance, in EU agricultural programs. This would allow a more coherent mapping of policy to the budget. Another measure that would also assist in achieving this outcome would be a move to a multi-year budget planning process, such as in the UK system and to make the budgets for Federal Targeted Programs binding on the annual budget process.

7.4.2 Monitoring and Evaluation of Public Expenditure

The budget management and reporting system does not yield the level of information or controls required to measure the efficiency or effectiveness of public expenditure. The budget allocation process and the resulting allocation are not transparent. Budget allocation is implemented in a top-down manner at each level of the bureaucracy with weak feedback systems. Feedback to the Ministry of Finance and to the Ministry of Agriculture on actual budget use is generalized into a few broad categories, making it almost impossible to monitor the performance of expenditures. Reporting of regional budgets is particularly poor. Some regions report over 50% of their expenditures under the category of “other uses,” without any further explanation. There seems to be an increasing trend toward categorization of agricultural expenditures under non-agricultural categories of the budget, perhaps because these expenditures become harder to track, and also Federal transfers depend on maintaining agricultural expenditures below certain limits.

The adoption of EU practices such as program-based budgeting and a multi-annual allocation of expenditure would greatly facilitate a more effective monitoring and evaluation of public expenditures. Also, the application of the EU approach to monitoring and evaluation with its use of key performance indicators for input, output, result and impact-based evaluation would also greatly improve the performance of public expenditure interventions.
Finally, improvements are needed in the auditing system. The Accounting Chambers of the both Federal and regional governments are responsible for the audit of budget use. For all entities that receive budget funds, partial audits of randomly selected budget line items are done on a quarterly basis. However, comprehensive annual audits are not required. SOEs that do not receive budget funds are not required to be audited by the Accounting Chamber. Enterprises that do not receive budget funds are subject to the same accounting rules as private companies, which require an independent audit every three years. It is not clear that this is the case in Russia, leaving open the possibility that the Accounting Chamber could be used to pursue political agendas or be prevented from carrying out truly independent audits. Another fundamental safeguard of the integrity of an auditing system is that its reports are available for effective public scrutiny. In Russia, only highly aggregated audit information is available to the public.

The Ministry of Agriculture is the first Federal Ministry to begin designing a Performance Based Budgeting System (PBBS), but full implementation of this system is still many years away. The successful implementation of PBBS in Russia will require fundamental changes in the entire budget and expenditure system. If this reform were to be implemented it would, however, place the public finance system in the Russian Federation among the top tier of countries in terms of best practice.

The international experience with PBBSs is that they are extremely difficult to implement and require very sophisticated management systems to yield positive results. In the United States, 47 of 50 states claim to use some form of PBBS for managing public expenditures and delivery of government services (World Bank, 2003). More recently, the UK has become a leader in PBBSs (Section 4.3). Even with their relatively high level of management training, accounting systems and transparency, these governments have found that there are limitations to PBBS. The primary benefit of these systems has been in the improved management and monitoring of government service delivery. However, as a feedback mechanism for the annual budget process, PBBS has had more limited use than was originally anticipated. The main lesson from the international experience is that PBBS is not a mechanical process and requires a high level of public disclosure and transparency for it to work effectively.

Implementing a performance based budgeting system in Russia will require considerably more than simply establishing broad goals, assigning budgets to these goals and monitoring outcomes. The entire budgeting and expenditure system will need to be changed. As discussed above, the budget classification and accounting system will need to be upgraded to provide more accurate feedback to decision makers. Public disclosure of information will need to become an integral part of the budget system which would be a fundamental shift from the current disclosure procedures. In summary, the basic budgeting, accounting and monitoring system will need to overhauled before a performance based management system can be successfully implemented.

7.4.3 Reforming the Provision of General Services

Considerable additional scope exists to improve the efficiency of provision of General Services. Many of the subordinate organizations that are responsible for the provision of General Services are being reorganized by the Federal government with a view to rendering their delivery more efficient and effective.

