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## **Twenty years of land reforms in Central and Eastern Europe: state of play and outlook**

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## **Twenty years of land reforms in Central and Eastern Europe: state of play and outlook**

### **Abstract**

The purpose of this article is to gain a perspective on the land reforms in the Central and Eastern European countries to show the extent to which the structure of agricultural production left by the socialist period has influenced the restructuring dynamics. In this context, the observed dual agricultural structure is seen as the result of a sticking point exacerbated by the agricultural transition's land component.

**Keywords:** transition, land reforms, property rights, initial situation

**JEL classifications:** Q15, D23, P32

## **Vingt ans de réformes foncières en Europe Centrale et Orientale : bilan et perspectives**

### **Résumé**

Cet article a pour but de mettre en perspective les réformes foncières qui ont été menées dans les pays d'Europe Centrale et Orientale pour montrer dans quelle mesure la structure de production agricole héritée de la période socialiste a influencé les dynamiques de restructuration. En particulier, la structure agricole duale observée est entendue alors comme le résultat d'un effet de blocage que la composante foncière de la transition agricole vient aggraver.

**Mots-clefs :** transition, réformes foncières, droits de propriété, situation initiale

**Classifications JEL :** Q15, D23, P32

## **Twenty years of land reforms in Central and Eastern Europe: state of play and outlook**

### **1. Introduction**

The economic transition in the Central and Eastern European countries involved a reallocation of resources to boost production efficiency, and called for market-based price and trade reforms and the privatisation of state-controlled production means (see Bignebat *et al.*, 2009). In the agricultural sector, privatisation entailed land reforms since land is generally the main factor input. Land legislation was among the first to be passed by the new governments elected at the end of the centrally-controlled regime. They were well aware of the vital need to privatise the land to maintain their countries' food production. The Central and Eastern European countries chose different forms of privatisation (restitution and/or redistribution) with mixed results. On the one hand, land fragmentation due to the privatisation method used and consolidation problems contributed to the persistence of small structures. On the other hand, large structures - state farms and collective farms - continued to operate through the transition. These factors have given rise to a duality in land structures. We put forward the hypothesis that, contrary to the dynamics observed in developing countries, where land privatisation is portrayed as an endogenous development due to growing land pressure, the initial conditions in place prior to the transition in the Central and Eastern European countries have played a key role in the development observed. Maurel (2006) concludes that the success of the economic reforms in the Central and Eastern European countries depends primarily on their historical and geographical heritage. In the agricultural sector, the “firm” component of the agricultural transition, i.e. the privatisation of state farms and collective farms as a whole (and not just the privatisation of the land), can hinder the reallocation of factor inputs as documented by the literature. This sticking point is exacerbated by the land aspect of the reforms conducted. The following section explains these land reforms.

### **2. The need for the land reforms and the methods used**

#### **2.1. The economic need for the reforms**

Many authors have pointed out the economic benefits of land reforms in the developing countries, especially the economic utility of the emergence of individual ownership rights. Although these benefits also apply to the countries with a centrally-controlled regime up to

1989, the reform methods used generally differ due to a characteristic that is specific to these countries: the initial situation.

### ***Ownership rights and the initial situation***

We consider the initial situation to be that which prevailed before the start of the transition period. The initial situations actually varied. The land collectivisation process launched in Central and Eastern Europe and the Soviet Union after the Second World War was not uniform across these countries. Civici and Jouve (2009) highlight the importance of resistance by farmers, historical traditions and political relations with the Soviet regime. For example, Poland and Yugoslavia avoided large-scale agrarian collectivisation and have always maintained a large agricultural sector under individual ownership. In the Central and Eastern European countries (with the exception of Poland and Yugoslavia), pre-transition land ownership was dominated by *de facto* control by state and collective farms – even though ownership rights remained individual in law except in certain cases, such as in Hungary (Macours and Swinnen, 2002). However, in the former Soviet countries of the Commonwealth of Independent States, land ownership on the eve of the transition was collective, and had been for over 70 years. Most of the former communist countries opted for large industrial production structures in two possible forms: a) state farms organised along the same lines as a firm, where employees received a wage and the state held all the rights to control investment and production; and b) collective farms very similar to state farms, but where worker remuneration was based on production (Rozelle and Swinnen, 2004). Despite substantial economies of scale, many empirical studies have concluded that these large structures were inefficient (e.g. Brada and King, 1993). Firstly, the separation of ownership and management did not give the workers enough incentive to work in a situation where earnings had little to do with the farm's performance. Secondly, labour supervision problems in these large-scale structures generated high transaction costs (Pollak, 1985; Schmitt, 1991). Thirdly, many collective and state farms ran at loss in the absence of any credible threat of bankruptcy or penalties for non-payment of loans granted by the central bank: the state granted generous government subsidies and allowed debt payments to be deferred (the soft budget constraint defined by Kornai, 1980). This situation did not concern the agricultural sector alone. The start of the economic transition therefore marked the start of reforms to remove price distortions induced by the centrally-controlled system and to re-establish incentives to guarantee farm profitability. In agriculture, this involved the liberalisation of the sector and the privatisation of production means, including the land.

