Impact of European Union Membership on Agriculture and Rural Development in Newly Acceded Member States

Drawing Lessons for Serbia

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WORLD BANK GROUP

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Executive Summary

On its path towards full European Union (EU) membership, Serbia must adopt the EU's body of law (*acquis communautaire*) and build a functioning market economy that will be able to withstand competition in the EU Single Market. With membership negotiations gathering pace, the urgency to reform will only grow. This is particularly valid for Serbia's agriculture sector and the segments of public administration that implement agricultural policy, as the alignment with the EU's Common Agricultural Policy (CAP) is particularly complex.

Facing increasing market pressures from abroad, Serbia's agricultural support system must address competitiveness challenges to the sector. The Government needs to use its pre-accession time wisely and focus on two objectives. First, it needs to recognize the core sector development priorities that will increase Serbia's agriculture competitiveness, and adjust its policy instruments accordingly. Second, national funds would be best spent on supporting these priorities, while complemented with EU funds. The Government's efforts will require the intensification of work both in sector policy, and in institutional development.

In terms of policy, the current agricultural support measures in Serbia come in a mix that is commonly seen in countries preparing to join the EU but is often insufficiently equipped to respond to core sector reform needs. They include a system of area payments loosely modeled on that of the EU, various kinds of headage payments, and systems of milk premium payments and input subsidies that no longer have any direct counterparts in the EU. Rural development and investment support is delivered through grants that are similar in approach to EU measures but generally simpler in implementation. So far relatively little attention has been given to agri-environmental measures, and compliance with environmental regulations plays only a minor role in the subsidy and grant systems.

More importantly, the current regular support payments (area payments, headage payments, milk premium, input subsidies) make very little contribution to raising agricultural productivity and profitability, while consolidating the *status quo*. In fact, instead of guiding the sector's transformation, these measures risk "freezing" the current dual farm structure defined by a large number of small-holders struggling to compete and a small number of large producers benefitting from liberalization. As a result, the current policy is insufficiently preparing Serbia's agricultural sector for the competition it will face in the EU single market. The recent re-introduction of higher tariff protection on dairy imports demonstrates how vulnerable the sector remains to competition from abroad.

In terms of institutions, Serbia has made some progress in aligning its administrative structures with the EU requirements but more needs to be done to ensure effective operation. It established a Paying Agency to deliver various forms of agricultural and rural development support, and is working

towards EU accreditation so that the Agency can start disbursing funds allocated through the EU's Instrument for Pre-Accession Assistance in Rural Development (IPARD). Progress towards accreditation has been slow in part because of insufficient staff tasked with handling national programs and preparing for IPARD implementation. Reducing the scope and complexity of national measures would free valuable resources.

Lessons learned from previous EU accessions provide important insights that can inform Serbia's agricultural policy in the period leading to full membership. Four overall recommendations stand out:

- i. *The urgency to clarify the focus of agricultural policy*—past experience shows that countries with similar agriculture potential and comparable farm structure challenges suffered from indecisions in choosing between competitiveness and equity objectives. As a result, sector restructuring before EU accession stagnated and they were unable to fully reap EU accession benefits.
- ii. *The need to address unfinished reforms*—strong and consistent commitment to address unfinished reforms (e.g., land or water management) will have lasting benefits on agriculture. Candidate countries often focus solely on meeting accession requirements and aligning to the EU policies, while sidelining unresolved national challenges.
- iii. *The importance of reforming and strengthening institutions*—strengthening institutions and reforming the agriculture administration can have important benefits in the public policy and service delivery beyond the EU context. Setting up the institutional structures mandatory for the implementation of pre- and post-accession agriculture and rural development programs is a lengthy and costly process, but has important positive spillovers.
- iv. *The importance of re-thinking the use of agricultural budgetary resources*—a substantial reduction in agriculture funds devoted to area payments should be considered, as there is little evidence that they would stimulate significant new investment or improve agriculture productivity. Serbia should retain sufficient direct payments to continue on the path towards meeting EU institutional requirements, but should use the time before accession to invest in agricultural competitiveness.

The re-direction of budgetary resources towards programs that will increase the competitiveness of Serbia's agriculture sector before EU accession is key. Taking into account the determining features of Serbia's agriculture, a number of specific recommendations emerge:

- i. Greatly increasing funds that help farmers invest and improve their competitiveness, through a series of simple but effective measures targeted at small and medium-sized farmers to complement the support for large farmers and agri-processors that IPARD will bring;
- ii. In parallel, reducing the funding for routine support measures (e.g., area and headage payments, milk premium, input subsidies) that do little to help the sector develop;

- iii. Focusing limited human and IT resources on preparing to implement IPARD measures and gaining EU accreditation for the Paying Agency and Managing Authority;
- iv. Developing a smaller and closely-targeted program of area-based measures to pilot additional EU requirements including environmental management and cross-compliance;
- v. Adjusting the relative emphasis on these different components as Serbia progresses along the road to full EU membership.

Abbreviations

ARD	agriculture and rural development
CAP	Common Agricultural Policy
EC	European Commission
EU	European Union
GMP	good manufacturing practice
HACCP	Hazard Analysis Critical Control Point
IPARD	Instrument for Pre-Accession Assistance in Rural Development
ISO	International Organization for Standardization
KRUS	Agricultural Social Insurance Fund (Poland)
MoAEP	Ministry of Agriculture and Environmental Protection
PES	payments for environment services
SAPARD	Special Accession Programme for Agriculture and Rural Development
SPS	sanitary and phytosanitary

Chapter 1

Introduction

Serbian agriculture is at a pivotal point in its development. In principle, the prospect of European Union (EU) membership has improved its future outlook, with the promise of EU budget support for agriculture and rural development (ARD) and access to a huge market. In practice, trade liberalization and access to wider markets has already begun, while access to EU budget support is still some way off. Hence, parts of the sector have benefitted from trade liberalization, with strong growth in response to a rapid increase in exports (cereals, oilseeds, fresh fruit and vegetables); while other parts of the sector are unable to adapt and are contracting (dairy and meat production). Not yet eligible for EU budget support, these less competitive components of Serbian agriculture are struggling to modernize and invest. Overall sector growth has stagnated as a result.

The current framework for agricultural policy and budget support needs to adjust quickly to this challenge. Otherwise, these disparate growth pathways will continue leading to low aggregate growth. This outcome is not inevitable, however, provided that government is willing to implement bold, forward thinking structural reform. Experience from countries that have acceded EU recently suggests that agriculture has prospered most in those that met this challenge. In contrast, agriculture struggled in countries that relied on higher, post-accession levels of financial support for agriculture as the basis for growth rather than combining it with structural reform.

