

## **9. FOOD AND AGRICULTURE POLICY IN EUROPEAN PERSPECTIVE<sup>184</sup>**

9.1 With the signing of the Stabilization and Association Agreement with the EU, Croatia faces the imperative to reorient its institutional and policy framework toward the need to compete on European markets. A whole cohort of reforms will be needed to create an internationally competitive agricultural sector and ultimately reconcile Croatia's agricultural policy with the CAP. An analysis of the impact of alternative agriculture policies for agriculture could help the Government in facing the challenge of choosing the right path to approach the future CAP. This study highlights the critical strategy and policy issues for Croatia's food and agriculture sector, providing a set of priorities for agriculture and rural development policies, in the context of Croatia's eventual integration with the EU.

9.2 The chapter will provide an overview of agriculture and food policies and describe the status of sectoral reforms. It will then assess selected impacts of potentially introducing the CAP under alternative scenarios and identify critical issues in this Report. The chapter concludes with reform proposals to accelerate reforms in agroprocessing, input supply and marketing and to adopt EU-type institutions and regulatory system.

### **A. AGRICULTURE AND FOOD SECTORS - OVERVIEW**

9.3 Agriculture, although smaller, continues to constitute an important component of the Croatian economy, and contributed 8.3 percent of GDP in 2001, which is still above the CEECs average. The importance of agriculture in GDP increased substantially in the initial post-independence period, from 10.3 percent in 1990 to 14.9 percent in 1992, mainly due to its higher resilience as compared to the other sectors of the economy which could not sustain the impact of the war and the loss of external markets (Figure 9.1). Since then, however, the share of agriculture has declined significantly, and has hovered around 9 percent since 1995.

9.4 Besides its role in the national economy, agriculture has always played an important role in Croatian society. Of the total population of 4.5 million people, approximately 42 percent live in rural areas. Levels of employment in agriculture, though decreasing, are still relatively high compared to the EU and the most advanced CEECs. After the relative increase at the beginning of the 1990s, when agriculture served as a buffer for livelihood and the sharp loss of employment in other sectors, employment in

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<sup>184</sup> This chapter was prepared by Csaba Csaki and Antonio Nucifora, based on a broader World Bank study by Csaba Csaki, Antonio Nucifora, Rapeepun Jaisaard, Thomas Herzfeld, Stejpan Tanic on the Croatian food and agriculture sector.

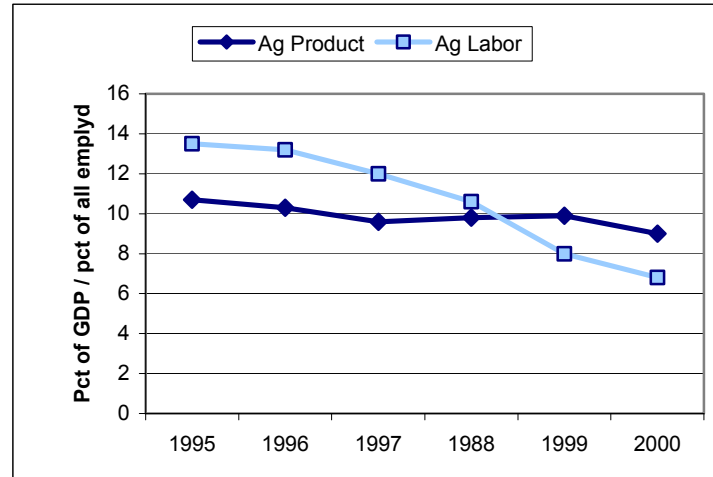
agriculture has decreased to the level of 8 percent. Three-quarters of actively employed in agriculture are self-employed farmers<sup>185</sup> (Figure 9.1).

9.5 Although it decreased less than the other sectors of the economy, agricultural production fell heavily from 1991 to 1992 (Figure 9.2). After the initial collapse in the early 1990s, gross agricultural output started to recover, however, still exhibiting a high degree of variation and instability. Crop production recovered rapidly, driven by a steady increase in the area cultivated, and by 1998 it exceeded its 1990 levels. Livestock production continued to decline from 1992 to 1996, due to a continued reduction of livestock numbers, and has now stabilized at around 70 percent of its original level (Figure 9.2). These differing trends have changed the structure of agriculture production, with crop output increasing to 57 percent of total production in 2001 from 49 percent in 1990.

9.6 Yield trends vary by crop and farming sectors. Maize is the only crop for

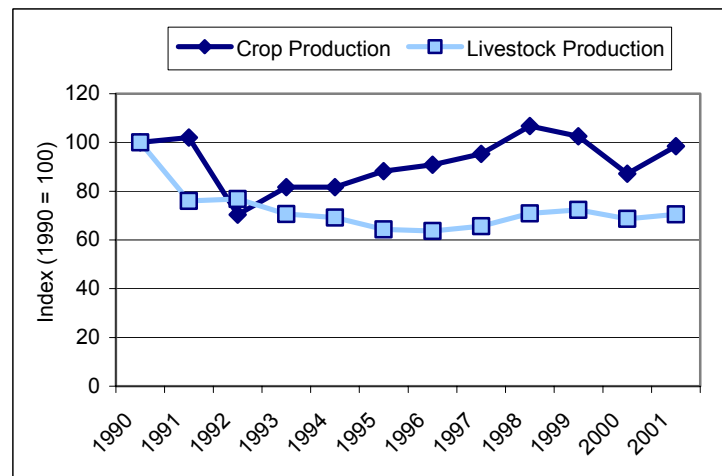
which yields have increased beyond the levels achieved in 1990, and this applies to both private farmers and AKs. For other crops, yields have recovered somewhat since 1992 but remain around or below the yields obtained at independence. AKs yields remain higher than private farm yields, although the margin has narrowed somewhat. In most cases, Croatian yields are below those observed in the EU 15 although close to the average of CEECs. The livestock sector has experienced significant changes in the level

**Figure 9.1: Contribution of Agriculture to GDP and Employment**



Source: Central Bureau of Statistics.

**Figure 9.2: Crop and Livestock Production (1990=100)**



Source: Central Bureau of Statistics.

<sup>185</sup> There are no official employment records and the assessment is based on indirect information about farmer's included in the health and social security schemes.

and composition of production over the last decade. Still, today livestock herds are significantly smaller than in 1990, notably because the cattle herd that is about half its pre-war size. Sheep, pig and poultry numbers have all begun to increase since 1998, due perhaps to increased demand in response to higher disposable incomes. As with crop production, per animal production is generally well below EU standards. In addition, livestock yields are significantly below those achieved by the EU accession countries.

