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**SLOVAK FARM FINANCIAL PROBLEMS:  
PROFITABILITY, DEBT, LATE PAYMENT,  
AND LACK OF CREDIT**

By

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# **Slovak Farm Financial Problems: Profitability, Debt, Late Payment, and Lack of Credit**

## **Abstract**

The paper assesses the farm financial problems in the Slovak Republic and provides recommendations for improving the situation. Although positive changes have occurred in the financing of agriculture in the Slovak Republic since becoming an independent country in 1993, problems still remain. Many farms remain unprofitable, farms still have old debt that was issued prior to 1990 and uncollectible debt that was issued since 1990, farms are not paid promptly for the products they sell, and there continues to be difficulty in farms attracting credit. Recommendations for improving the delinquent farm liquidation decision, farm profitability, prompt payment, and credit access are provided.

## **Executive Summary**

**Communication and Fairness.** Policies and programs that are developed to assist the agricultural and credit sectors must be transparent. These policies and programs must be communicated with the support of industry groups and be devised and administered in a fair manner to achieve the broadest acceptance by interested parties. Policies and programs also need to be devised so that they create proper incentives for managers.

**Profitability.** An underlying problem for agricultural credit is low profitability in the farm sector. A farm cannot afford to support any debt if it is unprofitable. One contributor to the profitability problem is the cost-price squeeze, rising input costs and stagnant or decreasing output prices. Potential short-term solutions to the cost-price squeeze are price controls and subsidies. Both of these solutions require large budgetary spending and create market distortions. A longer-term solution to the profitability problem is improved efficiency of agricultural production.

**Old Debt.** It appears as though the old debt problem is being resolved. Most of the old debt (4.1 billion sk), if not all, has been moved to the Consolidation Bank. Many of the farm businesses that have old debt at the Consolidation Bank are either in bankruptcy (54 percent) or in the process of liquidation (10 percent). However, bankruptcy and liquidation should only be pursued as a last resort. Prior to bankruptcy and liquidation, the Consolidation Bank and farms need to communicate and agree on repayment schedules that are reasonable to both parties if at all possible.

**Bad/Classified Debt.** Banks have had classified credits moved to the Consolidation Bank and Consolidation Agency. A strict procedure is needed to determine when credits are classified. Without a strict procedure to determine credit classification by an independent agency, there are incentives and opportunities for corruption. As with the old debt situation, farm businesses should not be forced into

bankruptcy and liquidated if the bank and farm business can agree on a repayment schedule for at least a portion of the debt owed.

***Prompt Payment.*** Slow payment by processors of farm products continues to be a problem despite the passage of a prompt payment law. Therefore, severer penalties for violating the prompt payment law should be investigated. Farm businesses should be able to write-off uncollectible accounts receivable as a loss to the business. And as a consequence of the loss, the tax liability of the farm business should be reduced.

***Lack of Credit.*** Farm businesses feel as though they do not receive sufficient credit to manage their businesses efficiently. Although some businesses may be unable to support any debt, other businesses may be able to improve their businesses with the judicious use of credit. In order for banks to be willing to extend credit to these deserving businesses, there needs to be an environment where banks feel confident about extending credit to farms. Several mechanisms, such as guaranteed loans, subordination agreements, insurance programs, cooperative credit, and contract production, for enhancing the availability of agricultural credit are discussed.

***Land Valuation and Ownership.*** Land and land leasing markets need to be developed. Additional study is needed on land valuation and leasing.

## **Introduction**

Positive changes have occurred in the financing of Slovak Republic (SR) agriculture since my first visit in January 1997. For instance, some of the old debt issued prior to 1990 is being repaid and some is entering the bankruptcy process and being liquidated, although the process could have started earlier. Another positive change has been the entry of foreign companies into the agricultural sector, particularly food processing, which has created a competitive environment for farms selling their production. In addition, these foreign investors are developing long term relationships with farms and utilizing forward production contracts. However, there still remain problems in the financing of SR agriculture. Many farms remain unprofitable, farms still have old debt and uncollectible/bad debt, farms are not paid promptly for the products they sell, and there continues to be difficulty in farms attracting credit. As it was before my first technical assistance visit in 1997, it would be heroic to suggest sweeping changes for the SR in the area of agricultural finance based on a short technical visit, but during this visit I was able to meet with many concerned groups and interested parties. They included a farm manager, Ministry of Agriculture officials, Agricultural and Food Economics Research Institute scientists, Agriculture and Food Chamber directors, Consolidation Bank and Consolidation Agency directors, a Consolidation Agency consultant, a Slovak Guarantee Bank director, and a Polnobank Bank official. Based on the discussions with these individuals and additional research, I have some suggestions that will assist the financing of SR agriculture.

