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**Implications of Domestic Policy Reform and Trade
Liberalization for Agricultural Sector: Estonian Case Study**

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Implications of Domestic Policy Reform and Trade Liberalization for Agricultural Sector: Estonian Case Study

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Since 1988 Estonia has gone through the difficult path of reforms. The aim of the reforms should have been to take Estonia out of the planned economy and enable it to be competitive under the rules of the market economy. It seems like 15 years provides a good enough distance to evaluate the success and consequences of these reforms on Estonian agriculture and food industry.

1. Background of the Transition

Production model of Estonian agriculture that was oriented on livestock production developed since the 2nd half of the 1960-ies on the basis of the so-called industrial principles, which aimed at concentrating the production and increased productivity. There were 350 state and collective farms in 1989, 300 000 cows and 1.4 million ha of land was in agricultural use. Most of the cows were kept in stables housing 200-600 cows. The value of assets in Estonian agriculture per one ha of arable land was 2,5 times higher and productivity of labour in livestock breeding 3 times higher than the average of the Soviet republics. This was the reason why the central government of the Soviet Union favoured imports of feeding crops to and exports of meat and dairy products from Estonia for supply of the big cities of the Soviet Union, this meant high processing capacity. Exports of livestock production accounted for 35-37% of total production in the end of 1980-ies.

2. The Transition

The 1st structural changes in Estonian agriculture began in 1988 being inspired by Gorbachov's "perestrojka", the declaration of independence of Estonia and readiness of rural population to re-establish private property and transfer from planned to market economy. Although Estonia was a part of the Soviet Union the political leaders had the will and courage to take the first steps towards market economy: pass legislation to re-establish private property (Farm Act on Dec 6, 1989 and Property Reform Act on June 13, 1991) and take decisions conflicting the economic principles of a totalitarian state. The aims of the Farm Act were based on the interests of entrepreneurship development. The wishes of the farmers and possibilities of modern technology were considered. There were 1053 farms in Estonia in 1989, but 3673 already in 1990.

During 1989-1992 several decisions were taken on the measures of agricultural support including creating favourable credit conditions to private farms: budgetary development of rural electricity, communication and road networks based on farm development needs and construction of irrigation systems and wells.

Systemic changes began after re-gaining the independence in 1991. The Land Reform Act was passed by the parliament of the independent Estonia (Riigikogu). Convertible national currency – the kroon (EEK) – was adopted in 1992 and the currency was devalued during the monetary reform. All subsidies were terminated the same year and all prices liberalised. The liberal foreign trade regime that was considerably more liberal than the average trade policy of the OECD, gave more advantages to processing industry and services sector that prolonged their ineffective existence and caused hidden taxation of farmers.

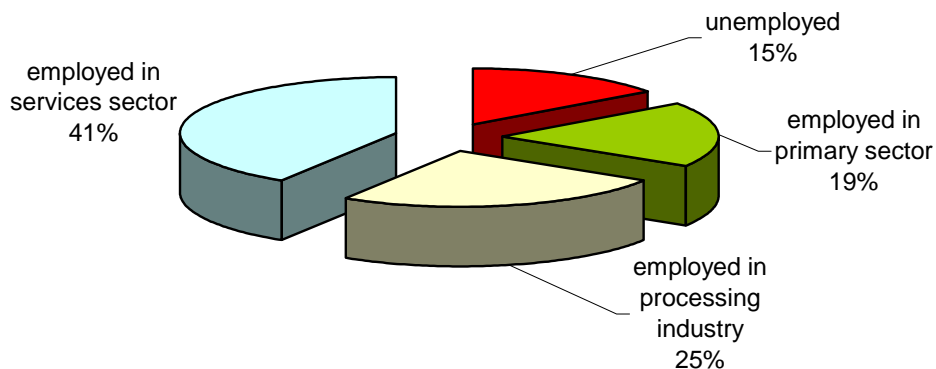
Aims of the land reform were based on the interests of lawful owners that conflicted with the interests of current farmers. The implementation of the Farm Act was stopped with the land reform.