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8 For more information on performance based budgeting see http://www.odi.org.uk/publications/working_papers/wp203.pdf.
“Off-Budget” expenditures are significant in scale, non-transparent and potentially highly distorting. A major problem that needs to be tackled as a priority is the high level of “off-budget” expenditures, much of which is not reported at all. What tentative evidence there exists on the scale of expenditures that could be involved suggests that “off-budget” funded activities could amount to a substantial fraction of budget expenditures. There are principally two types of entities in Russia that work with “off-budget” expenditures and revenues. There are government departments which collect fees for services provided: SUEs and SOEs. Allowing government agencies to collect fees for providing public services, and having SOEs or SUEs provide public services on behalf of the government are not in themselves bad practices. However, the quality of services that these sources of revenue help finance need to be subject to the same level of regulation and monitoring as directly-budgeted expenditures. During the chaos of the 1990’s a pattern of loose controls on SOEs and SUEs has led to a deficiency in the control and monitoring of these agencies. Of most concern is that very little information on revenues, expenditures and the services provided by these organizations is reported back to government, and almost nothing is available for public review. Since most government agencies receive government budget funds they are subject to tighter financial control and audit requirements than SOEs or SUEs.

A related issue of serious concern is that some regions create SOEs and SUEs, such as “food funds,” which are not viable commercial entities. After running for a few years the assets of these enterprises are transferred to a new enterprise and the “shell” company is left with the debt which creates a contingent liability on the Federal or regional budget.

The key issue in managing non-budget revenue collection and use of these funds is primarily one of implementation. In practice, there is no standard approach to managing these funds. For some agencies, the fee revenues are accumulated in a treasury account, accounted for by the Ministry of Finance, and all or part of the funds are released back to the agency to cover expenditures based on agreed arrangements with the Ministry. In other cases, government agencies retain all or part of their fee revenue in private accounts that are drawn on to cover expenditures. These expenditures are not necessarily reported to the Ministry of Finance. These agencies are sometimes involved in commercial activities and these funds are combined with the fee revenue and expenditures for public services. This makes it very difficult for the Ministry of Finance or implementing agencies to match expenditures with public service delivery. For public services that are provided for a fee by a government agency the government’s best international practice requires that both the fee structure and the service standards should be regulated. Government agencies that collect fees should be required to account for all fee income and expenditures, and report all financial activity to the Ministry of Finance and the main budget agency to which they are subordinated. Financial operation and performance of standards should be audited by independent auditors, and the information should be made public. The price of the regions receiving greater autonomy in the implementation of rural development policies, for instance, is that they become subject to rigorous audit. This is the practice with EU agricultural and rural development policies. Audit requirements and public disclosure reduce the inefficient use of resources and the potential for corruption. For SOEs and SUEs that provide public services or implement policies on behalf of the government, new legislation is probably required to enhance reporting requirements, independent audit and public disclosure of financial information and services provided.

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9 SUEs are wholly owned by the Federal, regional or municipal governments and have not been converted into joint stock companies. SOEs are joint stock companies which are wholly or partly owned by the Federal, regional or municipal government.
The Federal government is already in the process of reviewing and reorienting the functions of many government agencies. It has privatized many commercial functions that were formally managed by the government and further improvements are still possible. In particular, commercial activities of the government agencies that conflict with their regulatory functions should be curtailed. Commercial activities that do not provide a public service should be removed from the mandates of SOEs and SUEs and consideration should be given to their ultimate privatization. In restructuring SOEs and SUEs, the sequencing of commercialization or privatization of enterprises is however important. Many SOEs and SUEs are monopolies, commercializing or privatizing these entities without first curtailing the extent of monopoly power through regulation can have a worse effect on competition than simply having an SOE or SUE.