The following sections will address communication and fairness, old debt, bad/classified debt, prompt payment, lack of credit, and land valuation and ownership.

### **Communication and Fairness**

A key ingredient to achieving any goal is clear and effective communication. Policies and programs that are developed to assist the agricultural and credit sectors must be transparent. These policies and programs must be widely communicated to all potentially interested parties by various methods such as mailings and workshops with the support of industry groups. Programs and policies should not be developed in the interest of only one user. Instead they should be developed for many potential users to have the broadest appeal and deepest penetration in the market. For instance, loan guarantee programs should be developed in consultation with many banks so that these banks are likely to use the programs and more farms are able to receive credit at reasonable rates and terms.

Fairness is another ingredient to achieve broad acceptance of policies and programs by the various businesses and organizations involved. Policies and programs need to be devised such that they do not penalize managers conducting good business practices or reward managers conducting poor business practices. For example, forgiving debt for farms that have not repaid while not compensating farms that have repaid their debt rewards farms that were unable to manage their debt while penalizing farms that did manage their debt. Also, unfair policies and programs send improper signals to the market and create perverse incentives. In this example, the forgiveness of debt creates the incentive to borrow more than is fiscally prudent since the government has set the precedent of forgiving debt when it cannot be repaid. This example can be easily extended to the government transferring uncollectible loans of banks to other collection entities and not requiring the banks to be liable.

### **Profitability**

An underlying problem for agricultural credit is low profitability in the farm sector. This is not a problem that is unique to the SR. Given their current low returns, certain farms cannot afford to support any debt. In fact extending credit to unprofitable businesses may do more harm than good. The extension of credit can be good for the business as long as it makes the business more profitable, otherwise credit can exacerbate an unprofitable situation.

One contributor to the profitability problem is the cost-price squeeze, rising input costs and stagnant or decreasing output prices. Although the cost-price squeeze problem may be a relatively recent phenomenon for Slovak agriculture, it has been a problem for many of the world's farmers for decades. Potential short-term solutions to the cost-price squeeze problem are price controls and subsidies. Both of these solutions require large budgetary spending and create market distortions. For instance, in 1999 the U.S. government targeted approximately \$22 billion to support agriculture. Most of these funds

were directly paid to farmers in an effort to compensate them for low product prices. Thus, a large budget is required.

Policies could also be developed to decrease farm production costs. For instance, interest rate subsidies could be used to reduce the cost of credit. However, such a policy distorts the credit market and causes more credit to be used than would be economically efficient if there was no interest rate subsidy. If the credit does not make the business profitable enough to make debt payments on a regular basis, credit subsidies may actually make a bad situation worse. There may be an instance when differentiated, not subsidized, interest rates may be practical. Certain SR programs are currently allowing farms to pay a reduced interest rate if they make payments in a timely manner, otherwise farms pay a higher interest rate. For this payment incentive program to be effective, farms must understand that they are liable for the higher interest rate and that principal and interest payments will not be forgiven in the future if they do not make their payments when they are due.

A longer-term solution to the profitability problem is improved efficiency of agricultural production. To be able for SR agriculture to compete in a global market, SR agriculture must be efficient. It is not surprising that SR agriculture has not been profitable in recent years given the enormous change that it has undergone in such a short period of time. It is difficult to imagine making this tremendous change without having an adjustment period where losses are common. There have been positive changes over the past three years as noted above. However, there appears to be continued excessive employment of farm workers and, perhaps, under investment in physical capital which will require more time for adjustment.