We draw on Barzel's analysis (1997, p. 3) to define three types of ownership rights that can be transferred when an asset is privatised: the right to the profit generated by the asset, the right of use and the right of disposal - with the last two also being taken as a right of control over the asset.

***Private ownership rights, incentives and market efficiency***

The question of the economic benefits of land privatisation has been largely addressed by theoretical analyses conducted in development economics. The allocation of ownership rights, especially if they are individual, first secures land ownership and then encourages investment (Deiniger and Feder, 2001). Uncertainty over the returns on investment, due to the possibility of a third party creating an ex-post hold-up problem with the proceeds of this investment by claiming ownership of the good, discourages producers from committing to outlays that they could not recover in the event of a dispute.

Literature on the firm and its restructuring in a period of transition to a market economy raises another advantage to the privatisation of state farms. It finds that the links between the state (which, in the case of state farms, holds the right of control and the right to the profit) and the production unit imply the adoption of objectives often different to economic efficiency goals (Schleifer and Vishny, 1994), such as sustaining employment: given that privatisation allocates the right of control over the firm to private agents, production and investment decisions are more efficient. However, some analyses use the same theoretical framework to highlight the importance of the privatisation method. In particular, the transfer of shares to insiders, i.e. company employees, when the firm is privatised has been largely criticised: managers can take advantage of it to divert assets for themselves and take control of the firm, hence aggravating the soft budget constraint problem as the state refinances insolvent businesses (Debande and Friebel, 1995).

Lastly, where private owners have a right of disposal, privatisation allows for an efficient allocation of production means among heterogeneous individuals. In particular, as regards land ownership (Deiniger and Feder, 2001; Otsuka, 1985), the permanent or temporary transferability of the land encourages the reallocation of ownership, at least in the form of the right of use, to the relatively more productive units. Assuming that small farms, i.e. family farms, have a comparative advantage over large farms – due to lower labour supervision costs because they have no employees (Allen and Lueck, 1998) and in a situation of credit and labour market imperfections (Feder, 1985) – the large state businesses would have to downsize, and smaller, individual farms would logically emerge from the old farms or be

started up. Once again, the chosen method of privatisation should influence this relocation. In particular, in the case of the privatisation of collective or state farms by sale to insiders, the theoretical analysis shows that even an inefficient firm will not necessarily be bought out by outsiders (people from outside the firm), generally assumed to be more efficient in their management of the firm, since the coalition created by insiders raises their reserve sale price (Aghion and Blanchard, 1998). Similarly, some analyses of the reallocation of resources in transition economies (e.g. Bolton *et al.*, 1997) find that the transfer of ownership proves tricky where there are no prior savings at national level. At individual level, the literature makes this same observation of the developing countries, where private land ownership can enable producers to propose collateral as security when applying for credit (Deininger and Feder, 2001).

### ***Particularities***

In the case of the developing countries, Binswanger *et al.* (1985) are among the authors who analyse the emergence of individual private ownership rights as arising from greater land scarcity. This puts pressure on land and triggers an increase in the implicit value of the land (in the absence of markets) and therefore places a high opportunity cost on securing the land resource. The individualisation of ownership rights is described here as endogenous to the process of economic development. However, the transition countries start with a cohesive set of institutions based on collective or state ownership. This is followed by a break, in the form of privatisation, and then a shift towards new production structures via factor reallocation. In these circumstances, it is impossible to ignore the transition period's initial conditions, which some studies have underscored as being decisive (Macours and Swinnen, 2002, for the agricultural sector, for example). In particular, the transition economies have inherited a specific agricultural production structure and an agricultural sector comprising state and collective firms. Land reform consequently takes in an organisational aspect, as least in part, due to the privatisation of the production structures. Unlike certain developing countries where land reforms are autonomous and can consist of a simple land securitisation operation based on what is already there, land reforms in the transition countries cannot be analysed separately from the set of reforms to restructure the farms left over from the socialist period.