The lack of the clear separation between government functions and commercial activities has also made government policy-making in Russia during the transition extremely difficult. The inherent conflict of interest created by having the government setting the rules for business and at the same time participating in commercial activities has led to distortions that are detrimental to development. Once established, SOEs, which have strong connections to the government, especially at regional level, tend to be effective in lobbying to maintain their privileged positions.
ANNEX 1: REPRODUCTION OF “ANNEX 2: DOMESTIC SUPPORT—THE BASIS FOR EXEMPTION FROM THE REDUCTION COMMITMENTS” FROM THE URUGUAY AGREEMENT ON AGRICULTURE

1. Domestic support measures for which exemption from the reduction commitments is claimed shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production. Accordingly, all measures for which exemption is claimed shall conform to the following basic criteria:

   (a). the support in question shall be provided through a publicly-funded government program (including government revenue foregone) not involving transfers from consumers; and,
   (b). the support in question shall not have the effect of providing price support to producers;

plus policy-specific criteria and conditions as set out below.

Government Service Programs

2. General services

Policies in this category involve expenditures (or revenue foregone) in relation to programs which provide services or benefits to agriculture or the rural community. They shall not involve direct payments to producers or processors. Such programs, which include but are not restricted to the following list, shall meet the general criteria in paragraph 1 above and policy-specific conditions where set out below:

   (a). research, including general research, research in connection with environmental programs, and research programs relating to particular products;
   (b). pest and disease control, including general and product-specific pest and disease control measures, such as early-warning systems, quarantine and eradication;
   (c). training services, including both general and specialist training facilities;
   (d). extension and advisory services, including the provision of means to facilitate the transfer of information and the results of research to producers and consumers;
   (e). inspection services, including general inspection services and the inspection of particular products for health, safety, grading or standardization purposes;
   (f). marketing and promotion services, including market information, advice and promotion relating to particular products but excluding expenditure for unspecified purposes that could be used by sellers to reduce their selling price or confer a direct economic benefit to purchasers; and
   (g). infrastructural services, including: electricity reticulation, roads and other means of transport, market and port facilities, water supply facilities, dams and drainage schemes, and infrastructural works associated with environmental programs. In all cases the expenditure shall be directed to the provision or construction of capital works only, and shall exclude the subsidized provision of on-farm facilities other than for the reticulation of generally available public utilities. It
shall not include subsidies to inputs or operating costs, or preferential user charges.

3. Public stockholding for food security purposes

Expenditures (or revenue foregone) in relation to the accumulation and holding of stocks of products which form an integral part of a food security program identified in national legislation. This may include government aid to private storage of products as part of such a program.

The volume and accumulation of such stocks shall correspond to predetermined targets related solely to food security. The process of stock accumulation and disposal shall be financially transparent. Food purchases by the government shall be made at current market prices and sales from food security stocks shall be made at no less than the current domestic market price for the product and quality in question.

4. Domestic food aid

Expenditures (or revenue foregone) in relation to the provision of domestic food aid to sections of the population in need.

Eligibility to receive the food aid shall be subject to clearly-defined criteria related to nutritional objectives. Such aid shall be in the form of direct provision of food to those concerned or the provision of means to allow eligible recipients to buy food either at market or at subsidized prices. Food purchases by the government shall be made at current market prices and the financing and administration of the aid shall be transparent.

5. Direct payments to producers

Support provided through direct payments (or revenue foregone, including payments in kind) to producers for which exemption from reduction commitments is claimed shall meet the basic criteria set out in paragraph 1 above, plus specific criteria applying to individual types of direct payment as set out in paragraphs 6 through 13 below. Where exemption from reduction is claimed for any existing or new type of direct payment other than those specified in paragraphs 6 through 13, it shall conform to criteria (b) through (e) in paragraph 6, in addition to the general criteria set out in paragraph 1.

6. Decoupled income support

(a) Eligibility for such payments shall be determined by clearly-defined criteria such as income, status as a producer or landowner, factor use or production level in a defined and fixed base period.

(b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.

(c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.
(d). The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period.

(e). No production shall be required in order to receive such payments.

7. Government financial participation in income insurance and income safety-net programs

(a). Eligibility for such payments shall be determined by an income loss, taking into account only income derived from agriculture, which exceeds 30 per cent of average gross income or the equivalent in net income terms (excluding any payments from the same or similar schemes) in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry. Any producer meeting this condition shall be eligible to receive the payments.

(b). The amount of such payments shall compensate for less than 70 per cent of the producer’s income loss in the year the producer becomes eligible to receive this assistance.