9.7 The economic crisis of the early 1990s badly affected the food industry. Following independence and war, the socially-owned agroprocessors lost their traditional markets in former Yugoslavia. Their resultant over-capacity was exacerbated by the fall in domestic agricultural production and domestic demand. Output fell by over 35 percent, and since 1993 it has remained at less than 65 percent of 1990 production levels. Correspondingly, the share of agroprocessing in GDP decreased from 6.9 percent in 1990 to 4.6 percent in 2000.

9.8 Trade in food and agricultural products account for about 10 percent of all exports and 9 percent of all imports in 1999-2001, with trade in processed food products accounting for 70 to 80 percent of the total. This is somewhat lower than in the early 1990s, when agriculture accounted for about 14 percent of exports and 13 percent of imports. The agricultural trade deficit was almost US\$400 million in the year 2001.

9.9 Croatia's traditional trading partners in the former Yugoslavia are the most important market outlets, accounting for 55 percent of all agricultural exports in 1999 and 2000. In 1999 and 2000, the EU accounted for 42 percent of imports. A strong negative balance of trade thus characterizes trading relations with the EU, in contrast to the positive balance of trade with the countries of the former Yugoslavia. The volume of trade with the EU, both exports and imports, is likely to increase significantly in the future, as a result of the SAA which has reduced the barriers to trade on both sides of the border.

## **B. STATUS OF SECTORAL REFORMS - ISSUES**

9.10 As a result of overall macro-economic reforms, the agricultural sector now operates in a macro-economic and trade environment with direct links to world markets. The level of policy and institutional reforms achieved by Croatian agriculture, is, however, lower than among the leading reformers within the EU accession and candidate countries. According to the World Bank agricultural policy rating system evaluation<sup>186</sup> (based on a 1-10 scoring system where 1 represents a centrally planned economy and 10 represents a fully developed market economy), Croatia achieved a score of 7 in 2001, up from 5.8 in 1997. This constitutes significant progress in recent years, but Croatia is still behind Poland, Lithuania, and Romania, and still further behind the front runner countries of the Czech Republic, Hungary, and Slovenia. Current support programs, however, represent a complicated and sometimes inconsistent package which obviously creates

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<sup>186</sup> For a discussion of the methodology involved in this ranking system, refer to C. Csaki and J. Nash, *The Agrarian Economies of Central and Eastern Europe and the Commonwealth of Independent States: Situation and Perspectives 1997*, World Bank Discussion Paper No. 384, World Bank 1998.

distortions. The Ministry of Agriculture describes the current agricultural policy framework as gradually evolving toward CAP-type instruments. In reality, however, they would need further adjustment to fully conform with current EU practices. Past government interventions were largely discretionary and frequently lacking in transparency, as opposed to the rule-based systems of public intervention that characterize well-managed market economies. Without a more credible and consistent approach to policy and implementation, producers and processors will continue to avoid or postpone the changes that are needed to improve the sector's overall competitiveness.

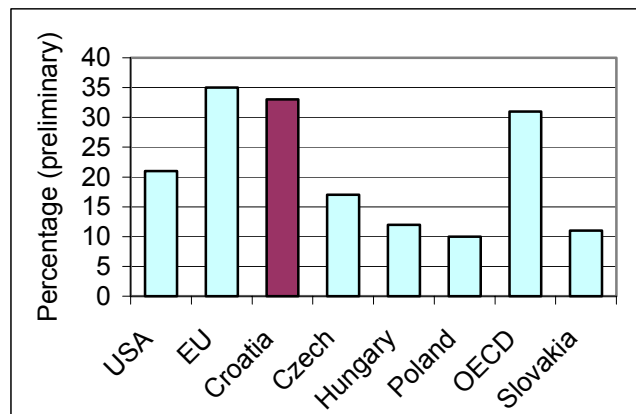
### Distortive Agricultural Support Policies with High Subsidization

9.11 The current system of price and support policy has its roots in the reforms introduced in 1998, in conjunction with the reform of trade policy required for WTO membership. To compensate farmers for the reduction of import protection and associated floor (producer) prices, area payments were introduced for most major crops combined with a quota system. Direct price subsidies for crops and all input subsidies were terminated.<sup>187</sup> These reforms have led to a significant increase in budget expenditures (from 2 percent of the central budget in 1995-1998 to 4.4 percent in 2000) supporting agriculture. On average, in the period 1999-2001, 54 percent of the agriculture budget was spent on support to crop production and 33 percent was spent on livestock production.

9.12 Reflecting this high level of Government expenditure, the percentage Producer Support Estimate (PSE) for Croatian agriculture appears to be quite high.<sup>188</sup> This basic measure of agricultural support was estimated at 33 percent in 2001. The current level of support, while comparable to EU and OECD averages, is significantly higher than that provided by its neighboring CEECs (Figure 9.3).

9.13 The Government hoped that the increased support would reduce production costs and by extension, farm gate prices, and at the same

**Figure 9.3: Producer Support Estimates (percentage) for Selected Countries in 2001**



Source: OECD and staff calculations.

<sup>187</sup> Implicit input subsidies remain on fuel through tax exemptions, and on interest rates for publicly funded rural credit programs.

<sup>188</sup> The Producer Support Estimate is an aggregate measure of support that summarizes the effects of a variety of government policy measures in a single figure (OECD 2000, 1987). In brief, to compute the PSE for a given year one has to calculate the ratio of total transfers to producers by the value of production adjusted for direct payments and levies to producers.

time secure adequate income levels for farmers. In reality, however, the area payments were combined with the requirement to purchase the inputs from domestic producers and traders, who, protected by tariffs, exhibited monopolistic behavior. This resulted in transfer of benefits to upstream and downstream sectors. Moreover, the allocation of (subsidized) area quotas was left to the local municipalities. This introduced an arbitrary decision process, supposedly carried out on the basis of the previous production structure, but often in a non-transparent manner. The system of subsidies was based on an arbitrary annual allocation which could give rise to lobbying and bad governance. The allocation of subsidized area quotas has had the effect of freezing and perpetuating the existing production pattern. Moreover, it has negative distribution effects; the small farmers who mainly produce for home consumption are excluded and the largest farms, as well as monopolistic processors and traders get most of the benefits.