## **2.2. The land reforms: several possible processes**

Three options were available for the reallocation of collective and state ownership to the people: restitution, redistribution or a combination of the two. Restitution consisted of restoring ownership to the original owners, i.e. those who owned the land before the imposed collectivisation. In general, so much time had passed between this collectivisation and the start of the land reforms that the restitution had to be made to the heirs, often the grandchildren of the initial owners. Redistribution consisted of distributing shares in land or capital to the people. These shares could be distributed free of charge or sold at auction to any citizen or primarily to collective and state farm workers.

The Central and Eastern European countries chose restitution, with the exception of Albania, which opted for redistribution like the Soviet Union countries. Although the Soviet countries felt that restitution was the fairest reallocation process, they thought it unrealistic because they would have had to find out who the owners were 70 years previously (Lerman, 2001). Another argument put forward against restitution was to avoid ethnic divisions in sensitive areas (e.g. in the Transnistria region in Moldova on the border with Ukraine) and avoid restoring lands to foreigners who owned them before collectivisation (e.g. Germans in Moldova) (Gorton and White, 2003). Two countries, Hungary and Romania, opted for restitution combined with redistribution.

Privatisation of the collective and state farms therefore potentially implied a fragmentation of their production means and the total dismantlement of these entities. However, this was not automatic since employees receiving shares of capital and land could choose: i) to leave with these shares, ii) to sell them for cash to the farms replacing the collective and state farms, or iii) to leave them in these farms as owners, hence making themselves shareholders or landlords. The choice between the first option and the third option came down to a decision between starting up their own individual farm (*de novo* farms) with the capital and land received or remaining a member of a collective farm. Several authors have proposed conceptual analytic frameworks to explain employees' choices such as, for example, a comparison of the utilities of the two options, net of exit costs (costs to recuperate their shares and costs to start up a new farm), and have put forward a number of factors behind their decisions (individuals' characteristics, profitability of the collective or state farm, price and production risk, transaction costs on the land market, share capital, etc.) (Mathijs and Swinnen, 1998; Rizov *et al.*, 2001; Slangen *et al.*, 2004).

### **3. The mixed results of two decades**

#### **3.1. Imperfect land markets and fragmented ownership**

In general, there were few transactions on the land markets during the transition period. For example, only around 0.2% of the entire country's utilised agricultural area was sold in the Czech Republic from 1993 to 2001 (Latruffe and Le Mouël, 2006). There are a number of reasons for this sluggishness. First of all, the reallocation of land via the attribution of shares created virtual ownership rights: beneficiaries had to first of all understand the principle and how to transform these pieces of paper into physical plots (Ferenczi, 2005). The conversion procedures themselves were often complex (Graefen, 2002). Moreover, trade in land was prohibited under the communist regime. Consequently, the land reforms had to first create the hitherto non-existent institutions required for this trade (land registry, land registry offices, land valuation office, etc.). It took time to build these institutions from scratch and it also took time for owners to get used to this new institutional set-up. Last but not least, owners were often reluctant to sell their land for sentimental or economic reasons (see Section 3.2), but also for administrative reasons (which can also be likened to economic reasons when considering the resulting transaction costs). These administrative reasons create land market imperfections. Land restitution is still not complete after nearly twenty years of land reforms. There are a number of reasons for this: the heirs of many deceased owners have not been identified; the physical boundaries of certain plots have not yet been able to be delineated with certainty; and the land registration procedures are long and complicated, making the land registry incomplete. Corruption is commonplace and changes to land legislation are frequent, making ownership rights uncertain. Lastly, sellers and buyers are subject to extremely high land transaction costs (plot identification costs, valuation, registration, etc.) (Latruffe and Le Mouël, 2006). For example, these costs were estimated at 10% to 30% of the value of a transaction in Romania. A number of surveys conclude that these transaction costs are a major reason for non-participation in the land market (Swinnen and Vranken, 2005). Alongside the land market imperfections, credit market imperfections hinder land purchases. Loan interest rates are high due to a risky economic situation, a lack of skills among the new banks, and the farmers' inexperience as loan applicants (the credit market did not exist under the communist regime). Moreover, the banks rarely accept farmland as collateral (Swinnen and Gow, 1999; Latruffe, 2005).