(c). The amount of any such payments shall relate solely to income; it shall not relate to the type or volume of production (including livestock units) undertaken by the producer; or to the prices, domestic or international, applying to such production; or to the factors of production employed.

(d). Where a producer receives in the same year payments under this paragraph and under paragraph 8 (relief from natural disasters), the total of such payments shall be less than 100 per cent of the producer’s total loss.

8. Payments (made either directly or by way of government financial participation in crop insurance schemes) for relief from natural disasters

(a). Eligibility for such payments shall arise only following a formal recognition by government authorities that a natural or like disaster (including disease outbreaks, pest infestations, nuclear accidents, and war on the territory of the Member concerned) has occurred or is occurring; and shall be determined by a production loss which exceeds 30 per cent of the average of production in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry.

(b). Payments made following a disaster shall be applied only in respect of losses of income, livestock (including payments in connection with the veterinary treatment of animals), land or other production factors due to the natural disaster in question.

(c). Payments shall compensate for not more than the total cost of replacing such losses and shall not require or specify the type or quantity of future production.

(d). Payments made during a disaster shall not exceed the level required to prevent or alleviate further loss as defined in criterion (b) above.
(e). Where a producer receives in the same year payments under this paragraph and under paragraph 7 (income insurance and income safety-net programs), the total of such payments shall be less than 100 per cent of the producer’s total loss.

9. Structural adjustment assistance provided through producer retirement programs

(a). Eligibility for such payments shall be determined by reference to clearly defined criteria in programs designed to facilitate the retirement of persons engaged in marketable agricultural production, or their movement to non-agricultural activities.

(b). Payments shall be conditional upon the total and permanent retirement of the recipients from marketable agricultural production.

10. Structural adjustment assistance provided through resource retirement programs

(a). Eligibility for such payments shall be determined by reference to clearly defined criteria in programs designed to remove land or other resources, including livestock, from marketable agricultural production.

(b). Payments shall be conditional upon the retirement of land from marketable agricultural production for a minimum of three years, and in the case of livestock on its slaughter or definitive permanent disposal.

(c). Payments shall not require or specify any alternative use for such land or other resources which involves the production of marketable agricultural products.

(d). Payments shall not be related to either the type or quantity of production or to the prices, domestic or international, applying to production undertaken using the land or other resources remaining in production.

11. Structural adjustment assistance provided through investment aids

(a). Eligibility for such payments shall be determined by reference to clearly-defined criteria in government programs designed to assist the financial or physical restructuring of a producer’s operations in response to objectively demonstrated structural disadvantages. Eligibility for such programs may also be based on a clearly-defined government program for the re-privatization of agricultural land.

(b). The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period other than as provided for under criterion (c) below.

(c). The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.

(d). The payments shall be given only for the period of time necessary for the realization of the investment in respect of which they are provided.
(e). The payments shall not mandate or in any way designate the agricultural products to be produced by the recipients except to require them not to produce a particular product.

(f). The payments shall be limited to the amount required to compensate for the structural disadvantage.

12. Payments under environmental programs

(a). Eligibility for such payments shall be determined as part of a clearly-defined government environmental or conservation program and be dependent on the fulfillment of specific conditions under the government program, including conditions related to production methods or inputs.

(b). The amount of payment shall be limited to the extra costs or loss of income involved in complying with the government program.

13. Payments under regional assistance programs

(a). Eligibility for such payments shall be limited to producers in disadvantaged regions. Each such region must be a clearly designated contiguous geographical area with a definable economic and administrative identity, considered as disadvantaged on the basis of neutral and objective criteria clearly spelt out in law or regulation and indicating that the region’s difficulties arise out of more than temporary circumstances.

(b). The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period other than to reduce that production.

(c). The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.

(d). Payments shall be available only to producers in eligible regions, but generally available to all producers within such regions.

(e). Where related to production factors, payments shall be made at a degressive rate above a threshold level of the factor concerned.

(f). The payments shall be limited to the extra costs or loss of income involved in undertaking agricultural production in the prescribed area.

Source: World Trade Organization, Uruguay Round Agreement on Agriculture
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