9.14 A new reform of agricultural support policies was approved in 2002 and became effective in 2003.<sup>189</sup> This reform brings in a number of significant changes that addresses several weaknesses of the previous system. The main innovative feature is that *any farm can now apply and automatically receive the production payments, without having to be allocated a quota by the municipal authorities. Introduction of a national maximum supported quantity of each particular production* has been envisaged to make sure that total expenditures do not grow unchecked. If the requests exceed the total national quantity (crop area or livestock heads) the specific incentive will decrease proportionally. *Also a maximum amount of yearly subsidy payment per farm has been introduced.* Other important features of the new approach are the separation of economic and social objectives—that are mixed in the current system—and the separation of sectoral and rural development support policies. A basic precondition for introduction of this new system is the classification of rural households between commercial or potentially commercial, and economically viable farms, and non-commercial households on the basis of the size measured in production units and the age of the active household family members. Since this implies creation of the farm register, which has only just begun (and is partially constrained by unresolved problems with the land register), the new system is likely to experience some difficulties initially.

9.15 Under the new reform, policy instruments are grouped in four categories:

- A “production support scheme” is envisaged for commercial farms, which have the obligation to register in the farm registry and to pay VAT. The production support program is similar to the existing model and consists of annual area payments for most arable and permanent crops and annual payments per livestock head. However, the number of different support schemes will be reduced (from 12 to 9 groups), allowing for larger product groupings eligible for area payments. This has the advantage of allowing farmers slightly greater flexibility to allocate quota areas across more products (within each group). As mentioned above, any farm can now

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<sup>189</sup> The new ‘Law on State Subsidies in Agriculture, Fishery, and Forestry’ was approved in July 2002 and became effective in January 2003.

apply and receive production payments, and the level of subsidy may vary depending on total requests.

- In addition, commercial farms also benefit from the farm capital investment scheme, which envisages the institution of grants for farm investment – up to 25 percent of total investment. No further details of this scheme have been made public so far.
- A new “income support scheme” is an alternative to the production scheme and has been envisaged for non-commercial farmers who are at least 55 years or older (mainly family farms with limited production). Qualifying farmers are now offered the option to receive an annual lump-sum income support payment in place of area production subsidies. This is aimed at stimulating the exit of small farms with elderly household members and creating an enabling environment for land market transactions leading to an increase in average farm size.
- A “rural development scheme” is envisaged as competitive grants in support of the projects within three major support programs (a) development of rural areas; (b) protection and preservation of authentic animal breeds; and (c) marketing of local produce.

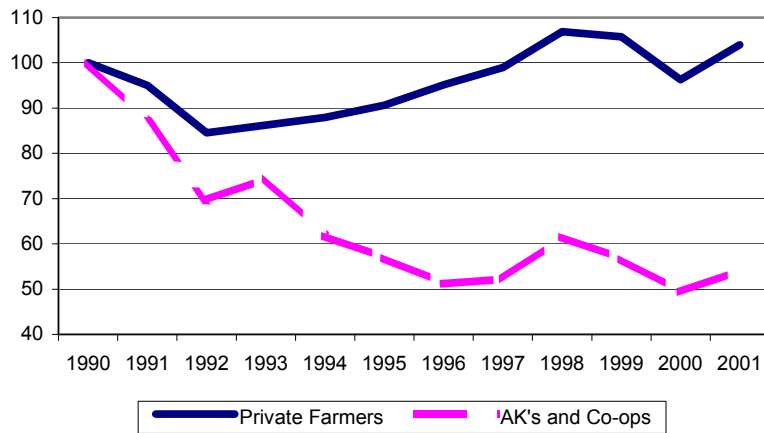
### **Incomplete Transition in the Farming Sector**

9.16 Croatia was one of the few countries in Central and Eastern Europe whose agriculture was not collectivized and remained predominantly organized in private family farms. Small-scale farmers with less than five hectares of land owned three-quarters of arable land, while the remaining quarter belonged to large AKs that frequently combined production and processing activities. Croatian traditional farm managers at the AKs seem to have been in a better position than in most other Central East European countries to apply survival strategies based on payment arrears, soft state budgets, and bad debts; they also seem to have enjoyed more effective political representation and support which ultimately delayed rather than facilitated their restructuring. This bi-modal farm structure has continued to prevail with profound implications for the development of the sector.

9.17 The public and private responses to economic transition have indeed differed substantially (Figure 9.4). Small-scale private farms recovered quickly from the impact of war and have increased output steadily since 1992.<sup>190</sup> By 1998, their production exceeded the level achieved in 1990. The AKs and cooperatives, on the other hand, have struggled to respond to the new economic environment. Output fell steadily after 1990 until it stabilized at 50 percent-60 percent of independence levels in 1996 and 1997. Livestock and crop output fell in equal measure during this period, reflecting the inability of these enterprises to adapt to the constraints and opportunities created by reform. Private family farms produce the bulk of agricultural output.

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<sup>190</sup> Measured as an index of net agricultural production (excluding crops used for animal production), valued at a three-year moving average of producer prices; as reported by the Croatian Bureau of Statistics.

**Figure 9.4: Agricultural Production Indices (1990=100)**

Source: Croatian Central Bureau of Statistics.

### Unconsolidated Land Ownership with Significant Role of the State

9.18 Although private land ownership continued to exist during communist rule, it was constantly restricted. Currently, 30 percent of the agricultural area remains under state ownership. The transfer of state agricultural land ownership is proceeding very slowly; only a negligible 7,280 hectares of state-owned land has been sold so far. Documentation on private land ownership remains sketchy. For more than half a century, land transactions between private owners were not properly recorded in the cadastre and land books. For roughly 40 percent of the agricultural land area, the ownership remains unclear and according to government estimates, it will take up to 15 years to clarify all private land ownership disputes. Currently, there are about 300,000 unresolved land registry cases at the various land courts. As a result, land markets are barely functioning.

9.19 There is, however, an active informal lease market, especially among private farmers, and mainly for short-term leases, and this market provides some (limited) flexibility at present. Land leasing has, to some extent, always been a practice between private individual farmers even during the socialist period. Land leases were based on informal agreements for short terms leases, most often annual, while rents were determined in kind. Although there are no official records of the extent, this practice has continued during the last 10 years. However, there was also an increase in formal leasing arrangements, particularly by pro-active and more commercially oriented farmers. Furthermore, the introduction of direct payment systems also stimulated formal leasing arrangements, because when applying for subsidies, farmers may also use lease contracts as proof of land availability. Realizing that the lessees benefit from state support (area payments may account for almost 30 percent of the gross income per hectare), lessors tend to increase rents.