Serbia has already made some progress in adapting its framework for agricultural policy and public institutions to the challenges of EU membership. The ARD strategy for 2014–2024 is closely aligned with the principles of the EU Common Agricultural Policy (CAP). Agricultural budget support has been aligned with the EU budget support framework, and a Farm Payments Agency has been established to administer these subsidies. The new law on Agricultural and Rural Development Subsidies provides a more stable and transparent basis for budget support, obviating the instability of previous support programs. In the private sector, the more forward-looking producers of cereals, oilseeds and fresh fruit and vegetables have benefitted substantially from improved access to EU export markets.

While these policy changes are a necessary first step, they are motivated by the more general, longer-term aim *to align* policies and institutions with the CAP, rather than the more immediate need *to prepare the sector to compete* in the newly liberalized trade regime. Similarly, the implementation of the fourteen operational goals defined by the ARD strategy would benefit from sequencing and prioritization, with greater emphasis placed on those goals that boost the sector's capacity to compete.¹

Likewise, the reform of the budget support program has emphasized alignment with CAP, rather than emphasizing measures that enhance the capacity to compete. As a result, the current emphasis on area and headage payments “freezes” farm structure and thereby reduces the capacity to compete. Slow progress with agreement on the Instrument for Pre-Accession Assistance in Rural Development (IPARD) program and associated delays with establishment of the Paying Agency also suggests a lack of urgency in the process of reform and preparation for EU Accession. This lack of urgency is further apparent in the ARD strategy, which makes minimal reference to the very real and very current problems created by trade liberalization with the EU. A more pro-active, forward-looking approach to reform is now required if the agriculture sector is to realize its considerable potential for growth within the EU.

Note

1. The Strategy outlines the following fourteen priority areas: (1) Stabilization of income in agriculture; (2) Establishing an efficient agriculture and rural development financing system and risk management; (3) Efficient land management and improved accessibility of land resources; (4) Improved physical resources; (5) Improvement of the knowledge transfer system and human resources development; (6) Adjustment to and alleviation of the climate change effects; (7) Technological development and modernization of agricultural production and processing; (8) Market chains and logistic sector support development; (9) Protection and improvement of environment and preserving of the natural resources; (10) Preserving agriculture, natural and human resources in the areas with limited conditions for agricultural production; (11) Diversification of rural economy and preserving the cultural and natural heritage; (12) Improvement of the social structure and strengthening of the social capital; (13) Modernization and adjustment of institutions and laws; (14) Improvement of the products safety and quality.

Chapter 2

Some Lessons Learned from Recent EU Accessions

In the area of ARD, the EU provides a comprehensive policy framework and significant financial resources to its members; important support is also available to candidate countries. Upon joining the EU, the newly acceded member state must give up its autonomous agricultural policy and start implementing the EU CAP. Member states, however, preserve significant freedom in choosing, out of a wide range of CAP policy instruments, those that best match their specific sectoral needs. Furthermore, the member states are responsible for implementing the CAP nationally; this includes creating, resourcing and running CAP-compatible institutions and systems. In turn, the CAP provides funding which can amount to up to 50% of these countries' total inflows from the EU budget. Countries that are officially designated as candidates for membership can benefit from pre-accession financial aid in the form of IPARD. IPARD emulates the CAP, but is a much lighter version of it—both in terms of support programs available and financial endowments.

Engagement on the EU accession path raises significant expectations in prospective member countries. Most commonly, these countries perceive the pre- and post-accession financial support as generous and capable of solving deep-rooted problems in the agricultural and rural sector. However, the experience from the recently acceded EU member states suggests that pre-accession countries and even new member states often over-estimate the role and importance of EU budget funding as a means to resolving constraints to agriculture sector development and competitiveness. There are several limitations and requirements to the use of EU pre-accession funds that the (potential) candidate countries, as well as new member states need to fully acknowledge and to meet. They are outlined in the remainder of this section.

Programming, Accreditation, and the Establishment of a Complex Institutional Structure

The candidate country only starts receiving EU financial support after a demanding programming and accreditation exercise. IPARD can only be accessed once the country in question prepares a national rural development program that is considered satisfactory by the European Commission (EC). Even more stringent rules apply to new member states.

In addition to developing the sector strategies and programs, candidate countries need to put in place a complex institutional structure in order to secure the IPARD funds. The Paying Agency is a central component of this structure and is subject to national and EC accreditation

rules and procedures. Given the complexity of the programming and accreditation process—often combined with the lack of experience in candidate countries—there is a risk of delays in the disbursement and absorption of the IPARD funds. The implementation experience from recent EU accessions on the use of the Special Accession Programme for Agriculture and Rural Development (SAPARD) convincingly supports such a conjecture.¹

One of the important lessons learned in the pre- and early-accession context is that having EU-compliant implementation structures up-and-running is a complex and lengthy process—an early kick-off is therefore considered as good practice. This involves early and strong commitment to investments required for, among others, setting up the agricultural Paying Agencies and related institutions and systems (e.g., an early start in developing a Land Parcel Identification System, market information systems). At the same time while supporting the establishment of necessary institutional structures will enable the country to access EU funds, this process often comes at a relatively high cost, as it absorbs policy-makers' attention, national budget and scarce staff resources in activities which may ultimately do very little to improve the competitiveness of the agriculture sector.

Candidate countries and member states retain considerable freedom on how to develop adequate institutional structures. In fact, although the EU has formulated common core requirements for the accreditation of the IPARD operating structure as well as for the CAP paying agencies, the acceding countries and the member states have significant flexibility in deciding the detailed institutional set-up and in adequately resourcing it. This may, however, result in varying efficiency levels in policy delivery. According to assessments concluded by the World Bank in various candidate and member states, the costs of running a Paying Agency range anywhere between 3% and 15% of the total funds disbursed.² All these operating costs are borne by the domestic budgets of these countries.

Key Elements for Successful CAP-Type Programs

Lessons learned in countries that implemented CAP-type programs demonstrate the need for well-integrated programs in order to effectively leverage, mobilize, and eventually absorb the available support funds. Key elements of success are the following:

- i. *Timeliness* in programming the specific provisions of rural development support measures and communicating these to potential investors and the concerned administration ensures adequate timing of investment planning/processing;
- ii. *Simplicity* of application processes and procedures reduces transaction costs during the preparation, submission, and processing of support applications³ and reimbursement claims;

- iii. *Selectivity and coherence* in measure definition/delineation increase the effectiveness of support programs in addressing country- and region-specific development challenges;
- iv. *Accessible* rural financial systems increase the effectiveness and absorption of rural development support measures because they ensure access to required sources of counterpart-financing.