The leaders of collective farms initiated the elaboration of the principles of the agricultural reform and the act was passed in 1992. It regulated the returning and compensation of collectivised assets and

privatisation of collective assets and liquidation of collective farms. More than 1/3 of collective assets was returned to lawful owners or compensated and given into municipal ownership. It is estimated that 3/4 of returned and compensated assets left agricultural sector. The process of agricultural reform generated conflict of interests between the new agricultural enterprises: owners of the production assets of limited companies and corporate farms with lawful owners who had the right of regaining land in previous boundaries.

The value of assets in collective farms in the beginning of the privatisation process was 67 billion Euros (before re-evaluation). Compensations in the amount of 24 million Euros were paid out on the account of collective assets to nearly 100 000 entitled subjects of the property reform, most of whom were no longer employed in agriculture.

Structure of Labour Force in Rural Areas in 2000
(% of the total rural labour force)



Source: Statistical Office of Estonia

In the conflict between the owners of production assets and appliers for property of land (restitution), the main loser was the development of agricultural entrepreneurship. Many agricultural enterprises lacked the clarity of becoming landowner in the future, which increased the risk for them to invest in agricultural production very much. It was also difficult to get credit as they lacked the collateral in the form of land property.

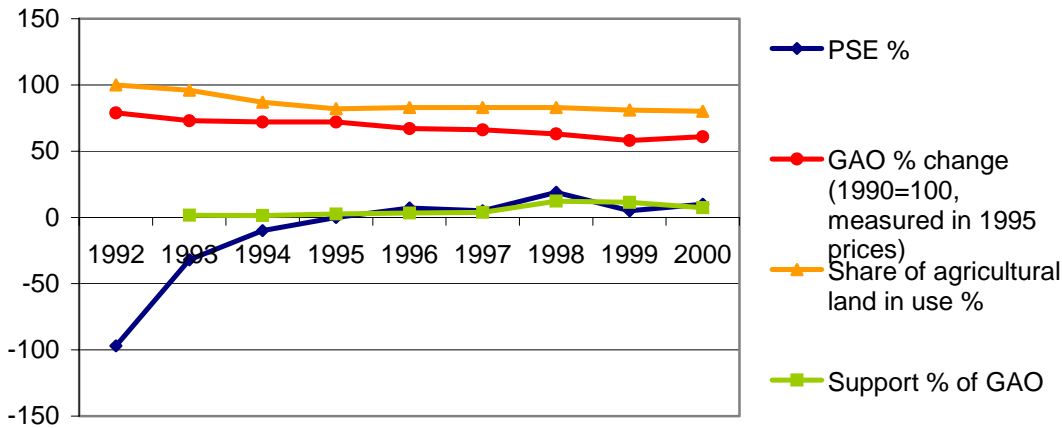
Agricultural reform was completed by 1996 in 2/3 and by 1997 in all collective farms.

Development of the Estonian agriculture was affected by radical changes in the economic environment and privatisation process. During 1990-1995 agricultural products and foodstuffs accounted for 17-24% of Estonian total exports and 10-16% of total imports. Demand for food products on both domestic and foreign markets declined during 1990-1994. Transition to market conditions was inevitable and showed the actual domestic and foreign demand. Prices of production input factors increased 17 times during that period, costs of agricultural production 11 times and consumer food prices 29 times, which was accompanied by decreased share for agricultural producers in the consumer prices of agricultural products and lower income of farmers.

Share of costs in prices was the main factor that demanded the adjustment process. Instead of protecting the national interests the simplified idea of free trade became dominant. The situation where import and export restrictions were absent gave the competition advantage to subsidised imports. This in turn caused decline in agricultural prices during 1992-1994 by an average of 1/3 when compared to the world market prices.