So the land reforms have not managed to create an operational land market as there are still so many imperfections. In addition, they have generated highly fragmented ownership. This

fragmentation is rooted in the reforms themselves, which have redistributed or restituted microplots, following which land consolidation has been impracticable on underdeveloped land markets. For example, a 2005 survey finds that tenanted land on large Slovakian farms (private firms or cooperatives) was owned by 789 individual owners on average (Latruffe and Davidova, 2007). In Bulgaria, a 2003 survey shows that farming households owned an average of six plots with an average size of 0.6 hectares per plot (Vranken *et al.*, 2004). The Czech Republic currently counts a reported 3.5 million very small owners (Latruffe *et al.*, 2008). Some countries have launched land consolidation, but this is made extremely problematic by the rather vague delimitations of plot boundaries and still-missing land registry registrations. In the Czech Republic, for example, just 8% of the land has been consolidated to date (Latruffe *et al.*, 2008).

### **3.2. An unexpected evolution towards a dual agricultural structure**

The land reforms were supposed to give rise to the creation of middle-sized farms such as those that prevail in Western countries. As explained in Section 2, the creation of ownership rights and the dismantlement of collective and state farms were meant to foster trade in land plots, the exit of the least efficient farms from the agricultural sector, and the creation or expansion of more efficient farms. Small subsistence farms below the critical size required for economies of scale, and very large farms suffering from high transaction costs and diseconomies of scale, were consequently supposed to disappear to be replaced by middle-sized individually-owned farms. The idea was that these middle-sized farms would be started up from scratch (*de novo* farms) or created from the expansion of existing farms, hence combining the two advantages of economies of scale and low transaction costs.

Yet nearly twenty years on from the launch of the reforms, the move in this direction has not been as clear as hoped. First of all, the dismantlement of the collective and state farms has not been systematic. Although legislation has phased out these two legal statuses, very large collective farms still exist in practice, even though there are fewer of them. The state farms have often been bought out by some of their managers, who have turned them into private firms (limited liability companies and joint stock companies). These businesses cover hundreds of hectares and employ hundreds of employees. Some of them, purchased by private funds initially invested in non-agricultural activities, are thriving (Rylko *et al.*, 2008). The collective farms have kept their collective attributes, in general, taking on the legal status of cooperatives: owned by a number of partners, managed by an elected board, often on a “one man-one vote” basis, they cover thousands of hectares and employ thousands of employees.

There are a number of reasons why the large farms are still there. The heirs of the former owners, generally their grandchildren, received the ownership rights to the plots restituted by the land reforms. Yet most of them are urban dwellers and have no links with agriculture. Setting up an individual farm themselves would have been too expensive. Finding a buyer would also have meant high transaction costs due to the land market imperfections. The cheapest option for these heirs was therefore to leave their plot leased out to the new farm (company or cooperative). Amblard and Colin (2006) report, for example, that some 20% to 50% of collective-type farm owners (agricultural societies) in Romania are urban landlords. The former collective and state farm employees, who received a share of these farms from the redistributions, faced the same options. The difference was that these employees already had farming skills and could have started up an individual farm more easily. Nevertheless, the share they received was generally too small and they would have had to buy additional plots, which would have meant an expensive transaction on the imperfect land market. Moreover, many of them found that there were more benefits to joining a cooperative (services such as a canteen and remuneration in kind), and this was often the option that best suited their personal convictions carried over from the socialist period (collective farming). Another major reason that argued against the creation of new individually-owned farms was risk. Setting up one's own farm in the first decade of transition was quite a risky business: the economic situation was bleak, prices and policies were unstable, and the creation of upstream and downstream infrastructures (which did not exist under the communist regime) was not rapid. The last reason that can be put forward to explain the low rate of withdrawal of individually-owned land from the collective and state farms concerns the difficulties involved in, and hence the cost of, such withdrawal. After decades of collectivisation and no land registry, it was hard, if not impossible to find the boundaries of the plots. Some plots were in the middle of land farmed by collective or state farms, which were consequently required to find an identical substitute plot in another place. And then after two generations, a single plot was often found to have a number of heirs, which made selling decisions difficult.