A contributor to the excess labor situation in agriculture may be government policy. For instance, half of the subsidies provided to agriculture are targeted to farms based on land quality. Farms with the poorest quality land receive the largest subsidies while farms with the highest quality land receive the smallest subsidies. This policy allows farms with poor quality land to operate inefficiently and continue to employ excess labor. This outcome of employing excess labor in the poorer agricultural regions may be the intended effect of the policy. If not for this agricultural policy, people would perhaps move from rural to urban areas in search of employment. If they could not find employment and decided to stay in the urban area, the cost of supporting the unemployed may be more than if they had stayed in the rural area. So the current policy of substantial support for farms in the less favored rural areas may be a politically economical course of action in the short run. However, market distorting practices adopted as a result of any price controls and subsidies will prolong the development of an efficient agricultural sector.

On a related issue, there appears to be a growing interest in tourism. Many of the rural areas as they currently exist could be prime tourist destinations. However, if the rural areas do not continue to receive agricultural subsidies, the villages could soon fall into disrepair and lose their attraction as a tourist destination. So on an interim basis it may be argued to continue agricultural subsidies to rural areas until a tourist industry can be established. However, there may be more efficient methods of allocating and

distributing the subsidies than on a land value basis as is currently being done. So if the intended effect of much of agricultural subsidies is to keep people employed in rural areas or to develop a tourist industry, the SR government should separate social policy from agrarian policy.

### **Old Debt**

There is still a considerable amount of debt in the farm sector that was issued prior to 1990 (old debt), although the old debt problem is apparently being resolved through the process of bankruptcy and liquidation. In 1997 several proposals for writing off and liquidating portions of the old debt were considered. However, none of the proposals were ever implemented. The lengthy delay in resolving the old debt problem has hindered the recovery of Slovak agriculture. Although an old debt write-off and liquidation would have been costly for the government and painful for farms in 1997, it is likely that the current resolution of bankruptcy and liquidation will be equally painful and at the cost of a three-year delay in the recovery of Slovak agriculture. Thus, it is usually more effective and less costly to take action sooner rather than later.

Most of the old debt loans (4.1 billion sk), if not all, have been moved to the Consolidation Bank. Many of the farm businesses that have old debt at the Consolidation Bank are either in bankruptcy (54 percent) or in the process of liquidation (10 percent). However, prior to bankruptcy and liquidation, the Consolidation Bank and farms need to communicate and agree on repayment schedules that are reasonable to both parties if possible. Repayment of the loans, even on a partial basis, is preferred to bankruptcy and liquidation in many instances since both parties will be better off than incurring the costs associated with bankruptcy and liquidation. Bankruptcy and liquidation usually result in low sale prices for machinery, equipment, and livestock. Therefore the costly process of bankruptcy should be avoided if at all possible.

Farm businesses should not be forced into bankruptcy and ultimately liquidation just because of the costs associated with their old debt. Instead, businesses should be entering into bankruptcy and then liquidated in two cases. One case is if the business is consistently unprofitable even if it held no old debt. The second case is if the business is unable or unwilling to reorganize its operation to be profitable and to repay a portion of the old debt that is mutually agreeable to the bank and farm.

Debt and its associated repayment obligations can be detrimental for a business and an entire sector of the economy as they were for the U.S. agricultural sector during the mid-1980s. In response to economic and financial difficulties, the United States strengthened its income support program and developed a debt write-off program. Income support and debt write-off programs can be extremely expensive for a country, particularly if the programs allow, or even encourage, inefficient use of limited resources. For instance the income support program involved the government subsidizing prices of many crops by essentially setting a price for farmers to receive that was usually above the market price. To receive the subsidized price, farms were required to set aside a portion of their land in an effort to

decrease production and increase market prices. The program was not very effective at increasing market prices and proved to be quite expensive.

A debt write-off program can also be ineffective. If debt is written off and businesses are profitable, then the program will be a success. However, if debt is written off and businesses remain unprofitable, then the program will be a failure because businesses will continue to accumulate accounts payable and debts that cannot be paid. Thus, it is critical that other issues essential to an efficient, profitable agricultural sector are resolved prior to implementing a debt write-off program.

