

## **Institutional Development Promoting Agricultural Credit in Slovakia**

*Axel Wolz*

### **Abstract**

The transformation process in all Central and Eastern European Countries, including Slovakia, has been accompanied by the decline or even implosion of the former institutions and organisations. Among others agricultural production and (rural) banking had to be completely restructured. However, as it could be observed, while formal institutions and organisations collapsed and new ones have been established fairly easily in line with the market economic system, the norms, values and behaviour (or the informal institutions) of the people, including bank personnel and agricultural entrepreneurs did not change that rapidly or even not at all. Both groups had to learn to adopt to new rules and regulations which are common knowledge to their counterparts in the market economic system. Therefore, it is not enough to simply copy the rural finance system but to adjust it to the actual situation in the respective country. After some short remarks on institutions and organisations and the transformation of the agricultural production units in Slovakia the major problems of the agricultural credit system are assessed.

### **Institutions and organisations**

Institutions can be defined as "the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North: 3). They define and limit the set of choices of individuals based on values and goals of a given society. Institutions establish a certain behaviour pattern of acknowledged actions and reactions among individuals. Institutional constraints include both what individuals are prohibited from doing and under what conditions individuals are permitted to undertake certain activities. In this sense, they reduce risks in everyday life as well as on markets. They can be regarded as "the framework within which human interaction takes place" (North: 3-4). Institutions can be both formal, such as laws and decrees, and informal, such as unwritten conventions and codes of conduct that underlie and supplement formal rules. Institutional constraints have to be observed by the individuals, otherwise there will be no structure in everyday life as well as in the sphere of economic interactions. This implies, once the formal rules and the informal codes are violated, sanctions have to be enacted. In short, the formal and informal rules and the type and effectiveness of enforcement characterise the socio-economic system. Together they define the incentive structure of societies and specifically of economies.

A crucial distinction has to be made between institutions and organisations. Like institutions, organisations provide a structure to human interaction. Organisations are developing in

consequence of the framework set by the institutions. They can be looked upon as "concrete instruments for keeping a social system going on the basis of institutional patterns" (Kötter: 13). To illustrate the distinction between institutions and organisations, it can be said that the family, the market or banks as abstracts are institutions. A specific family, a village market or a local branch of a bank are organisations. Or to put it differently, the rules have to be distinguished from the players. The purpose of the rules is to define the way the societal and economic game is played. But the objective of a group of individuals within that set of rules is to accomplish certain tasks (i.e. "to win the game"). There is a permanent interaction between institutions and organisations. On the one side, what types of organisations come into existence and how they evolve are fundamentally influenced by the institutional framework. On the other side, they in turn influence how the institutional framework evolves (North: 4-5).

While it is the major role of institutions in a society to reduce uncertainty, they are changing permanently, albeit in general gradually over time. One of the main reasons to modify the institutional framework is the fact that individuals perceive that they could do better otherwise. Organisations can be identified as major agents of institutional change. However, institutional change means much more than just setting up new organisations. Institutional change means a change in the state of mind in the different groups of society, it means "changing the rules of the societal game" (Kötter: 10). However, whereas formal rules may change overnight as the result of political and judicial decisions, informal rules embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies. It takes time and a learning process in order to change these (North: 6).

### **Transformation in agricultural production**

Slovakia implemented a far-reaching transformation of the agricultural sector, which primarily comprised a privatisation and decollectivisation process. Up to 1989 collective farming was the dominant form of agricultural production. The national agrarian policy in light of the introduction of the market economic system had to tackle three problems at the same time: (a) to identify the legitimate owners of the agricultural resources, generally land and buildings, and transfer them to those ("restitution"), and (b) to create rational and efficient organisations of agricultural production. While the collective farms had to be transformed, it had to be assured that the supply of agricultural goods to the national consumers and export markets was not threatened. Finally, (c) the position of the agricultural production units vis-à-vis the state and the up-stream and down-stream sectors had to be newly defined, which includes, among others, the role of agricultural finance system.