Pre-Accession Policy Choices Can Impact Post-Accession Funding and Outcomes

Pre-accession choices with regard to the size, scope and targeting of the national subsidies to farmers can have a great impact on the post-accession distribution of financial support and sectoral outcomes. Most of the new EU member states⁴ have applied policies that relied more on agricultural subsidies rather than investments—or, in EU parlance, they were implementing *Pillar 1* (Direct Payments) to the detriment of *Pillar 2* (Rural Development support). The transition to the CAP has thus often led, on the one hand, to a significant increase in the public spending in agriculture, and, on the other hand, in a restructuring of the support instruments typically from input-based subsidies towards decoupled area payments designed to compensate farmers for potential income losses when meeting EU environmental requirements.⁵ These were typically applied as a blend between flat area payments (expressed in monetary unit per ha), and commodity specific national top-ups, which may have been either coupled or decoupled from the actual outputs.

This shift had variable impacts across countries, commodities and farm-size clusters, as evidenced by several public expenditure reviews carried out by the World Bank (e.g., in Romania, Bulgaria or Slovakia). For instance, in Slovakia, the middle-size farm segment enjoyed an increase in their relative farm income following accession and therefore received a boost, whereas, in Romania, it suffered a loss in relative income, and the early years of CAP implementation actually contributed to deepening the structural divide in the sector and lower overall sector competitiveness.

A more recent tendency observed in the EU candidate countries is an early alignment with the EU area-based payments. While this presents administrative simplicity (see appendix B for a more detailed discussion), it is generally not conducive to facilitating the much needed sector restructuring. On the contrary, it risks freezing farm systems in suboptimal situations. While the motivation of these countries to emulate EU policies is understandable, one needs to acknowledge that, particularly when it comes to farm subsidies, the conditions in which these are applied differ very much between the old and the new member states/candidate countries.

More importantly, early alignment with CAP might impair the necessary sector transformation. This aspect is often overlooked, yet is key to a successful EU market integration. While the attention of the policy-makers during the pre-accession period should rightly be set on building and piloting the mechanisms that are needed for disbursement of EU

funds, an equally important policy priority should be placed on the use of national measures for meeting specific development needs, including measures that will no longer be possible once the country joins the EU.

In view of this, there are several considerations the current candidate countries should take into account when deciding on the type and structure of policy instruments used in agriculture. First, what are the ultimate objectives of the national agriculture policy: restructure the sector towards a superior competitive curve, or to support farmers' incomes, while aiming for a more equitable redistribution of public funds? Second, is there room and commitment to improve agricultural productivity (both land and labor), and are flat area payments the most appropriate tool to achieve this? Finally, what are the budgetary costs of delivering the different measures chosen under each policy scenario?

The Importance of Addressing Existing Market Failure

Addressing existing market failures is an equally important concern for an effective use of both pre- and post-accession EU funds. The former SAPARD program had a slow take-off in part because of underlying failures in the domestic financial and land markets. For instance, with small plots and oftentimes insecure land ownership, many farmers failed to prove credit-worthy and secure the funds needed to pre-finance and co-finance the SAPARD farm investment support. Across the Balkans, and in many other countries, the problems are rooted in local level administration due to the inaccuracy of land ownership and infrastructure registration records. For example, the on-farm construction records in the Balkan countries are often unreliable because such assets are not registered regularly due to tax avoidance considerations. Regularizing these assets, and addressing similar issues, is a major constraint to IPARD implementation best tackled by improving the efficiency of local administration. Counties/districts that are ISO 9001 (Quality Management Systems) certified tend to address constraints more effectively.

Advisory Services and CAP/IPARD Policy Blank Spots

Past experience shows that lack of appropriate extension services reduces farmers' knowledge of existing support opportunities and of (often complex) procedures to access these funds. Most of the current candidate countries face this challenge to various extents; if left unaddressed, the knowledge gap may limit the actual disbursement of EU funds. This is even more pressing, as IPARD does not provide relevant funding to support the EU fund application process. However, to address this limitation several countries were able to improve utilization of SAPARD funds by using their own farm extension services for educating potential applicants about access to EU funds.

For example, in Croatia, resources for extension services were converted from technical to SAPARD application advice.

Finally, it is important to understand that both the CAP and the IPARD policy coverage leave some critical blank spots. IPARD has been designed to emulate the EU's rural development policy and covers a wide range of policy areas (e.g., investments in agricultural holdings, investments in agri-processors, setting up of producer groups, income diversification activities in rural areas, or agri-environmental measures). A number of policy areas of specific significance to the (potential) candidate countries, however, are not eligible for EU support and would need to be covered from or complemented by domestic resources. These include a good share of their services related to farm extension, technology innovation, land consolidation and food safety, which need to be addressed in order to promote both sector competitiveness and effective use of the EU funds for ARD.⁶

Notes

1. SAPARD was an earlier version of IPARD, used during the pre-2007 EU enlargement cycles.
2. Not accounting for the cost to the farmers.
3. Depending on the country-specific institutional and administrative set-ups, administration costs for CAP support are estimated to range from 3.5% and 12% of financial support.
4. For the purposes of this note, the term “new EU member states” refers to the countries that joined the EU during the enlargements of 2004 (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia), 2007 (Bulgaria and Romania) and 2013 (Croatia).
5. The original rationale for introducing direct payments was to compensate for price cuts under the 1992 MacSharry reform. The environmental element was added at a later date to make the CAP politically and socially acceptable, though several specific measures are genuinely environmental and do consider the issue of additional cost/income foregone.
6. EU funds may partially cover the cost of advisory services in relation to specific technical questions. This rule applies also for European Agricultural Fund for Rural Development (EAFRD) and IPARD. Normally, support for EU funding applications is not subsidized from public resources, although exceptions are possible, as the example of Croatia shows.

Chapter 3

Overall Implications for Existing EU Candidate Countries

The CAP or IPARD alone fall short of addressing the multiple challenges that agriculture in new EU member states and candidate countries is facing. In fact, additional national actions and resources are vital both for tapping the benefits of EU membership and for addressing key sectoral shortcomings. More specifically, the key priorities for these countries include the following: (1) addressing polarized land ownership and the resulting dual farm structure; (2) establishing credible management of food safety and quality; (3) overcoming institutional and administrative bottlenecks; and (4) introducing policy measures to tackle climate change and natural calamities.

Polarized Land Ownership and the Resulting Dual Farm Structure

As is the case with small farmers in much of the region, national pension systems do not have the capacity to cover smallholder subsistence farmers. Consequently, small part-time farmers have to remain on their small property as long as they can sustain themselves independently. This prevents the release of farm land from being used by more efficient and better equipped commercial farmers. Especially in countries where farm fragmentation is also accompanied by a severe aging challenge, the coordination between agriculture and social policies needs to be strengthened in order to create an environment conducive to agriculture restructuring and increased competitiveness.¹ Otherwise, if pension systems are providing weak benefits, sector exit through retirement is difficult, and farming becomes the income source of last resort.