### **Bad/Classified Debt**

The General Credit Bank (VUB), Slovak Savings and Guarantee Bank, and Investment Bank recently had their classified credits moved to the Consolidation Bank and Consolidation Agency. A strict procedure is needed to determine when credits are classified. Without a strict procedure to determine credit classification by an independent agency, there are opportunities and incentives for corruption. There is also a moral hazard issue when governments bail out banks. That is, banks do not have an incentive to effectively scrutinize loan applications and vigilantly collect loans since they expect to be bailed out by the government in the future if bad debts occur. However, future foreign investors of banks may not feel the same level of commitment on behalf of the government to bail out their bank if bad loans develop.

As with the old debt situation, farm businesses should not be forced into bankruptcy and liquidated if the bank and farm business can agree on a repayment schedule for at least a portion of the debt owed. However, if the farm business consistently is unprofitable and unable to make at least some minimum payment even if the farm business is reorganized, then the business should enter into bankruptcy and be liquidated.

### **Prompt Payment**

Prompt payment throughout the distribution chain is an essential element to the efficient operation of any sector of the economy. This is particularly true for the agricultural sector because of the lack of market power and the biological nature of production agriculture. Slow payment by processors of farm products continues to be a problem despite the passage of a prompt payment law. Evidently the costs associated with violating the prompt payment law are not severe enough to encourage processors to pay promptly. Therefore, severer penalties for violating the prompt payment law should be investigated.

The arrival of foreign processors of farm products has offered a greater selection of potential buyers for farm products which has helped the situation. Farm managers must realize that there is a tradeoff between the price quoted by processors and the promptness of payment from the processors. That is, a



food processor offering the highest price may also be the processor that takes the longest to pay. At some point if a payment from a processor is uncollectible, the farm business should be able to write-off the account receivable as a loss to the business. And as a consequence of the loss, the tax liability of the farm business should be reduced.

### **Lack of Credit**

Farm businesses feel as though they do not receive sufficient credit to manage their businesses efficiently. Although some businesses may be unable to support any debt given their low returns, others may be able to improve their businesses with the judicious use of credit. In order for banks to be willing to extend credit to these deserving businesses, there needs to be an environment where banks feel confident about extending credit to farms. This leads back to an earlier point made on the need to effectively communicate government programs to all potential creditors and to develop programs that are transparent.

A guaranteed loan program is one such program that should make creditors feel confident that they will be repaid at least a portion of the funds they extend. The U.S. Department of Agriculture has a guaranteed loan program where the government will guarantee up to 90 percent of a loan made by a credit institution to a farmer.<sup>1</sup> In some instances the guarantee is up to 95 percent for certain targeted groups such as beginning and socially disadvantaged farmers.

An advantage of the guaranteed loan program is that a relatively small budget is required since the credit institution raises the funds to make the loan. The government only pays when a loss occurs for the credit institution after the loan has been liquidated. Then the government pays the credit institution the guaranteed rate on the loss that occurs. The guaranteed loan program can become expensive for the government if loss rates become severe or if an interest rate subsidy is used in conjunction with the guarantee. With loss rates less than 2 percent during the 1990s, losses have not been severe in the United States (Settlage, Dixon, and Ahrendsen). The U.S. Department of Agriculture has offered an interest rate assistance program. Through the interest rate assistance program, the government enters into an agreement with the credit institution to subsidize a guaranteed loan. This enables the credit institution to reduce the interest rate charged to the farm by up to four percentage points. The interest rate subsidy is a direct cost to the government and can cause budget problems.

Another advantage of the guaranteed loan program without interest rate assistance is that little market distortion results from the guarantee. The farm receives a loan because the loan loss exposure of the credit institution has been drastically reduced. If no interest rate assistance is received, the farm pays the

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<sup>1</sup> For additional information on the U.S. Department of Agriculture's guaranteed loan program see: [www.fsa.usda.gov/dafl/Guaranteed.htm](http://www.fsa.usda.gov/dafl/Guaranteed.htm).

same interest rate as good clients of the credit institution. So there is not an incentive on the part of the farm manager to use too much credit.