Private ownership of land has become the prevailing pattern. Land ownership is highly fragmented; hundreds of thousands persons own on average 0.5 - 2 hectares. Many of them live in urban areas. Therefore, private ownership rights do not imply private farming. In 1994 just 5.6 % of the privately owned agricultural land is cultivated by private farmers. Still, 80.5 % of the privately owned land are managed by transformed agricultural producer co-operatives (APCs), whereas the last 13.9 % by business companies like joint-stock companies and limited liability companies. Agricultural production in Slovakia is characterised by a bimodal pattern these days: On the one side, there are about 20,000 private farmers cultivating up to a few hectares each. They can be characterised as subsistence farmers which ensure the food supply of the family with simple production methods. Some surplus is sold for cash. Only a small share can be regarded as the nucleus of viable family farms. Just three per cent of individual farmers cultivate more than 50 hectares for the time being. On the other side,

there are about 1,000 transformed APCs cultivating about 1,800 ha each. In addition, there are about 150 state farms cultivating, on average, about 3,000 ha. These are supposed to be privatised in due course (Blaas: 2-5). While their number has been quite small right after the transformation in 1992, joint stock companies and limited liability companies have become more important since then. The transformation of the agricultural sector is still an on-going process.

### **Transformation of the rural finance sector and implications for agricultural credit**

The changes in the financial sector of Slovakia have been profound. Reliable finance systems had to be created. As in market economies the functions of the central bank had to be separated from those of the commercial banks. In addition, existing commercial banks were privatised, new ones were established. In other words, the institutions and organisations, or more specifically the formal rules were copied from the market economies. However, the agricultural sector, i.e. both the private farms as well as the large-scale farming units, is still characterised by a low-input-low-output strategy. One of the main reasons is the missing access to credit which had been readily available during the socialist period. Due to the general low profitability, the still on-going changes of agricultural organisations and the difficulties in monitoring agricultural operations bankers regard agriculture as an unattractive sector for investments (high risks). Therefore, no competition among the banks developed, so far. The government had to react in order to avoid a total collapse in agricultural production. Although overall funds were cut back it intervened in three inter-linked areas, through (a) loan guarantee programmes, (b) investment subsidy programmes, and (c) credit programmes. As organisations, it set-up the Slovak Agricultural Bank in 1990, the Guarantee and Development Bank in 1992 and the State Support Fund for Agriculture and the Food Industry in 1994. The role of the state is vital for all three organisations.

In general, credit analysis by the banks can be based on the following three main criteria (Schemmann: 756): (a) With the assessment of personal indicators it is enquired whether the borrower used to show a good repayment morality in the past, i.e. if possible, there should be a proven repayment record. (b) With the help of economic indicators it is deduced whether the intended investment will be profitable, i.e. the borrower will be able to pay back the principal with interest after a stipulated period. (c) With the help of collateral indicators the bank assesses whether the borrower is the owner of assets whose resale value compensates the borrowed sum. In general, a borrower has to transfer respective ownership rights to the bank until he has paid back principal and interest, completely. The credit analysis in market economies might encompass one criterion or up to a mix of all three criteria which were not at all decisive during the socialist period. Therefore, when adopting the market economic system the informal institutions like the respective codes of behaviour and conduct have to be internalised by the bank personnel and the agricultural entrepreneurs if the financial system will be of a lasting nature. Based on in-depth interviews with bank managers and agricultural entrepreneurs, the following items seem to be of the utmost importance:

(1) During the socialist period the state allocated credit through the banks to the various agricultural collective enterprises in order to ensure that the targets in food production were met. The provision of collateral was not required. Similarly, the economic profitability of the investment had not to be ensured. It is evident that a close relationship developed between bank personnel and managers of the collectives. In case of debts the state was bailing out both

the banks and the collectives with fresh money, anyway. In these days, credits (as well as savings) cannot be arranged by the state, anymore but have to be decided by both sides according to their economic needs and potentials.

(2) In this respect, new rules and regulations, including changed obligations have to be observed by both sides. Both the undertaking of an investment and its financing through credit constitute costs and involve risks. The agricultural entrepreneur has to be prepared that his investment will not be successful. Nevertheless, he will have to pay back the principal and the interest through other sources of income. In an extreme case, he might have to file for bankruptcy. On the other side, also the banks have to reckon with defaults of credits. They have to be prepared to share risks in writing off debts. In some cases this might be the better option in the long run than to apply for bankruptcy proceedings of the respective enterprise.

(3) For the time being, the banks in Slovakia show little inclinations to run risks. They, including the Agricultural Bank and the Savings Bank are not making much use of their own capital in stimulating agricultural production. In general, they hand out credit as well as subsidies in line with those funds which have been allocated to them by the state budget and other external donors. In this respect, the banks adopt more the role of channelling state funds to the agricultural sector than of actively promoting economic growth at the local level. Therefore, a fourth criteria for credit analysis is decisive, i.e. whether it is guaranteed or supported by a fund.

(4) It is evident that the demand for capital is by far higher than the supply. So far, the banks have not encouraged savings among the population in order to enlarge their equity capital. During the first years of the transformation interest rates on savings were even lower than inflation. Now, there are indications that banks are looking for ways to encourage savings more actively.