9.20 The Government has a decisive role in land markets. First, its influence on land policies and second, as the largest single landowner in the country. Buyers of state-owned land currently have access to highly subsidized state credit, which inflates land prices. There is no justification for taxpayers subsidizing the purchase of land. Non-collection of

lease payments has a similar result. The less efficient farms are thus able to survive, and land does not become available to the potentially more efficient.

### **Barely Restructured Agroprocessing Industry**

9.21 Due to the slow pace of privatization and the low levels of FDI, only limited restructuring and modernization has occurred in Croatian agroprocessing over the past decade, resulting in a continued decline in the output of most commodities. The agroprocessing sector can be broadly differentiated in three groups:

- Private sector processors are mostly modern and up to international standards. Several have constructed new state-of-the-art facilities and are manufacturing and trading against top line competition from neighboring countries and multinationals, and are supplying into the supermarket chains. They are progressing well and some appear set to become important players on a regional basis.
- The second group is composed of privatized former public sector companies—food processors—that have been bought out, usually by the employees or managers, and have commenced major modernization programs with substantial investments. Many companies are operating successfully and are exporting.
- The worst situation is being faced by the third group, the AKs. Many of these are loss-making, still public-sector enterprises that have been bailed out with Government funds several times and are in a holding pattern pending decisions on privatization. The plants and buildings at most AKs processing factories are reportedly in poor condition and deteriorating. These firms will face renewed pressure over the next 3-4 years, as trade protection declines due to the reductions negotiated with the WTO.

### **Weak Commodity Markets**

9.22 The poor development of competitive agricultural markets at the wholesale level would create quite a significant impediment to introducing the CAP. One of the main characteristics of the CAP is the fact that price and market support is mostly done at the wholesale level and not at the farm gate. It constitutes an indirect support to farmers and not a direct intervention by buying directly from farmers. As a result, farmers in the EU benefit most when wholesale markets are competitive and the commercial margins taken by the wholesale marketing agents remain minimal, thanks to a high degree of competition. If, as is often the case in Croatia, a small number—sometimes only one—buyer is active in a region, there is not much pressure on this buyer to minimize its commercial margin nor its costs. The rent created by the intervention of the State (in the form of market price support) in such a case is likely to remain in the books of the local monopoly rather than being passed on to its suppliers. The competitive functioning of wholesale markets, therefore, is an essential prerequisite to the transmission of the CAP-like support to producers. The current status of wholesale agricultural markets in Croatia raises the possibility that these gains will accrue to the oligopolistic wholesale agents

rather than the farmers. Accordingly, the Government should facilitate the emergence of alternative and competitive private wholesaling firms for major agricultural products. Marketing cooperatives and associations have yet to establish a strong presence in agricultural markets, as the basis for improved market access and lower marketing costs.

### **Limited Use of Credit**

9.23 A strong private sector capacity for lending to small, private farmers has yet to evolve in Croatia, and public lending to these farmers is very limited. Available data suggest that less than 1 percent of the total number of small farmers is currently borrowing 80-90 million kuna annually, with an average loan size of 40,000-45,000 kuna. Public schemes, such as the Ministry of Agriculture Special Account for the Development of Agriculture (SADA), and the Croatian Bank for Reconstruction and Development (HBOR) rural SME program, have had mixed results at best, the former due to the high default rates and the latter due to the very limited amount lent to small farmers (about 12 million kuna). On the private side, the limited involvement of commercial banks in farm lending is caused by a lack of expertise in dealing with small farmers, the low level of profitability and potentially high-riskiness of farming, the relatively high transaction costs of the small loans required by small-scale farming, the existence of government credit schemes with subsidized interest rates which undermine the commercial market, the lack of provable title to land (and the lack of adequate land markets which limit the collateral a farmer can provide), the weak enforcement of contracts and bankruptcy procedures, and a culture of non-repayment of loans.

9.24 There has been little effort to broaden the institutional base for credit delivery beyond public credit programs and traditional commercial banks. Other than some small savings and credit cooperatives, the private sector financial institutions that target small enterprises and flourish in rural areas elsewhere are absent in Croatia. Given the large population of rural households, most of whom are part-time farmers, there is no obvious reason that the savings and credit cooperatives could not be expanded, and that micro-credit organizations could not be established. There is equal scope for specialized commercial banks such as the Micro-Enterprise Banks now operating successfully in Serbia, Bosnia and Kosovo, which also target small enterprises.

### **Weak Representation of the Private Sector**

9.25 The Agriculture, Forestry, and Food Industry Department of the Croatia Chamber of Economy (CCE) presently acts as the overall representation of the various players in the food and agricultural sector. All legal commercial entities in Croatia are required to register with the Chamber. Although the CCE purports to represent private farmer interest, however, it represents primarily the interests of larger corporations, which in agriculture tend to be the remnants of former socially owned enterprises. The CCE does not seem to provide an adequate representation of private interests for each profession in terms of vertical integration of each particular subsector. Adequate representation of all stakeholders or agents is crucial for the smooth operation of markets, as it ensures that all interests are accounted for in the decision making process and that market power is well balanced across all agents. Asymmetric distribution of market power is at the root of

market failures associated with oligopolistic rents. Similarly, a lack of adequate representation will eventually lead to sub-optimal policy decisions. In the EU, such representation is a crucial element of the implementation of the CAP. It contributes to a better understanding of private interests by the European Commission and the governments in the EU, and of government policies by the concerned private sector. In addition, many decisions related to trade, research and technology, market information, training could be taken in common by operators belonging to the same profession or to the same marketing chain (the so-called inter-professional associations, or, like in Hungary, the "product councils"). The development of such organizations should be promoted and facilitated, parallel with the abolishment of compulsory membership in the CCE.

### C. FUTURE POLICY OUTLOOK AND WELFARE IMPACT

9.26 Croatia is likely to experience a number of changes in agricultural policies over the next few years. *First*, a reform of agricultural policies has just been introduced in January 2003. *Second*, the implementation of the SAA will lead to a free trade area between Croatia and the EU. *Third*, Croatia may eventually join the EU's Common Agricultural Policy.