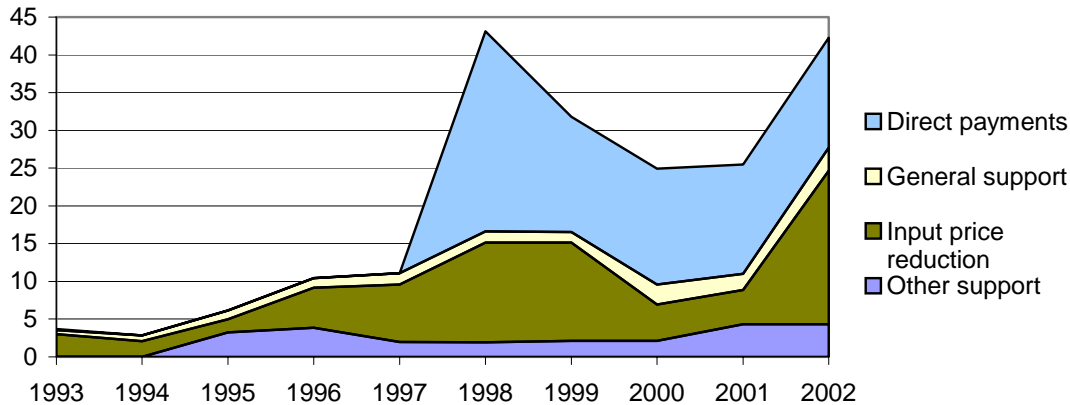
The nominal protection of agriculture was 0.51-0.89 during 1992-1994 (1.48 in OECD countries). According to estimations agriculture missed 21 million Euros in 1993 and 13 million in 1994 from the sales of milk alone thanks to the reduced prices. Agricultural support estimate was negative during that period -89% to -10%.

Support for Agriculture 1992-2000



Source: OECD PSE/CSE database, Statistical Office of Estonia

Budgetary Expenses for the Support of Agriculture, mn €



Source: Ministry of Agriculture

The pressure of the IMF for foreign trade policy choices was obvious. Based on the IMF memorandum the competition advantage was given to imports. As a result the domestic prices were suppressed and caused an outflow of means from agriculture to the services sector in an estimated value of 51-58 million Euros annually. Estonia had to accept the right of limited use of trade and market regulation mechanisms when becoming a member of the WTO.

In 1991 the soviet arrangement of financing the food industry, according to which low percentage (2%) credit was given for production process (cheese ripening period 3-4 months), was terminated. This caused substantial increase of debts of the food industry to agriculture. The industry paid to agricultural enterprises with a 3-4 months delay. Several processing enterprises bankrupted and did not pay for the raw material.

An agricultural congress in 1993 took many decisions through which the rural people expressed their will to the politicians but there was no significant impact on the political choices.

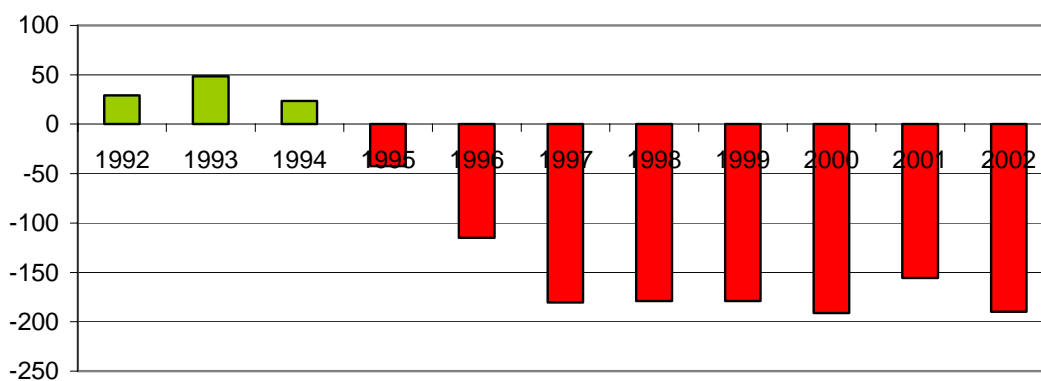
The decision of Riigikogu taken in February 1994 declared the need for fair prices, farm development, regional policy and implementation of market regulation mechanisms, however it was not considered necessary to work out farm and market regulation legislation.