In contrast with the majority of current EU candidate countries, including Serbia, a few EU countries feature extremely low percentages of farm managers over 65. These are Germany (5%), Austria (8%) and Poland (8%). To a large degree, this can be attributed to effective sector exit incentives for the elderly. After a series of reforms, Poland established the Agricultural Social Insurance Fund (KRUS) in 1999, based on a defined-benefit system. While some challenge KRUS for paying benefits disproportionate to the contributions and, thereby, for creating fiscal pressure, the system did contribute to the desired inter-generational transfer. In other countries, such as Germany, an agricultural holder has to transfer the ownership of the farm to a successor in order to be eligible for a pension scheme, leading to a small share of holders aged over 65.

Management of Food Safety and Quality

The food safety agenda is usually one of the most difficult areas in the EU accession negotiations. This is due both to the fact that the body of EU law (the so-called *acquis communautaire*) is voluminous and complex in this area, and its adoption is therefore time and resource-intensive, but also due to the high adaptation costs that both public and private sectors have to pay.

Nevertheless, the experience in new EU member states has shown that, while the short- to medium-term compliance costs for producers and processors are high, the medium- to long-term costs of non-compliance can be even higher. Bridging the food safety regulatory gap is crucial for enhancing competitiveness and thus for supporting growth and rural employment in the longer run in four ways: (1) by counterbalancing a potential erosion of domestic market shares; (2) by ensuring access to export markets, particularly in the EU; (3) by helping to offset a potential future decline of market support to producers; and (4) by boosting competitive advantages through addressing limiting factors. Furthermore, the EU accession perspective further increases the importance of food safety on the domestic policy agenda. In other words, it is an area where adopting the *acquis* brings significant benefits long before membership.

However, the full adoption of the food safety *acquis* may result in a significant reshuffling of the food processing industry in a country, as demonstrated by the experience of the most recently acceded member states. The effects were particularly magnified in those countries that were also facing structural duality in the farming sector (e.g., Bulgaria, Romania and Hungary). For instance, 144 out of 237 slaughterhouses in Bulgaria were closed upon accession, while 71 had to be upgraded during a negotiated transition period. For the private sector the costs of upgrading can represent a high burden, and the EU funds (CAP or IPARD) usually only manage to cover a relatively small fraction. Therefore, allowing adequate time to prepare the transition to higher standards may reduce the shocks to the national food industry, while using the pre-accession funds (possibly supplemented from national or other resources) to modernize both the public and private food establishments is important for a smoother integration into the EU agri-food market. The introduction of Hazard Analysis Critical Control Point (HACCP) processes and International Organization for Standardization (ISO) and Good Manufacturing Practice (GMP) standards is not only important in the context of EU accession, but also for consumer protection and reduced public costs through the introduction of risk-based inspection.

Institutional and Administrative Bottlenecks

The EU accession process and eventual membership require several formal institutional requirements in the ARD sector, such as the setting up of a Paying Agency and putting in place strict management structures for the delivery of

EU-funded support. What is often overlooked, however, is that a much larger share of national sectoral functions performed by the public administration remain outside the remit of these requirements and are left entirely to the latitude of the national government. These include both strategic functions (such as policy-making) and operational functions (such as financial management, inter-institutional coordination, human resources, information and communications technologies). Furthermore, several important areas in the ARD sector are entirely nationally-regulated, such as agriculture research, extension, various inspections and controls (not related to the mandatory checks on the administration and use of EU funds and veterinary policy).

Functional reviews performed in several new member states revealed that operational management deficiencies—in areas such as those highlighted earlier—represent the most important constraints to effective policy and service delivery. These are more severe than any budgetary constraints. Especially in a budgetary environment that is characterized by a usually significant increase of financial resources for the ARD sector (due to the EU budget transfers following accession), these institutional and administrative deficiencies may pose serious threats to the full and effective utilization of these post-accession opportunities.

A further key lesson learned is that an evident performance gap within the ARD administration presents both challenges and opportunities. While services and agencies in charge of programs benefitting from EU financing rank at the upper end of the performance scale, those related to internal services or national programs usually achieve lower performance ratings, which has negative spillover effects. This represents a challenge, as low-performing non-EU-related functions (e.g., strategic planning) or business lines (e.g., irrigation or advisory services) may sometimes limit the effectiveness of EU programs. It also provides an opportunity, as good practice examples exist within the administration that can be used to guide reform.

Climate Change and Natural Calamities

While the CAP is becoming increasingly “greener” and covers an expanding set of incentives to promote more sustainable farming, there are a number of areas that continue not to be covered by EU policies. These include managing catastrophic risks brought by natural calamities, and investing in mitigation of the impact of climate change (through increased investment in research and extension, support for strengthening the capacity of farmers’ associations to manage irrigation schemes and mobilize EU support, or through supporting the development of targeted government strategies).

Furthermore, the current EU policy and investment framework is not fully equipped to address large scale irrigation and drainage needs, which represent an important priority in much of the Central, Eastern and Southern Europe region. Typically, the CAP provides financial support for on-farm irrigation systems, whereas the much larger primary and even secondary canals have difficulties being captured under either of the EU-funded programs.

Structural funds, for instance, finance flood protection infrastructure, but not irrigation and drainage systems as such.

An additional challenge faced by the new members and candidate countries is that governance structures in the irrigation sector are often underdeveloped. This results in further impediments to the effective use of investment funds, even if available. With the changing climate, farming in these countries will be increasingly affected by the change in temperature and precipitation patterns—so the importance of having proper adaptation infrastructure in place will be paramount.

Having sound water management strategies in place, identifying public and private financial resources for large scale investments, and improving the governance structure in advance of EU accession are all actions that significantly improve the performance of the agriculture sector once fully integrated in the EU. Even to this day, some of the new member states—such as Romania and Bulgaria—continue to be confronted with the challenges of under-reformed and under-invested irrigation sectors, with undesired consequences on current farm performance.

Note

1. Outdated inheritance laws are often a further impediment to successful restructuring and merit particular attention.

Chapter 4

Drawing Lessons for Serbia

Lessons learned from earlier EU enlargements can be translated into a set of recommendations for Serbia that will assist the sector during the transition to full EU membership. They encompass four broad areas: (1) agricultural policy during the period leading to eventual EU membership; (2) commitment to the completion of necessary reforms; (3) institutional adjustment and capacity building; and (4) re-thinking the use of limited budgetary resources.

Clarifying the Policy Focus

Regardless of its EU accession trajectory and calendar, it is important that Serbia clarifies its policy focus. Countries with similar agriculture potential yet comparable farm structure challenges suffered from their indecision in choosing between competitiveness and equity objectives. As a result, the much needed sector restructuring stagnated, and the countries were unable to fully reap their EU accession benefits. A healthier approach would be to clearly delineate between the aims and functions of the agriculture policy and those of other complementary policies, social in particular. In this vein, the role of the agriculture sector could be to promote the development of competitive farm units, while social and employment policies (including rural development) could promote alternative income generation opportunities or welfare, and encourage surplus labor to exit agriculture.