A subordination agreement is another way to promote credit to agriculture. A subordination agreement is an agreement between creditors. Creditors need to work with farm borrowers to satisfy their credit needs. Creditors should be expected to require adequate collateral to securitize loans. However, if a creditor has excess collateral and is unwilling to extend additional credit to a farm business when another creditor is willing, the primary creditor should enter into a subordination agreement with the other creditor. The creditor with the highest priority for collateral of a farm subordinates its position on specified collateral to the other creditor to the extent that the other creditor has sufficient collateral to secure a loan to the farm business. Once the other creditor has been repaid, the subordination agreement is terminated and the primary creditor retains its priority position for the collateral. A subordination agreement is often used when input suppliers are willing to provide credit on a short-term basis. However, other creditors could also use the agreement.

Another mechanism to enhance the availability of credit to agriculture is to provide an insurance program. Insurance lessens the risk to farm businesses and creditors. Insurance products should be developed for buildings, machinery, livestock, and crops. Insurance products have been available in the United States for decades. However, there has been only limited livestock insurance, for example for death due to lightning. Also, crop insurance products have never been fully effective from a policy view. Insurance is particularly susceptible to moral hazard and adverse selection problems. An example of a moral hazard problem is when farmers may not make every effort possible to produce a good crop. An example of an adverse selection problem is when farmers only purchase insurance when they have a high probability of collecting insurance payments and the government cannot detect this probability. The U.S. Department of Agriculture is continuing to develop and test new and innovative crop insurance products and has recently received funding to provide even larger subsidies to entice farmers to purchase insurance.<sup>2</sup> Several of the insurance products are:

Crop Revenue Coverage (CRC)--provides revenue protection based on price and yield expectations by paying for losses below the guarantee at the higher of an early-season price or the harvest price.

Income Protection (IP)--protects producers against reductions in gross income when either a crop's price or yield declines from early-season expectations.

Revenue Assurance (RA)--provides dollar-denominated coverage by the producer selecting a dollar amount of target revenue from a range defined by 65 to 75 percent of expected revenue.

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<sup>2</sup> For information on government crop insurance programs in the United States see: [www.rma.usda.gov/policies](http://www.rma.usda.gov/policies).

Since these programs are still being tested and used on a trial basis, there continues to be much work needed on developing insurance programs. Something also to be considered is that the insurance premium subsidies required to entice most farmers to purchase insurance may be quite high.

An alternative way to deliver agricultural credit is through a cooperative credit institution. A problem with a Slovakian, farmer-owned credit cooperative at this time is that there are so few farms that have funds to invest in the cooperative. Therefore, it would be extremely difficult to attract sufficient equity capital to capitalize the credit cooperative. One option would be for the government to provide adequate seed capital to start the credit cooperative. The seed capital would be repaid in the future by the credit cooperative. However, it may be inefficient to essentially duplicate the infrastructure of other credit institutions unless an infrastructure is already in place.

Finally, another way for farms to be able to attract credit is to contract their production with reliable processors that pay promptly. Creditors will be confident that the farms will be promptly paid by the processor at a certain price. However, there will still be production risk, but an insurance product or government loan guarantees would limit production risk to the extent that creditors will be willing to make loans to farms.

### **Land Valuation and Ownership**

Most farms and land owners would benefit from the development of better markets for the leasing and sale of farmland. It appears as though the market for leasing land is continuing to develop. However, it appears as though the market for the sale of land is almost nonexistent. One reason for this lack of a land market is large transaction costs associated with assembling an efficient-sized track of land. Another reason for the lack of a land market is what appears to be an arbitrarily high value placed on land relative to its earnings. Based on a limited number of observations of what is being paid for leasing land, it appears land is overvalued by a factor of five to ten under the current earnings environment. More study is required in the area of land valuation.

No land market and land being overvalued by a large amount would explain why banks are hesitant to lend to farms and use land as collateral. When banks do lend to farms and use land as collateral, the loan-to-value ratio for the transaction appears to be quite low by U.S. standards. However, SR banks may be behaving quite rational since there is almost no land market and land is overvalued.

The development of land and land leasing markets would be of great benefit to the SR. The markets would allow more efficient use of the most important input available to agriculture, land. Efficient land markets and laws to protect lenders that use land as collateral for loans would attract capital into the agricultural sector. Successful farmers would benefit by being able to lease or buy land. Land owners would benefit by having the opportunity to receive better returns on their land. SR consumers would

benefit by having land operated by the most efficient farmers. Additional study is needed on land valuation and leasing.

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