Restrictions on imports of food products with dumping prices, introduction of agricultural support schemes and speeding the land reform was demanded with the decisions of the extraordinary rural congress of 1994 triggered by the deepening dissatisfaction of the rural population. According to the sociological surveys 97% of rural inhabitants considered the agricultural policy unsuccessful and 79% thought the land reform was not successful.

However, the politicians representing rural interests managed to succeed to a certain degree: Agricultural Market Regulation Act was passed in 1995. This Act aimed at creating the conditions for profitable agricultural production. The act regulated negotiations between the agricultural producers and the government, assessing the shortage of agricultural incomes and ways of support payment. Restrictions to food imports stated in the act were declarative and had no regulative effect. Unilateral openness and imbalanced economic relations caused an economic loss for the state as a whole as was found by researchers (J. Reiljan).

Since 1995 Estonia became the net importer of agricultural production. According to estimations an additional 1/3 of jobs ceased in rural areas as a result of imbalance economic relations. Sociological surveys found that it was impossible to find a new job close to the place of residence for 4/5 of previous members of collective farms who had lost their jobs.

Trade Balance of Agricultural Products (mn €)



Source: Statistical Office of Estonia

In 1995 the Europe Agreement was signed according to which Estonia was unconditionally obliged to accept the politics, purposes and measures of the Community. However, the systematic work with the *acquis* of the European Union started more than two years later in 1997 when the European Council decided to start pre-accession negotiations with Estonia.

Increased impact of the EU and the 1998 economic crisis, which caused the income (not accounting the subsidies) of farms and agricultural enterprises to decrease by more than 1/3, forced even the most radical ideologists of liberal economy to change their views.

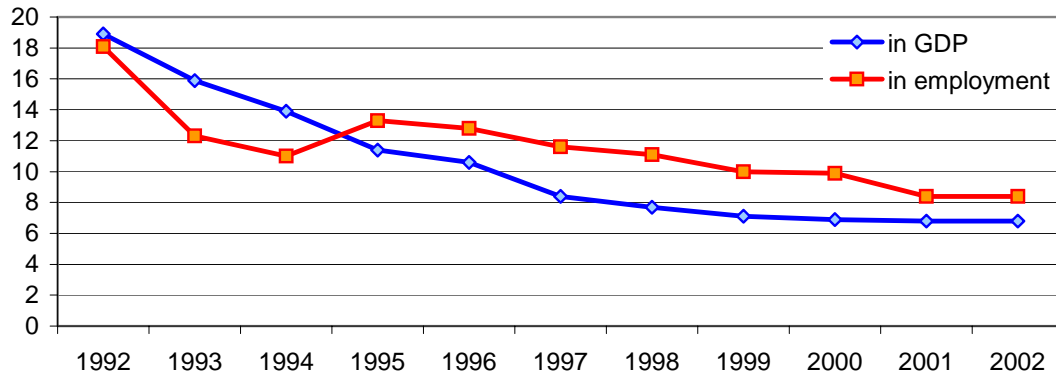
The pre-accession programs of the EU had a real impact on Estonian administrative capacity and on taking the production into compliance with international environmental and food safety requirements. Thanks to the SAPARD support investments to agriculture have doubled. Dairy industry already complies and meat-processing plants will be in accordance with the EU requirements by accession.

Food Act, which is in accordance with EU legislation and Rural Life and Agricultural Market Regulation Act, which is in accordance with the principles of the Agreement on Agriculture of the WTO and trade agreement with the EU, providing Estonia favourable conditions for development of food exports, were enforced in 2000. In the recent years alternative fields of activities have developed

in Estonia next to traditional agriculture: rural tourism, aquaculture, growing of herbs and spices etc. There are 17 rural tourism farms and motels per every 1000 km² in Estonia.

As the result of the reforms the share of agriculture in GDP during 1991-2002 decreased from 15% to 3.3% and employment in agriculture from 15% to 5%. The share of people employed in agriculture in rural employment fell from 56% in 1989 to 18% in 2001.