9.27 The implications of the adoption of the various agricultural policy scenarios on farmers incomes, on consumer incomes, on poverty levels and on the budgetary implications has been simulated using a partial equilibrium modeling framework. The key results of the model's simulations for each of these policy changes are summarized below.

#### Impacts of the 2003 Reform of Agricultural Policies

9.28 As discussed above, the 2003 reform will bring in a number of significant changes. The reduction in the number of product groupings in the support schemes will allow greater flexibility to producers in production decisions. As a result, the levels of support for some products will be changed, leading to adjustments in production. The impact will not be homogeneously distributed, with some farmers gaining and some losing, depending on their production mix. The net result should be an overall increase in farmers' income. This will be achieved via an increase in budgetary outlays financed by taxpayers. *Our simulations indicate that the 2003 reform of agricultural policies will altogether increase farmers' incomes by 8 percent, but lead to a 0.24 percent reduction of average household incomes due to higher taxes needed to finance the new farm support expenditures.*

#### Implementation of the SAA

9.29 The implementation of the SAA will eventually lead to a free trade area between Croatia and the EU. All quantitative import restrictions have been abolished with the entry into force of the Agreement. Also, the Community has abolished all customs duties and charges on imports of agricultural products originating in Croatia (with very few

exceptions).<sup>191</sup> Croatia has abolished custom duties for some products and will progressively reduce duties on the remaining products to between 20 percent to 50 percent of current levels (depending on the product) by 2006. A scenario was run to simulate the effects of implementation of the SAA under the current 2003 reform regime. Elimination of restrictions and reductions in duties on agricultural goods will generally lead to a decrease in agricultural prices (although the price of a few products will moderately increase), leading to an overall average 4 percent decrease in food prices favoring consumers in general and the poor in particular – in view of the larger share of food on their consumption basket. *Overall, the implementation of the SAA will lead to lower prices which in turn will imply real income gains of 1.5 percent on average household income and will reduce poverty by about 1.7 percent. The continuation of the current regime of direct payments in Croatia will lead to a projected 2.5 percent increase in farmers' incomes - agricultural production will rise 6 percent on average – over the long term.*

### **Adoption of the Common Agricultural Policy**

9.30 What would then be the additional impact of adopting the EU's CAP? EU-like agricultural reforms would probably have a mixed impact on incomes in Croatia. While the new policies would harm farmers, the population as a whole would be better off due to lower food prices on average- some agricultural prices will rise and others will fall. Specifically, compared to current policies (as envisaged under the 2003 reform), the CAP-type policies would lead to *a reduction in farmers' income of about 1.6 to 1.9 billion HRK, and an overall gain for consumers of about 2.6 to 3.6 billion HRK. These calculations imply a net welfare gain of between about 0.6 percent to 0.8 percent of GDP as a result of the reduction in agricultural support (compared to existing policies). Further, under the CAP-like policies, the number of poor people in Croatia is projected to decrease from 28.7 percent to 27 percent.*

9.31 The magnitude of negative impact of the CAP on farmers' income compared to the 2003 reform policies depends on the amount of direct payments and the level of support prices. The highest decrease in farmers' income would result from the simulation of the so-called "Agenda 2000" policies, without direct payments: these would lead to a reduction of farmers' incomes of about 35 percent in the medium to long term. However, implementation of Agenda 2000 policies including EU direct payments (at the level of 35 percent of those granted to EU farmers, in line with the recent EU proposal to accession candidates), would limit the reduction in farmers' income to 24 percent (compared to the base scenario).

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<sup>191</sup> EU agricultural products also benefit from production subsidies and export subsidies. These subsidies, however, are within the limits allowed under existing WTO agreements. In order to counteract this problem, several accession countries have negotiated the so-called "double zero" trade agreements with the EU. These agreements open up farm trade in a smooth, step-by-step way, through developing trade flows on which neither duties nor export refunds are paid. This type of negotiated agreement would allow Croatia to resolve the issue in a manner that does not violate its WTO commitments.

### **The Net Welfare Impact of Various Agricultural Policy Scenarios Against the Counterfactual of No Intervention**

9.32 A scenario has also been run to evaluate the impact of the various agricultural policies discussed above by comparing the impact of the various policy regimes with the results of the *removal of all government policy interventions (and assuming no EU transfers)* (Scenario E in Table 9.1). The results of this comparison in the model's simulation highlight that significant economic welfare losses were associated with pre-2003 agricultural policies. In fact, *as much as 2.7 percent of Croatia's GDP was being lost (change in net welfare) as a result of pre-2003 government intervention in agriculture* (Scenario A.1 in Table 9.1). Pre-2003 intervention had a positive impact on farm incomes, but a more than equivalent negative impact on the income of the population at large, due to the higher food prices associated with these policies.

9.33 Simulations show that agricultural policies under the 2003 reform (Scenario A/2 in Table 9.1) result in an even larger (77 percent) increase in average farm incomes compared to a non-intervention scenario. However, as in the previous scenario, higher food prices imply increases in consumers' food expenditures of about 10 percent on average and, since Croatian households on average spend about one-third of their disposable income on food and beverages, an equivalent 3 percent reduction in average household incomes, with the greatest reduction for the poorest households. The net welfare loss – 2.7 percent of GDP – vis-à-vis the non-intervention scenario is similar to the pre-2003 policies since the increase in farmers' income (HKR637.5 million) is far smaller than the reduction of household incomes (HKR5248 million). Given the large impact on farm incomes, these results also call for caution in removing government intervention in agriculture. However, they also suggest that it would be more efficient to transfer income to farmers directly via equivalent lump-sum payments, without distorting agricultural markets and creating such large welfare losses.

9.34 Although the adoption of CAP policies (Scenarios C2 and C3 in Table 9.1) would represent a welfare improvement with respect to the pre-2003 regime, these policies still would fall short of achieving the economic gains associated with a system based on lump-sum payments and no distortions. When measured against the standpoint of economic efficiency, it becomes clear that adoption of the CAP would maintain significant economic welfare losses in Croatia's agricultural sector. Specifically, simulations show that the CAP Agenda 2000 policies would correspond to net welfare losses of about 1.3 percent GDP compared to the removal of government intervention scenario. Compared to a non-intervention scenario, the CAP Agenda 2000 policies would lead to increases in farmers' income of about 0.5 billion HRK (excluding direct payments), but an overall loss for consumers of about 2.6 billion HRK, again due to the higher food prices. As mentioned, the net welfare losses are somewhat smaller than under the current policies, at about HKR2.2 billion (or 1.3 percent of GDP). These policies, therefore, represent a moderate improvement with respect to pre-2003 agricultural policies in Croatia, and fall short of the gains that would originate from the complete removal of distortions (2.7 percent of GDP).