In the case of Serbia this is of particular importance, as only 6.6% of Serbian rural households derive their main income from agriculture, with a large majority dependent on non-agricultural employment and pensions.¹ Even amongst farms, non-agricultural income sources are dominant, with just 11% of farms getting over half their income from agriculture. The 2012 UNDP Rural Household Survey in Bosnia and Herzegovina found a very similar situation (figure 4.1), with only 6.0% of rural households declaring agriculture as their main source of income. The data also showed a weak relationship between a household's level of agricultural activity and its total income.

If the same relationship holds in Serbia, we can draw two conclusions: (1) knowing how many hectares of land or head of livestock a household keeps tells very little about its total income and hence of its need for income support; and (2) the small correlation that does exist shows that larger farms tend to have higher household incomes, so size-based income support gives most money to the people who need it least. As a result, this shows that agricultural direct payments are a highly ineffective and inefficient tool for addressing the problem of low rural incomes, and suggests that income objectives are better pursued by traditional benefit systems whilst agricultural support should focus specifically on agricultural development objectives. Box 4.1 provides a brief background for the role of the non-agriculture sectors in poverty alleviation.

FIGURE 4.1 Bosnia and Herzegovina: Household Income versus Agricultural Size

Source: 2012 UNDP Rural Household Survey.

BOX 4.1 The Importance of Non-Agricultural Policies for Rural Development and Rural Poverty Reduction in Serbia

Agriculture accounts for only 20% of rural household incomes in Serbia, with the balance coming from non-farm employment (35%), social assistance (35%) and other income sources (10%). Hence, while highly desirable, a 25% increase in agricultural incomes would increase the overall income of rural households by only 5%. Effective policies to increase the contribution of non-farm sources of household income are thus critical to rural development and rural poverty reduction. Recent analysis of growth and poverty trends also shows that improved access to non-farm employment opportunities also reduces the vulnerability of poor rural households to income shocks. Of the various factors that contributed to increased poverty after the global financial crisis, a fall in non-farm labor incomes was one of the most important.

Any increase in agricultural output will itself increase the opportunities for non-farm employment, of course, but much of this increase will be in the form of unskilled, informal employment with lower wages. An expansion of unskilled, low-wage labor opportunities does not create the highly skilled, more productive labor base viewed as critical if Serbia is to build a more sustainable, export oriented basis for future growth based on enhanced productivity and competitiveness. Hence, policies and programs to improve both the quality and quantity of non-farm employment are critical—not only for rural development but also for Serbia's broader development. With its existing base of competitive but low value-added commodities, the agriculture sector will benefit doubly from the creation of a more highly skilled labor force, not only

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BOX 4.1 The Importance of Non-Agricultural Policies for Rural Development and Rural Poverty Reduction in Serbia *(continued)*

at household level through increased household incomes but also at sector level through increased high-value output and exports.

A broad range of non-agriculture policy and program measures is needed to increase the quality and quantity of non-farm employment opportunities. First, a more concerted effort is needed to redress the substantial gap between the quality of rural and urban education and the consequent disparity between rural and urban levels of educational attainment. Only 52% of young people complete secondary education in lightly populated (i.e., rural) areas, versus 83% in densely populated areas. Rural schools are also characterized by a lower level of well-educated, well-trained teachers. Second, the quality of vocational training for those who do complete secondary school also requires substantial improvement. Due to outmoded teaching curricula and inadequate awareness of the needs of modern employers, the current vocational training programs are failing to produce the graduates sought by potential employers—particularly in the area of agri-business. Better education policies and programs are thus essential for improving the access of rural people to non-farm employment.

There is also a more general need to link social welfare policies and programs more closely to government employment services—for both urban and rural people. The current information systems developed for social assistance beneficiaries are not being linked to the information systems developed for employment creation as a means to connect those people seeking work to the employment opportunities available.

Source: Serbia Systematic Country Diagnostic 2015.

Commitment to Address Unfinished Reforms

Providing strong and consistent commitment to address unfinished reforms (e.g., land or water management) will have lasting benefits on agriculture. A pitfall that many countries that recently joined the EU experienced was that their focus on meeting accession requirements and aligning to the EU policies diverted their attention from unresolved national challenges. Given that these challenges are not shared with most of the old EU member states, the CAP (or even IPARD) is understandably not equipped to address them. Countries that have adopted the CAP without resolving these underlying structural deficiencies saw their accession benefits fall below expectations, and often suffered more abrupt transitions to the single market (in the area of food safety, for instance). Serbia is now in a good position to make strong commitments towards undertaking structural reforms in its agriculture, land and water sectors. As these reforms are usually costly and take a significant amount of time, it is important to start them early and pursue them consistently.

Strengthening Institutions and Reforming the Agriculture Administration

Strengthening institutions and reforming the agriculture administration can have important benefits in the public policy and service delivery—whether in an EU context or not. The experience of the new member states demonstrated that setting up the institutional structures mandatory for the implementation of pre- and post-accession ARD programs is a lengthy and costly process, but has important positive spillovers in terms of good management practice in the public sector. It is important for Serbia to allow for sufficient time to set up and test its EU-related institutions (such as the Paying Agency, and other information systems), and the IPARD program, once launched, can be regarded as the “training wheels” for getting the country prepared for the much more complex and comprehensive EU programs.

At the same time, focusing primarily on strengthening the EU-related institutional structures would be myopic. Serbia should consider providing equal attention to reforming the institutions and functions in its agriculture administration not directly related to the EU, as, otherwise, they will negatively impact on the overall delivery of both EU and nationally funded programs and services in the future.

Re-Thinking the Use of Limited Budgetary Resources Devoted to Agriculture

Serbia should consider a substantial reduction in the share of the agriculture budget devoted to area payments. There is little evidence that area payments are driving significant new investment in agriculture or improving agriculture productivity. Serbia should retain sufficient direct payments to continue on the path to accreditation of its Managing Authority and Paying Agency and demonstrate to the EU that it will be able to implement the CAP, but, rather than committing 60% of the budget to direct payments, it should, instead, use this scarce resource to: (1) strengthen key public good services/programs; (2) create incentives for private investment in improved agriculture production and productivity that are largely self-targeting; and (3) ensure an environmentally secure future.

Key areas of investment in “public goods” for improved agricultural competitiveness include:

- i. Establishment of an effective and efficient risk-based sanitary and phytosanitary inspection service for agriculture inputs and outputs, including strengthened border crossing points and streamlined export/import processes, improved information technology² and public and private laboratory infrastructure, while avoiding overlapping ministerial responsibilities;

- ii. Completing the livestock identification system so that all livestock are recorded and therefore identifiable in the event of a disease outbreak or food safety incident;
- iii. Accelerated implementation of the community-driven land consolidation program of the Ministry of Agriculture and Environmental Protection (MoAEP), which combines geodetic survey, investment in works (access, irrigation and drainage), land re-allocation and an appeals process. This should include action/investment to: (1) harmonize the laws regulating the legal regime and status of agricultural and forest land (Law on public ownership, Law on agricultural land, Law on forests); (2) complete the consolidation of agriculture and forest land; and (3) following the completion of private land consolidation, include state land in the enlargement of private farms;
- iv. Rural development measures that improve agricultural competitiveness (roads, irrigation, etc.) or the quality of rural life (health, education, potable water, bio-energy for heating, sewerage, etc.)