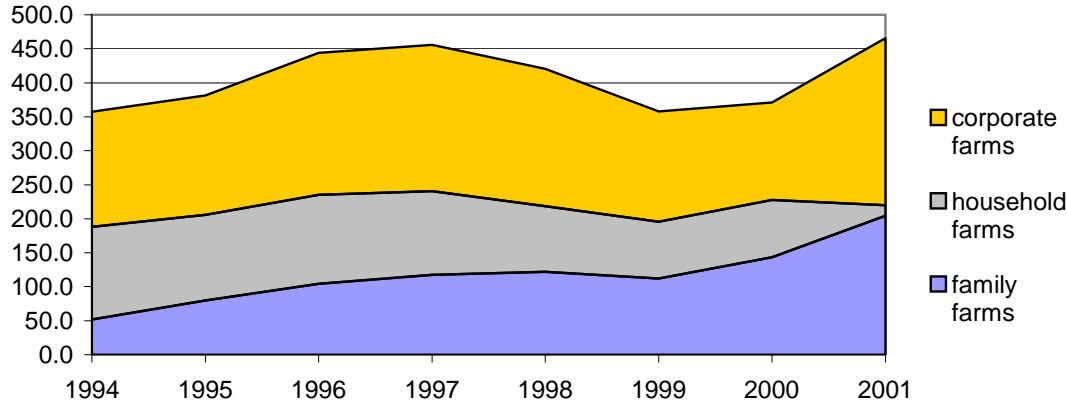
Share of Agro-Food in GDP and Employment, %



Source: Statistical Office of Estonia

Due to structural changes 8300 productive agricultural firms (farms, corporate farms and limited companies) were established in Estonia by 2001. The average size of those firms is 320 ha.

Share of different Farm Types in Agricultural Output (mn €)



Source: Ministry of Agriculture

In the round table of ministers of agriculture in the Transition Seminar held in Tallinn in December 2002, the success of reforms and achieved level of competitiveness necessary to succeed in market economy was evaluated on a 10-point scale. The first characteristic was evaluated with an average of 4.75 and the latter with 7.4. The evaluation seems to be paradoxical. One of the possible explanations would be, that agriculture happened to be in harsher economic conditions, when compared to developed countries and mostly the strong ones survived.

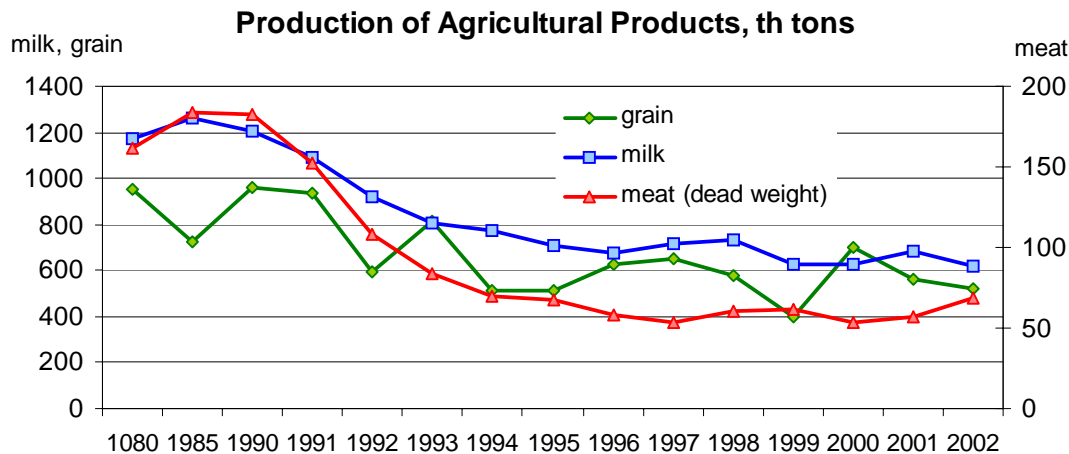
3. The Present Situation

The structure of Estonian agricultural production can roughly be split in two: there are small family farms and big farms developed from the old collective farms. This division is especially clear in milk production. 2/3 of milk producers have herds with 1-2 cows, but they produce 10% of total milk

production whereas 12% of milk comes from the herds of more than 900 cows and these herds constitute 0.2% of all herds.