(5) From the side of the agricultural entrepreneurs the process of applying for credit is quite confusing. Although the overall amount of credit is smaller than demand, there are various credit programmes handled by the Agricultural Bank which are financed by different national and international sources. Depending on the source of refunding the interest rates on credit vary from 5 % to the market rate of 20 %, annually. Similarly, the amount to be invested can be subsidised up to 40%. It is evident that all entrepreneurs want to be among those who get high subsidies on their investments and only have to pay the lowest interest rates. The guidelines in participating in one or several programmes are not very specific since their respective objectives are overlapping. Therefore, the bank managers of the branch offices are in a powerful position to decide who actually can benefit from what programme, or in other words, about their respective credit costs. Agricultural entrepreneurs are well aware of the need to have good informal contacts with their bank managers.

During the last years the international community supported the Slovak banks in organisational set-up and training of the staff to tackle these short-comings. Banks received technical assistance and training to improve a wide variety of fundamentals to prudent bank management. Still, there is a long way to go until a reliable rural finance system will be operational.

## Conclusions

Financial institutions and organisations in Slovakia need further strengthening in order to support agricultural entrepreneurs efficiently. As was shown above two major groups of agricultural entrepreneurs can be distinguished; namely private farmers on the one side cultivating small-scale farms and large-scale farm units, like APCs, joint-stock and limited liability companies on the other.

(1) Most of the private farmers took up cultivation after 1990. In most cases they cultivate an area of up to two hectares. In this respect, as the legal owners of land (and in most cases of houses, too) they can offer collateral for applying for credit. However, for the time being farmers are reluctant to do so. For most of them farming just signifies a survival strategy; a little surplus is sold for cash. Farm prices are relatively low. Most of them have no experience as farmers and they do not want to take any risks in these times of rapid change. Similarly, they do not want to lose their newly acquired personal property that quickly. On the other side, banks are not prepared to provide small-scale credits. The transaction costs are too high to hand out relatively small sums and to monitor their performance. In case of default in repayment the banks would have to keep the land since there is no market for land for the time being. Appropriate financial organisations serving this clientele are still missing. One option would be that those who want to continue with private farming will be encouraged to form savings and credit groups. There will be two effects: On the one side, private farmers as entrepreneurs will gradually get used to capital; on the other side banks will be able to cut their transaction costs. However, banks themselves are also required to search for appropriate organisational and financial innovations to address private farmers' financial service demands.

(2) Large-scale farming is still the dominant type of agricultural production in Slovakia. However, in line with the laws on privatisation and restitution, their asset base has decreased tremendously. The land they use for agricultural production is owned by private persons and has to be rented. Actually, they have limited values for collateral at their disposal, i.e. mainly buildings and equipment. Their credit needs can only approximately be assessed by the banks according to economic indicators. A network of banks is available which is supposed to serve this clientele, i.e. the organisations are already established. The informal rules of the institutions, however, are not fully adjusted as banks look mainly for external guarantee funds when analysing credit applications and only, to a limited extent, for collateral. Banks mostly distribute external funds and commit their own resources, marginally. Both bank personnel and agricultural entrepreneurs will have to pay attention to creditworthiness and to take loan repayments seriously (Csaki/Lerman: 23). So far, banks do not play a significant role in pushing for agricultural development.

## Acknowledgements

This paper is based on a joint research project executed by the Research Centre for International Agrarian and Economic Development, Heidelberg and the Research Institute of Agricultural and Food Economics, Bratislava and financially supported by the Volkswagen Foundation.

## References

- Blaas, Gejza (1994): *Privatisation and Restructuring of Agriculture and the Rural Sector in the Slovak Republic*. Paper prepared for FAO Agricultural Policy Network for Central Eastern Europe. Bratislava
- Csaki, Csaba and Zvi Lerman (1995): *Agricultural Transformation in Central and Eastern Europe and the Former USSR: Issues of Land Reform and Farm Restructuring*. Paper presented at the 41st EAAE-Seminar in Gödöllő, Hungary, 8 September 1995
- Kötter, Herbert (1988): *Institutions and Organisations in Rural Development*. Quarterly Journal of International Agriculture, Vol. 27, pp. 7 - 19
- North, Douglass C. (1990): *Institutions, Institutional Change and Economic Performance*. Cambridge, University of Cambridge
- Schemmann, Gert (1994): Ratio-Based Credit Rating Procedures Used By Co-operative Banks. In: Dülfer, E. (ed.): *International Handbook of Co-operative Organisations*. Göttingen, Vandenhoeck & Ruprecht, pp. 756 - 762