9.35 Simulations show that the CAP mid-term review proposals (scenarios D1 and D2 in Table 9.1) also would fall short of achieving the full welfare gains which would arise from removal of government intervention, but they would constitute an improvement with respect to current policies and CAP Agenda 2000 policies (as a result of the slight price reductions envisaged in the CAP mid-term reforms). As compared to a non-intervention scenario, the mid-term review would lead to an increase of about HRK0.07 billion in farmers' income and an overall loss of about HRK1.6 billion for consumers. The net welfare loss compared to a non-intervention scenario would be just under 1 percent of GDP. Both the Agenda 2000 and mid-term review scenarios are associated with increases in the percentage of the population below the broad poverty baseline poverty (respectively an increase of 1.5 percent and 1 percent) albeit less than under current Croatian policies.

**Table 9.1: Net Welfare Impact of the Various Agricultural Policy Scenarios, Compared to Non-Intervention**

	Change in farmers' income <sup>1</sup> (long-term)		Direct payments	Change in farmers' income less direct payments (Long-term)		Change in household income (long-term)		Change in net welfare (long-term)		Poverty (long-term)
	(1)	(2)		(3)=(1)-(2)	(4)	(5)=(3)-(4)	(5)/GDP)*100			
	Million HRK	%	Million HRK	Million HRK	%	Million HRK	% <sup>2</sup>	Million HRK	Percentage of GDP	Percentage of population below Broad Baseline <sup>3</sup>
Scenario E: Non Intervention	0	0.00	0.0	0.0	0.00	0.0	0.00	0.00	0.00	25.9
Scenario A1: Pre-2003 policies	2114.3	67.91	1514.6	599.7	19.26	-5248.9	-3.04	-4649.2	-2.69	28.7
Scenario A2: 2003 reform policies	2397.9	77.02	1760.4	637.5	20.48	-5248.9	-3.04	-4611.3	-2.67	28.7
Scenario C2: Agenda 2000 with 35% direct payments <sup>4</sup>	1107.6	35.58	607.6	500.1	16.06	-2659.0	-1.54	-2158.9	-1.25	27.4
Scenario C3: Agenda 2000 without direct payments <sup>4</sup>	457.5	14.69	0.0	457.5	14.69	-2659.0	-1.54	-2201.5	-1.28	27.4
Scenario D1: Mid-term review with 35% direct payments <sup>4</sup>	841.4	27.02	775.1	66.3	2.13	-1674.8	-0.97	-1608.5	-0.93	26.9
Scenario D2: Mid-term review with decoupling <sup>4</sup>	840.6	27.00	775.1	65.6	2.11	-1674.8	-0.97	-1609.3	-0.93	26.9

Notes:

1. Income effects deriving from market price support and income effects deriving from direct (compensation) payments to farmers are considered jointly.

2. Based on HR GDP of HRK billion 172.66 in 2001.

3. Poverty Line using Food-Energy-Intake method + 50%. The base data for Scenario A were taken from *Poverty and Inequality in Croatia*, Erzo Luttmer (2001), Background Paper for *Croatia: Economic Vulnerability and Welfare Study* (World Bank Economic Report 22079).

4. These are the direct payments granted to EU farmers as compensation for the price cuts introduced under the CAP reforms in 1992 and 1999.

Source: World Bank staff estimates.

## D. CRITICAL ISSUES FOR EUROPEAN INTEGRATION

### Selecting the Appropriate Course for Agricultural Policy

9.36 The logical conclusion of the simulations presented above is that Croatia would be better off (a) to align its instruments of agricultural policy with those of the CAP; and (b) to bring down the levels of produce support from the current high levels to below those currently offered within the EU. The levels of support within the CAP are in any case declining and Croatia must take into account the evolving reflect, among others, the results of the 2002 WTO Ministerial Conference in Doha. In the interim period, Croatia would be best served by a set of agricultural policies that significantly reduce or eliminate current distortions to achieve potential welfare improvements elaborated above. Croatia should also facilitate the process of privatization and restructuring to ensure improvements in efficiency and competition. A two-phase strategy is therefore recommended (a) immediately remove current distortionary policies and implement policies to accelerate farm restructuring; and (b) prepare for the adoption of EU agricultural policies, but not apply them (or not apply them at the same level as the EU) until accession. nature of the instruments and requirements of the CAP as a “moving target”. The latter will need to be adjusted to

9.37 In the first phase, current policies should be immediately reformed to concentrate support towards enhancing efficiency and competitiveness, as well as reducing the overall levels of support, in order to create the necessary pressure for the required restructuring in primary production and processing. The agricultural policy framework and support system would need to focus on the following objectives:

- **Removing the current policy emphasis on self-sufficiency (expressed in a range of price support measures and direct production incentives).** The new support program continues to use the argument of food security to advocate self-sufficiency of food production. Given the open trade environment of our time in general, and the trade goals of European integration in particular, Croatia should shift its agricultural policy away from self-sufficiency and towards competitiveness and efficiency in agricultural production.
- **Refocusing agricultural policies towards improving competitiveness and accelerating farm restructuring.** A more effective use of budgetary support to agriculture requires the revision of support programs to focus on efficiency enhancement rather than direct subsidies. In order to support efficiency enhancement, many EU accession countries have made investment grants the major form of budgetary support to agriculture. Other policies to facilitate efficiency enhancement include measures facilitating the exit of inefficient farms via the imposition of hard-budget constraints and good bankruptcy legislation and procedures, and removing obstacles to the expansion of new and more efficient units such as the unresolved land ownership issues and the creation of functioning land markets.

- **Strengthen the separation of social safety-net from agricultural policies.** Measures to reduce social tensions and provide social protection in the rural areas need to be separated from the major instruments of agricultural policy aimed at improving efficiency and competitiveness. The 2003 reform of agricultural policies has made progress in the right direction.