Key areas for investment in public-private collaboration for increased agricultural production and productivity include:

- i. Promotion of a land market with a view to providing an exit from smallholder agriculture and the parallel opportunity to grow, recognizing that Serbian attachment to family land is powerful and land rental rather than sale is the most likely short-term outcome. It is recommended to study the experience of other countries supporting buyer-led land consolidation by assisting the buyer to develop productive projects (rather than applying incentives for farmers to sell land, which has produced mixed results in the Balkans). This process (1) establishes objective criterion to put an upper bound on the price that can be expected to be paid; (2) provides a necessary basis for financial intermediaries to evaluate and eventually support such projects; and (3) requires beneficiaries to familiarize themselves with the realities they are likely to confront as independent farmers and, in the process, provides them with greater clarity on their own aspirations as well as the potential-and the limitations-of land reform to contribute to the attainment of these goals.
- ii. Establish a stronger policy focus on small to medium-sized farms, to create a broader basis for sector growth. Farms of 2–20 ha account for approximately 50% of sector output. Within this target group, give priority for financial support to those farmers who are actively seeking to invest in agriculture and increase farm size through land leasing or land purchase;
- iii. To complement the complex IPARD schemes, the government could run simple investment support schemes aimed at smaller farmers (e.g., purchase of milking machines and cooling tanks);
- iv. Co-financing export-oriented agri-businesses to modernize processing plant and infrastructure, adopt international quality control standards

and processes (ISO, GMP, HACCP, etc.) and improve their market branding, including through Geographic Indication where appropriate (IPARD funding);

- v. Support innovation in agriculture through public-private partnerships for agricultural technology development and promotion, preferably delivered through modernized, certified agri-businesses (IPARD funding)
- vi. Support for young farmers who can obtain sufficient land, capital and knowledge to give a high chance of long-term success, whilst recognizing that the long-term goal of farm enlargement requires that the majority of farmers' children should build careers outside agriculture;
- vii. Improved access to financial services, for example through a government loan guarantee scheme.

Key areas of investment for agriculture sector greening and climate change adaptation and mitigation include:

- i. Development of EU compliant “greening” policies including, *inter alia*, the introduction of Good Agricultural Practice policies and regulations and taking steps toward the initiation of the EU Nitrates Directive;
- ii. Development of Payments for Environment Services (PES) in agriculture and forestry to support land users for the positive externalities they create through the adoption of sustainable resource management practices;
- iii. Accelerated development of water infrastructure for irrigation, drainage and flood control.

There is a variety of policy tools that the Government of Serbia can choose from in order to maximize the benefits of public expenditure and improve the agricultural sector's competitiveness. While an extensive review of all possible measures and their budgetary considerations would go beyond the remit of this Note, the appendixes attached do provide some preliminary estimates of budgetary impacts of an optimized set of policies (appendix A) and an overview of different mechanisms available (appendix B).

Notes

- 1. Derived from the 2013 Household Budget Survey.
- 2. Veterinary, plant protection and food safety SPS and food safety IT systems all require further substantial development and integration.

Appendix A

Public Expenditure Considerations

Towards More Balanced Agricultural Support and Sector Development

In order to become more competitive, Serbia's agricultural sector must adapt and invest. Key areas in need of investment have already been broadly identified by earlier studies commissioned by the EU.¹ The following pages provide an illustration of some priority areas and estimated budgetary requirements.

Dairy

The principle areas for investment and reasoning are subsequently outlined.

Farms

Buildings: to improve hygiene, animal welfare and labor efficiency, to reduce pollution from manure and silage effluent, and to allow farms to expand.

Equipment: milking machines and milk cooling tanks to meet EU hygiene rules (though much of this need has already been met with the support of dairies and MoAEP grants) and to allow farms to expand.

Machinery: general-purpose machinery and specialist machinery for forage production and manure handling, to improve efficiency, protect the environment and allow farms to expand.

Livestock: to expand herds, gaining economies of scale, reducing the unit costs of milk collection, and allowing some farms to move from part- to full-time.

Dairies

Buildings and equipment: to improve efficiency, meet EU hygiene standards and produce new and more competitive products.

Effluent storage: to reduce pollution.

Milk laboratories: to ensure compliance with EU standards and support quality control.

Total investment need was estimated at €990 million:

- €940 million for 173,000 farms (average investment €5,400):
 - €866 million for buildings, equipment & machinery;
 - €74 million for livestock for herd expansion;
- €50 million for 109 dairies (average investment €460,000).

If this investment were to be made over a period of 5 years, with one-third coming from public funds and two-thirds from the beneficiaries themselves, government would have to provide each year around €66 million to some 20–50,000 beneficiaries (assuming that one farm could receive a number of different payments over this period).

IPARD is an appropriate tool to assist many of the dairies and the larger farms, but the stringent application and financing requirements will effectively exclude most of the small and medium-sized farms where the bulk of investment is required. The Ministry's IPARD II program includes a budget for "investment in agricultural holdings" rising from €10 million in 2015 to €26 million in 2020. If the dairy sector takes around a quarter of the total budget for this measure, it will leave a public funding gap of around €50 million per year. The IPARD dairy measures are targeted at some 600 farms with at least 20 cows, these provide 20% of the milk supply to dairies and so are obviously important, but this will still leave 172,000 smaller farms dependent on national support.

The main national measures supporting the dairy sector are as follows:

Measure	Outcome in 2013		
	RSD	EUR	Applicants
Milk premium	3,360 million	€27.6 million	1,165
Heifer refunds	2,850 million	€22.7 million	29,342
Investment grants for primary production (all sectors)	700 million	€0.5 million	1,700
Total for dairy sector	6,910 million	≈ €60 million	≈ 30,000

The amount of public money directed to the sector could potentially be sufficient to support its investment needs, but the way it is used now has little impact on sector development since most of the funds are given to farmers who continue farming in the same way, rather than being used to drive change.

The same amount of money could be used with much greater impact on competitiveness by:

- i. Transforming the heifer subsidy (part of the *Subsidies on quality breeding livestock* measure) into a *Herd enlargement scheme* where a payment is given for each additional cow brought into the herd and retained for a number of years. Control could be exercised using the bovine animal identification system managed by the Veterinary Directorate.
- ii. Greatly expanding the budget for investment grants (rural development measure *Subsidies for investments in primary agricultural production*).
- iii. Making more use of simplified grant schemes where many farms require the same kind of investment (as was done in 2005–06 for milking machines and cooling tank).
- iv. Transferring funds from the milk premium to the aforementioned measures, and also reallocating some of the funds from livestock subsidies to capital grants for buildings, equipment and machinery, given that these represent over 90% of the estimated investment need for the sector.