Although the more efficient big farms have been maintained, due to the history of forced collectivisation co-operation of agricultural producers has proven to be difficult. In the light of the CAP reform it will probably be difficult to reach a consensus in the matter of direct payments base since small and big producers obviously would have converse interests.

Agricultural production has fallen significantly during the 15 years. Milk production has decreased by half (from 1.2 million tons to 0.6 million tons), meat production 60%, grain production 45%.



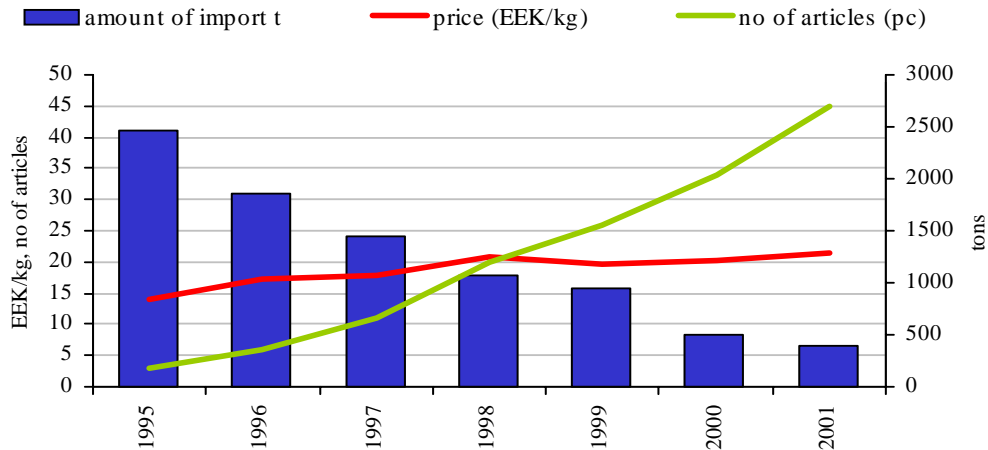
Source: Statistical Office of Estonia

This has caused large plots of unused agricultural land and abandoned production facilities, serious unemployment and thus social problems in rural areas, and also big unutilised capacities of food processing industry.

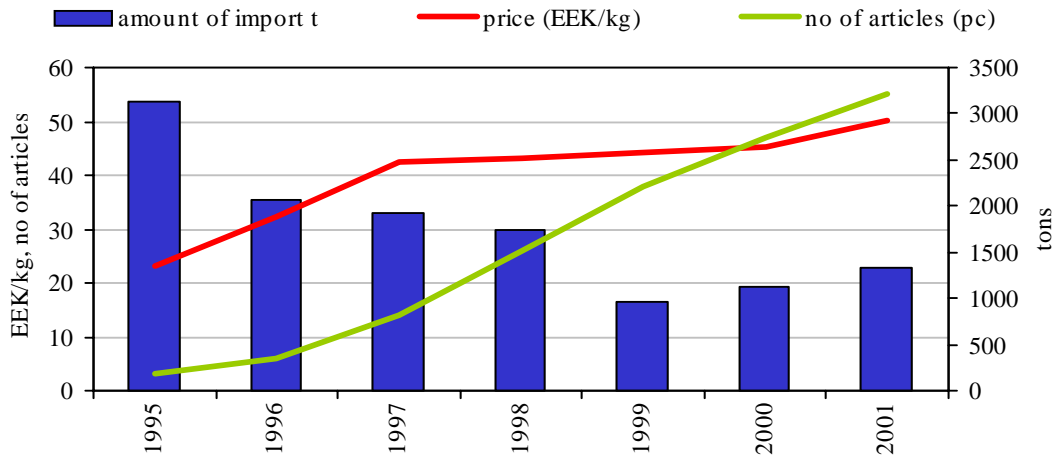
The liberal trade regime and the fact that there were many food processing enterprises created a very intense competition on the domestic market. Estonian food processors realised that the quality of their production needs to be elaborated in order to survive. Also the government initiated a quality label indicating Estonian products to promote domestic goods.