9.38 The second part of the strategy, therefore, entails the **adoption of the same policy instruments as used in the EU** (but not applying them at the same level as in the EU). Agenda 2000 and other recent proposals for the reform of the EU's CAP should be used as a benchmark in this work. In particular, the following adjustment would need to be considered:

- The market support system needs to be adjusted to a transparent CAP-conforming framework incorporating the potential use of quotas in the case of some products. Changes should be made in the current intervention which is based on an *ex-ante* system (the intervention is based on short-term forecasts on production and consumption) to an *ex-post* CAP type intervention mechanism when market intervention decisions by private sector are based on the observed evolution of market prices. In addition, to be consistent with the principles of the CAP, price support would need to be transferred to the wholesale level instead of the farm gate for most products.
- The direct payments and other current structural support measures have to be adapted to the EU format, while new ones, such as an agro-environmental program will have to be introduced. The generalized area payment scheme outside of the less-favored areas could be adapted and fitted into the national envelopes proposed for the dairy and beef sectors under the Agenda 2000.
- A more integrated regional and rural policy and related support programs have to be developed.
- The taxation system and the provided tax concessions need to be harmonized with the EU practices and requirements. All tax preferences for farmers, in particular, would have to be eliminated (including the current tax exemptions on fuel used for farming purposes).

### **Consolidation of the Farming Sector**

9.39 The task of creating a farming sector that has the potential to be competitive in an eventual European environment is complex. Policy and institutional measures should concentrate on the following major objectives.

- **Settle remaining land ownership issues and create conditions for a functioning land market.** A strict deadline should be set for identification and resolution of uncertain land ownership, and beyond that deadline much of the state-owned land should be expeditiously privatized through

auctions. It is also essential to remove distortions and uncertainties resulting from the involvement of local authorities from the land lease markets. Specifically, the following actions can be recommended: resolve all outstanding claims for land restitution with a strict deadline in the near future;

- accelerate the development of a land cadastre and registration system to facilitate both restitution and settlement of all existing registration problems;
  - break up most of the unclaimed state-owned farmland into lots and sell by tender as a means of enlarging or creating viable private farms;
  - terminate the subsidized loans currently given for purchases of state-owned land;
  - strictly enforce all existing lease and land concession contracts; and
  - drop the legal provision to renegotiate land lease prices.
- **Accelerate the privatization and restructuring of remaining AKs and other large farming structures.** The Government should revise its current approach to privatization of agro-combines, since in their current form they do not provide a viable framework for profitable operation. Several recommendations can be made:
    - First, the privatization of the remaining AKs should take place immediately to avoid any further waste of public funds and any further deterioration of the conditions of the equipment and buildings at most AKs processing factories.
    - Second, privatization should be carried out on the basis of individual components, which would be formed as separate legal entities prior to privatization. The Government should not attempt to keep the AKs intact. Its role should be limited to dividing up the AKs according to existing functions and offering each part for sale separately, without any attempt at ‘second guessing’ what commercial investors actually want. Those units that do not find viable commercial investors within a given time period should be liquidated.
    - Third, the Government must recognize that as indicated by the experience of other transition countries and past experience in Croatia as well, privatization of financially insolvent companies does not lead to the desired results. These companies require new capital, market linkages, new products, etc, that an employee/general manager group is not able to provide. Therefore, privatization should aim at attracting new owners, either domestic or foreign, and additional FDI.
  - **Impose hard-budget constraints.** Unprofitable farms must be allowed to disappear and free the resources for profitable and efficient operations. This can only be achieved by adopting hard-budget constraints, encouraging strict financial discipline, and effectively implementing the ultimate threat of bankruptcy for non-performers, regardless of farm type.

## **E. ACCELERATING THE NECESSARY REFORMS IN AGROPROCESSING, INPUT SUPPLY AND MARKETING**

9.40 The main impediments to Croatia developing competitive processors, marketers and the farms behind them concern land, post-harvest services, finance, irrigation and transport, investment conditions, regulatory burden, company governance and management. Certain technological supports are also crucial. The overall strategy should be to help all elements to become entrepreneurial and dynamic by reducing impediments and ensuring the availability of technological supports (Box 9.1). The continuing impediments in Croatia to efficient business operation, such as time-consuming registration requirements, difficult logistics, red tape, corruption, unreliable contract enforcement, legal vulnerability, non-transparent taxation, standards and regulations that are inconsistent with EU standards, etc. also need to be addressed.

### **Box 9.1: Challenges for the Agroprocessing Industry**

Processors in all transition countries, including Croatia, will be acutely affected by new EU legislation requiring all meat, milk and processed food products to be from HACCP-registered processing plants by January 1, 2004. This new deadline leaves the Croatian industry with considerable and costly work to be done in a very short time to bring their processing plants up to HACCP standards. The less profitable and poorly managed plants will not be able to finance the costs of modern equipment meeting ISO standards.

The primary task of Croatian agriculture and agribusiness must be to improve product quality and packaging while at the same time be able to compete on price, initially in domestic markets. From this base it can then expand into regional and EU export markets. Though export markets offer the potential for growth based on competitiveness, they presently account for a relatively small part of the value of total agricultural output. Products for export must continually meet the cost, quality, product-characteristic, delivery, and reliability requirements of evolving foreign consumer demand. The limited number and value of export commodities and the difficulty of meeting export market requirements, limits the capacity of agricultural exports to pull the whole sector into sustained growth or even to prevent decline.

The Government should not attempt to “pick winners” by favoring particular commodities, industries, work forces, types of enterprise or export destinations, but rather aim to develop an enabling environment for investment and production. Increasingly competitive domestic and international markets will pick the winners (and losers) on a continuous basis. Governmental regulations and “help” typically insulate their intended beneficiaries from the consequences of poor market performance, distort their incentives, prevent the adjustments necessary to retain market share, prevent the transfer of resources to firms and farmers that can adapt, and ultimately, cause the “beneficiaries” to fall far behind. Among other things, the Government should move to improve the climate for investment and SME development (e.g., reduce regulatory burden, improve contract enforcement and tax administration, improve product standards). In particular, it should create the conditions that foreign investors, with their knowledge of international food-industry trends, need to provide finance, technology, and risk-taking, management and marketing skills. One element of this is to improve the legal framework and enforcement to reduce monopolistic practices in agroprocessing and input supply.

9.41 Marketing cooperatives potentially have an important role in high-quality post-harvest activities and some processing and in intermediating between small holder producers and supermarkets and large distributors and exporters. But private, entrepreneurial agroprocessors and packers (and some large farms) will have the leading role in developing competitive high-value agricultural production, but only if there is a conducive business environment for them to operate in and grow. They are best placed to

sell in export markets, and thereby gain the volume necessary for competitiveness and market penetration.