Management of the new *Herd enlargement scheme* should be no more complex than managing the heifer refunds system that it would replace, so administrative capacity should not be an obstacle.

Managing grants is generally more demanding than managing subsidies, but the Ministry's rural development expenditure in 2006 was more than three times its current level, so a considerable expansion of the grant program should be administratively possible. Simplified grant schemes for smaller farms and specific kinds of investment could reduce the administrative burden on farmers and ministry alike, and help to keep the transfer cost down when handling large numbers of relatively small grants.

The benefits of such investment in the dairy sector would include:

- Increased agricultural output and gross value added;
- Increased international competitiveness and reduced imports of milk and dairy products;
- Increased readiness to join the EU, as most new member states found that their dairy sectors faced the greatest challenge in accession;
- Increased income for up to 173,000 rural households which have a realistic future as part- or full-time dairy farms.

Other livestock

Beef and sheep producers have very similar needs to dairy farmers, without the complexity and expense of handling a highly perishable product—milk. They could be served by the same kinds of instruments as for the dairy sector and, since few of them would be able to compete effectively for IPARD funds, most of the support will need to come from national funds. Part of the funding could come from better use of the budget allocated for breeding animals, but there is no equivalent of the milk subsidy for the other species so there might need to be an increase in overall budget allocation.

For pig and poultry production, if Serbia is to compete with the best producers in the EU, it will need to become much more concentrated, make significant investments in buildings and equipment in order to increase technical efficiency and meet EU animal welfare standards, as well as form partnerships with international companies to gain access to the best genetic material. However, the concentration of this sector means that IPARD will be an appropriate instrument to support many of the needed investments.

Many slaughterhouses will need upgrading at all stages, including disposal of animal wastes and liquid effluent. They do not have the same need for laboratory testing as dairies, but do face the additional cost of meeting strict EU rules on animal waste disposal to prevent the spread of BSE and scrapie; part of this will be a public cost for construction of rendering plants and incinerators.

The IPARD meat and dairy sectoral study for Bosnia found that 85% of total investment needs were on dairy farms. Serbia has greater potential to develop intensive livestock because of the ready availability of cereals and oilseeds in Vojvodina, but it is still likely that the total investment need for beef, sheep, pigs and poultry combined will be less than for that for dairy. An annual target for public investment support to the entire livestock

sector might be in the order of €100 million. Without this investment, EU accession would accelerate the rapid increase in imports of pig- and poultry-meat and contribute further to major challenges for domestic producers.

Fruit and Vegetables

This sector requires on-farm investment in orchards, in greenhouses and irrigation systems. Considerable post-harvest investment is also needed in cold-stores and in facilities for sorting, packing and grading. IPARD is relevant for larger investments in big greenhouses and in post-harvest facilities, but most of the on-farm investment will need support from national funds. Most of domestic support to this sector is already given in the form of investment grants, so the need is mainly to increase funding for existing measures rather than to introduce new ones.

This is one of the few sectors where a family can make a good living from a small area of land, so it can make a real contribution to rural development as well as being a leading export sector.

Arable Production

Cereals, oilseeds and sugar beet have considerable potential in Vojvodina and parts of Central Serbia, and the main investment needs are for machinery and on-farm storage. Economies of scale are significant so there is a strong case for concentrating support on medium and large farms, with the larger farms able to apply directly to IPARD. Improvements in the land and credit markets are needed in parallel with investment support, in order to facilitate the necessary farm enlargement.

Currently, national support to this sector is not targeted at supporting long-term change. The main elements from 2013 are outlined in the table below.

Measure	Outcome in 2013		
	RSD	EUR	Applicants
Area payments	10,520 million	€92.4 million	
Fuel subsidy	7,820 million	€42.0 million	
Investment grants for primary production (all sectors)	700 million	€0.5 million	
Total for arable sector	19,040 million	≈ €165 million	

Major reallocation is required to move away from dependence on annual subsidies and help farmers to invest and restructure for long-term competitiveness. Funds should be reallocated from arable area payments and fuel subsidies to investment grants in this and other sectors. Improvements in the arable sector will directly contribute to increases in agricultural output, gross value added and exports.

Next Steps

Systematic analysis should be performed of each sector to develop a phased plan for reallocation of the subsidy budget, and to analyze its impact on different sectors, farm types and sizes as well as on the national budget. Some area and headage payments should continue to be used, though on a much smaller scale and with better targeting, to continue development of the administration and control systems that will be needed for future implementation of subsidies under the EU's Common Agricultural Policy. Implementation of larger grants can directly emulate EU grant procedures, to develop and demonstrate capacity in this area.

Note

1. The studies were produced within the framework of EuropeAid/127054/C/SV/Multi and EuropeAid/127054/C/SER/Multi contracts and focused on: (1) the meat sector; (2) the fruits and vegetables; and (3) the dairy sector.

Appendix B

Force Field Analysis of the Policy Instrument Options for the Agriculture and Rural Sector

	Definition	Promoting factors	Restraining factors	Other considerations
1. Flat area or headage payments	Budgetary payments made to individual producers on the basis of area of eligible land, or number of eligible livestock	<ul style="list-style-type: none"> • Allow farmers to better respond to market signals, by not being commodity-specific (only the area payments) • Are less distortive to trade, by not being coupled to actual production • Create an incentive for farm consolidation, as the amount of subsidy increases with farm area/ herd size • Are easy and relatively inexpensive (for the government) to administer, once a farm registry is in place • Can create a predictable budget environment, if payment rates and eligibility rules do not change 	<ul style="list-style-type: none"> • Do not encourage structural transformation in sectors with dual farm structures, if these payments are significant enough to lock the smallholders in • Cause an uneven and inequitable distribution of subsidies, favoring large holdings • Have no real contribution to broader sector goals (e.g., higher competitiveness, increased resilience), other than stabilizing farm incomes • Do not create incentives for increasing productivity in farming activities 	<ul style="list-style-type: none"> • While the uneven distribution can be corrected through capping the receipts of large farmers, such a measure often results in an “artificial” breakdown of farms to reach eligible size, with negative impacts on production efficiency • Blue Box payments under the WTO regime (if production is required to qualify for support) or Green Box (if farmers receive payments independent of whether they are producing or not)
2. Conditional area or headage payments	Same as above, with the distinction that payments are only made subject to producers complying with a set of predefined requirements or standards (e.g., quality, environmental), or adopting certain practices and behaviors (e.g., grouping, transferring farm assets)	<ul style="list-style-type: none"> • Allow farmers to better respond to market signals, by not being commodity-specific (only the area payments) • Are less distortive to trade, by not being coupled to actual production • Create an incentive for farm consolidation, as the amount of subsidy increases with farm area/ herd size • Contribute to elected sector goals (e.g., higher competitiveness, increased resilience), in addition to stabilizing farm incomes 	<ul style="list-style-type: none"> • Require upfront costs (time and money) for setting up the legal and institutional framework needed for their implementation • Rely on an effective and integrity-based control/inspection systems • Depend on good and broad-based communication of the required conditionalities to the potential beneficiaries • May see low uptakes (farmers opt out) if the incentive levels are not properly set, thus compromising the achievement of envisaged sector objectives 	<p>Same as above, plus:</p> <ul style="list-style-type: none"> • The incentive levels must be carefully determined (e.g., through sound analytical work) to ensure that they exceed the transaction costs farmers incur when fulfilling the desired conditionalities • Stability of the policy framework is critical for the credibility of the incentive system, especially for payments meant to encourage farmers to exit the sector and transfer their holdings to more productive uses • For the same reasons, the effective design and implementation need strong coordination with other sector policies (e.g., social, environment) • In setting the conditionality targets, it is important to follow a gradual and realistic approach. Especially at the beginning, it is important to test, learn and adjust, until the system is operating smoothly