The product development resulted in an incredibly increased numbers of product articles, increased product quality, consumers preferring Estonian production and won-back market shares by Estonian producers.

Yoghurt



Ice Cream



Source: Estonian Institute of Economic Research

Higher quality for end products also meant that the quality of raw material had to go up. This has happened quite successfully in milk production, where today 91% of milk meets the EU requirements. This development was facilitated by the modern farm structure, it is easier to raise quality in big farms.

In grain sector, however, this development has not happened, first because the quality of Estonian grain is too poor to be suitable for processing into fine quality flour and further into pastry products. Thus, the domestic grain is mostly processed into animal feed. Second, because of the import of cheap grain and flour from Ukraine and Russia.

Meat cattle amounted to a mere 0.2% of total cattle in the beginning of transition. The number of meat cattle has increased to 3%. Purchasing power of the population is also growing (meat consumption has risen from 55 kg per capita in 1995-99 to 63 kg per capita in 2002), which stimulates production of higher quality meat. However the worldwide trend of red meat being replaced by poultry is also visible in Estonia.

The long-hoped structural adjustments in food industry have not happened. There are too many enterprises competing on the market dragging down the processing efficiency and therefore weakening the competitiveness of Estonian food industry.

The food industry is very well equipped, it has invested considerably during the 15 years, the investments have also been supported by the EU and Estonian government via the SAPARD programme to help the industry to comply with EU standards. As a result, the bulk of the companies have qualified for the EU, it seems that investments have exceeded optimality. Struggling with high cost, huge unutilised capacity, therefore limited possibilities to adjust profit margins and tough competition will place Estonian food industry into a difficult situation on accession.

As a result of the agricultural policy and the impact of the Russian crisis that forced many agricultural producers to stop the structure of agricultural production has somewhat clarified. There are small family farms that are not competitive with EU producers, but they maintain the production as a lifestyle. The other quite different side of agricultural production are the big farms where production is more industrial. These farms are more cost-efficient and therefore more competitive. The above-mentioned conclusion of the agricultural ministers seems to hold here: through the hard times only the strong ones survived.

The same does not apply for food industry as the industry has always had a buffer in the form of the producer where to transfer the losses. As a result the essential structural reform has not happened. However, this has led to good quality and wide selection of Estonian food products making the consumer the main beneficiary in this process.

Summary

Estonia has been often named as an example of the successful transition from the command economy to the functioning market economy; the key to the success was the ultimately liberal economic policy. The same approach was applied also to the agricultural sector, where the state support and border protection was minimal.

The evaluation of the success of transition in the agricultural sector has actually two dimensions. From the one side, this has led to the radical restructuring of the sector, where only the most efficient farms have survived. The agricultural production in Estonia, especially in milk and pork sector are concentrated now into the high capacity enterprises that are also quite competitive.

From the other side, the radical reforms accelerated the process that normally accompanies the efficiency increase in agriculture, namely the outflow of employment from agriculture, abandonment of land. The result was very high unemployment rate, low incomes in rural areas, and decrease of rural population. Although these are the problems with social character, social policy has been unable to address them. Furthermore, the speed of these processes, have left no time for adjustment to the rural community and finding alternative activities. The situation is rather contrary; there is a lack of investments in infrastructure, decreased access to different kinds of services in rural areas (schools, shops, banks etc.), which decreases further the incentives of people to establish new activities in rural areas.

To summarize, the restructuring of the agriculture and increased competitiveness has been realized at the expense of high social costs. It may be too early to conclude, whether the restructuring and competitiveness achieved, has generated more welfare than it has been lost. The result depends now on how well the rural community is able to gain viability and adjust to the changes. The issue is a very complex and time consuming. It can definitely not be solved solely by social or agricultural policies, rather by integrating rural community to the whole economy, developing human and natural resources.

Literature

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