9.42 Other needed reforms are to (a) improve court capacity for contract enforcement, and improve tax administration, which is perceived as non-transparent; (b) protect the rights of farmer cooperative members through the separation of cooperative professional management and membership (the establishment of a one member, one vote rule, the linking of membership fees to contribution to cooperative throughput, and the establishment of the unassailable indivisibility of cooperative assets); (c) develop a real-time national and international market information system, the national data based on production and marketing data provided by growers' associations (the current system is of limited use to agricultural traders and farmers); and (d) improve the efficiency of all private sector agents through programs to improve business management.

## F. CREATING EU-CONFORMING INSTITUTIONS AND REGULATORY SYSTEM

9.43 The Government of Croatia has already started the process of harmonization with the EU legislative and administrative system and has drawn a list of preparatory actions to begin the harmonization of Croatian legislation with the *aquis communautaire* in the area of agriculture and food. Given the administrative complexity involved in the operation of the CAP, the adjustments required are quite substantial. Not only the alignment of legislation will be necessary, but also the development of the judicial and administrative capacity to implement and enforce the new arrangements. Some institutions will need to be strengthened and some new ones created. Specific points of concern regarding the administration of the Common Agricultural Policy, food safety and control institutions, and veterinary and phytosanitary services, are highlighted below.

- **The establishment of an Agricultural Intervention Agency and a Paying Agency is a necessary prerequisite for the implementation of CAP-like arrangements.** The Agricultural Intervention Agency's main purpose would be to manage the smooth operation of the agricultural support regimes and their transition towards the CAP. The Payment Agency would disburse direct payments and other subsidies to farmers. Croatia is now taking initial steps in establishing a payment agency.
- **The introduction of the Integrated Administration and Control System (IACS) also constitutes a critical prerequisite for the functioning of the CAP.** The introduction of the IACS centralized database is particularly challenging because the current system in Croatia is entirely different from the EU-style IACS, and because the data required for the IACS system are not easily available. Notably, there is currently no farm register, no functioning cadastre and no Geographical Information System (GIS) imagery in Croatia. In addition, as is discussed below, the register of livestock herds is shared between two institutions. The Ministry of Agriculture and Forestry (MAF) has recently begun the process of preparation for the IACS and a new farm registry.
- **Establishment of an Agency or Department for Rural Development (ARD) would facilitate the implementation of a coherent rural**

**development strategy.**<sup>192</sup> The experience of both existing EU Member States and current applicants suggest the need for extensive training and assistance in supporting the preparation and implementation of rural development projects and activities at the local level. To overcome these difficulties, several governments have established Agencies for Rural Development (ARD), either as part of the MAF or as independent nonprofit organizations under the guidance and funding of the MAF. The ARD should be tasked with coordinating implementation of a coherent rural development strategy and supporting activities that promote sustainable, and balanced socio-economic development of rural settlements, generating employment, and additional sources of rural income, assisting rural entrepreneurship and helping villages prepare and realize development projects. The role of such an agency, notably in the preparation and implementation of rural development projects and activities at the local level, is fundamental to fostering rural development.

- **A unified veterinary and food control authority in line with EU policy would eliminate overlapping and improve efficiency.** None of the various agencies engaged in food safety and inspection focuses exclusively on food control and food safety issues throughout the distribution chain and across all product sectors. This situation has been faced by most EU nations, leading many to adopt the strategy of a single agency with sole responsibility for food safety matters including food processing, border inspection, monitoring of residues and inspection at markets. *This reform would also lead to a more homogeneous set of principles and processes and, therefore, to simpler and better-integrated food testing procedures across the whole food chain.* The harmonization of inspection standards, through common training, standard inspection guidelines, internal quality assurance and periodic benchmarking exercises would be an additional benefit of a common, focused management structure. In addition, putting the whole process under the supervision of a single authority would concentrate the responsibility and facilitate the decision making process; and the creation of a single body should facilitate the implementation of the relevant *acquis* for food safety and inspection of foodstuff and provide the EU authorities with a clear counterpart to address any food safety issues.
- **Several barriers to the free movement of food products will need to be removed.** Notably, the food quality standards and certification requirements will need to be integrated with those of the EU in such a way to allow free movement of food products originating from the EU.
- **Reorganizing the provision of animal husbandry services by reducing the public role and eliminating current overlapping would increase efficiency.** The current provision of animal husbandry services in Croatia and the management of livestock records are split under the responsibility

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<sup>192</sup> Croatia is currently working with the Food and Agriculture Organization to formulate a rural development strategy.

of two separate parastatal companies, the Croatian Center for Reproduction in Livestock Breeding and the Croatian Livestock Selection Center, with significant overlapping. The inefficiency associated with the overlapping should be eliminated by reorganizing the institutions and establishing a single livestock register. As farmer association membership expands and associations consolidate in the coming decade, farmers associations will likely take control of animal testing, as has occurred elsewhere.

- **Establishing a single, central agency to manage plant protection and adopting EU phytosanitary standards.** Only the Plant Protection Law (1987), which conforms to the International Convention for the Protection of New Varieties of Plants (UPOV), currently meets EU norms. Croatia also lacks a single, central agency, under the control of the national Government, to manage plant protection under EU standards. Such an Authority for Plant Health should become a state-funded one-stop-shop for plant health inspection, survey, management and certification, and should also be responsible for plant protection product monitoring and testing, and for residue testing. Croatia should also aim to the early adoption of the minimum legal plant protection requirements and procedures of the EU. This would involve preparing, using the same definitions of terms as in the EU legislation, general legislation for plant varieties, seeds and planting materials, plant health (harmful organisms), plant protection products, and pesticide residues, supported by detailed secondary legislation.
- **Promote and facilitate the creation of farmers association (based on voluntary membership).** Agricultural growth will be enhanced if farmers associate to provide services and seek representation in the market and at the political table, acting in their own interests, as farmers and members of rural communities, rather than in the pursuit of narrow vested interests as is so often the case today with existing organizations.
- **Adoption of EU standards will require a profound transformation of the current surveys in the areas of agriculture, forestry and fishing.** The Croatian Central Bureau of Statistics (CBS) has joined the arrangements made by Eurostat for candidate countries to develop their statistics on agriculture, forestry and fishing to meet EU requirements. Adoption of EU standards will require a profound transformation of the current surveys in the areas of agriculture, forestry and fishing given the different concept of these statistics as well as the fact that the data previously collected had concentrated on physical quantities, without monetary values.

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