	Definition	Promoting factors	Restraining factors	Other considerations
3. Direct production subsidies	Budgetary payments made to individual producers on the basis of the quantity (tons, liters) of eligible agricultural goods produced	<ul style="list-style-type: none"> • Encourage farmers to increase their production and/or productivity • As a result, they can improve a country's negotiating position in cases where the reference output is relevant (e.g., negotiation of the EU accession financial envelope) 	<ul style="list-style-type: none"> • Create market distortions by favoring certain commodities • Disconnect farmers from market signals • Risk creating market gluts, with negative impacts on prices and farmers' incomes • Generate uncertainty as regards the budget resources needed in a given year (as outputs may vary) and/or amounts farmers will receive (if budget is fixed) • May encourage intensification of production, with little regard to environmental costs or product quality 	<ul style="list-style-type: none"> • Under the WTO regime, direct production subsidies may be accepted as <i>de minimis</i> support, which is exempt from reductions if the amount of support does not exceed 5% of the value of the production of the agricultural product in question • Originally based on a system of direct production subsidies, the EU has reformed its agricultural payments after encountering major over-supply and budget crises. It is now primarily based on decoupled income support, although it has retained the possibility of using coupled support for a positive list of products, within a regulated budget limit, and under specific circumstances (social, economic or environmental difficulties associated with a given agriculture sub-sector)
4. Input subsidies	<ul style="list-style-type: none"> • Budgetary payments made to individual producers to reduce the price that buyers pay for a good or service below its market price. • They can cover a whole range of inputs (e.g., fertilizers, pesticides, fuel, seed, equipment, but also training, insurance, finance), as well as a variety of delivery methods (e.g., direct distribution, vouchers, reimbursement of acquisition costs) 	<ul style="list-style-type: none"> • Increase the affordability of inputs to farmers, especially smallholders, as well as improve access • May help develop input supply systems, by creating demand, if private supply is absent • May help restore soil fertility (e.g., fertilizers) 	<ul style="list-style-type: none"> • Depending on the delivery mechanism, may create market distortions, by crowding out private sector supply and delivery • Under high input use intensity production systems often results in oversupply of inputs and deadweight loss • Divert resources from uses yielding higher rates of return (e.g., research, extension, education) • May involve significant administrative costs (e.g., administrative and financial checks for reimbursing acquisition costs, or storage and transportation costs for the direct delivery of certain inputs) • Are more prone to frauds and irregularities • Create a less predictable budget environment and/or less equitable access rules for beneficiaries 	<ul style="list-style-type: none"> • Under the WTO regime, agricultural inputs subsidies are typically only accepted under two sets of circumstances: (1) as developmental measures for the low-income and resource-poor WTO members, and (2) <i>de minimis</i> support, which is exempt from reductions if the support does not exceed 5% of the value of the production of the agricultural product in question (for commodity-specific supports) or of the total agricultural production (for non-product specific subsidies) • Even some of the EU member states have maintained some input subsidies (e.g., fuel), falling under the WTO <i>de minimis</i> rule and also strictly regulated by the EU state aid rules • Not all input subsidies are created equal. Depending on their targeting, delivery mechanisms and impact on the markets, some types of input subsidies can actually help correct market failures (e.g., interest rate subsidies for credit access), help farmers protect against agricultural risks (e.g., insurance rate subsidies), or help them acquire the knowledge that would allow them to become more competitive (e.g., subsidies for access to training and advisory services). In such cases, it is important that the delivery mechanisms do not create market distortions.

	Definition	Promoting factors	Restraining factors	Other considerations
5. Investment grants	Budgetary payments made to individual producers who undertake eligible investments; the grant may cover only a portion or the entire value of the investment	<ul style="list-style-type: none"> • Encourage economic viability and sustainability of investments, especially when financial responsibility is shared with the beneficiary • Incentivize farmers to behave as entrepreneurs, and to understand and respond to market signals • Direct public resources towards clearly defined objectives and results, rather than being spent unconditionally • Generate competition for public resources, thus rewarding the best investment proposals • May support a broad range of goals (competitiveness, quality, resilience), and cover a wide set of eligible activities (farm equipment and infrastructure, processing and storage facilities, on-farm water systems) 	<ul style="list-style-type: none"> • May face low uptake, if beneficiaries have difficulties raising financing (in the cases when pre- and/or private co-financing is required) • Involves increased administrative costs and requires stronger administrative capacity compared to area payments • May favor the largest farmers (who typically have a superior financial situation and better access to knowledge), and may generate deadweight, if not properly targeted • Require a skilled audience, or at least good support systems (e.g., consulting to help develop business plans) • May be hampered by broader unfinished reforms (e.g., unresolved property issues may limit farmers' capacity to collateralize real estate and obtain access to credit) 	<ul style="list-style-type: none"> • Investment grants have gained considerable weight under the EU's Common Agricultural Policy framework. The budget share of the so-called Pillar II of the CAP (which includes investment grants but also other types of rural supports) has been steadily growing over the past couple of decades. It has been instrumental in helping increase the competitiveness, sustainability and territorial cohesion of the European rural areas. • Worldwide, there is a growing consensus that investment grants are a better suited tool to achieve agriculture and rural sector development objectives. • Other countries' experience has shown that there are effective solutions for addressing some of the restraining factors. Access to credit, for instance, can be alleviated through financial engineering instruments, such as credit guarantees or interest rate subsidies. Consulting services develop to help farmers take advantage of the new investment and market opportunities. Finally, with proper investment and training, public administration capacities evolve and adapt over time, to better manage investment programs and more effectively serve the needs of the farming and rural sector.