Alongside the sustained operation of very large farms, a multitude of very small holdings have also continued to exist. These are generally semi-subsistence farms with little or no commercial orientation (Pouliquen's "microfundia", 1999). The main reason for this is the economic situation during the transition, in particular a high unemployment rate and soaring inflation. These circumstances left farming as the only option in rural areas, and the land itself was seen as a safety net for the rural dwellers and for the workers who had lost their jobs in

the collapse of the state-controlled industrial sector (Bafoil *et al.*, 2003). A second reason worth mentioning concerns essentially Poland: the agricultural pension in this country (drawn from the KRUS pension fund) was much more generous than the pension paid to workers from the other sectors, and the pension claim requirements were not too hard to meet (claimants simply had to have owned at least one hectare of land for a number of years of paid contributions). This policy encouraged many farmers to hang on to their small plots of land. The third and last aspect that could explain why small holdings have survived has to do with attitudes: after decades living under a regime that did not allow personal property, the land owned had not only an economic value but also a strong sentimental value. Selling or renting it out to other people would have been too evocative of the period of forced collectivisation.

So the land reforms in the Central and Eastern European countries did not have the effect hoped for in terms of agricultural structures. Instead of the expected emergence of medium-sized structures, the transition gave rise to a dual agricultural sector in which a host of very small holdings exist alongside a small number of very large units dominating the lion's share of the agricultural land (see, for example, Bazin and Bourdeau-Lepage, 2009).

#### **4. Outlook**

Even if the governments of the Central and Eastern European countries were aware of the probable complexity of their planned land reforms, it is doubtful that they were expecting them to take so long and they were probably not prepared for the psychological element that affected these transactions. The long-drawn-out implementation of the reforms had an unexpected impact on the development of the agricultural structures, with the creation of a dual structural system. Today, nearly twenty years after the launch of the land reforms, the land markets are still imperfect, and this situation strengthens the dual structure.

Nevertheless, the continuing existence of small semi-subsistence farms and large structures employing hundreds of employees, sometimes superfluous, probably averted a social crisis during the difficult period of economic transition by guaranteeing a minimum standard of living to millions of people in the rural areas. Pouliquen (1999) believes that this mitigated the social cost of the transition. Aware of this social issue, the European Commission ended up compromising on this point in accession negotiations, allowing new entrant States to give their farmers subsidies in addition to the Common Agricultural Policy (CAP) payments. In fact, agriculture was a key issue in the negotiations for the enlargement of the European

Union to the Central and Eastern European countries. Not only was agriculture a vital sector in these countries, it also accounted for a large chunk of the European budget (45%) in the form of farm subsidies. To the Central and Eastern European countries, accession meant getting a slice of this cake with its generous agricultural subsidies. To the Commission and the long-standing Member States, however, enlargement meant raising the budgetary share of agriculture and hence certain countries' contributions (such as France and Germany) to the European budget. Moreover, many economists felt that it was risky to give farmers in the new Member States the same CAP subsidies as farmers in the old Member States, since this could put a brake on the restructuring process and strengthen the inefficient structures. At the end of the day, it was decided to gradually raise the sum of CAP subsidies granted to new Member State farmers through to 2013 (the so-called phasing in process), when they will receive the same amount as farmers in the old Member States. However, given the social stakes of sustaining the agricultural sector, the governments of the new Member States were authorised to pay top-ups and special subsidies to small semi-subsistence farms.

The literature posits that the emergence of individual private land ownership rights in the developing countries is the result of growing pressure on land resources. This process reportedly makes land reform on the whole relevant and acceptable to the population, who are willing to participate by applying for title deeds. The empirical literature is not unanimous when it comes to the effectiveness of a land privatisation policy (securitisation, legislation and registration). In some cases, it advances more flexible possibilities for various hybrid systems somewhere between customary law and statute law (Chaveau and Lavigne Delville, 2002). Yet, for the Central and Eastern European countries, the land reforms were one element in a set of policies, especially industrial policy, meant to restructure the productive mechanism inherited from the socialist period. A mass in-sector and cross-sector reallocation of factor inputs was expected: in the presence of subsidies that are holding up the restructuring, it is the notion of transition speed that is at stake.

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