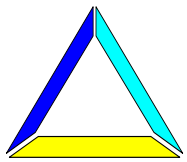
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**S29**

# Comments on the Draft Law of Ukraine *„On supporting the production and development of agricultural markets"*

## 1. Introduction

In recent months, a variety of proposals for increasing state regulation of agricultural markets and agricultural development have been circulated and debated in Ukrainian policy making circles.[1] The latest such proposal is the Draft Law of Ukraine *„On supporting the production and development of agricultural markets"*.

According to its preamble, this Draft Law is designed to "create conditions for the efficient functioning of the mechanisms of state support for agriculture and the development of agricultural markets". The Draft Law provides for increased expenditure to support agricultural production (section 2), price support and market regulation (section 3), state guarantees and the provision of subsidised credit (section 4), and subsidised insurance schemes for farmers (section 5). Section 5 also contains provisions for the establishment of an oversight committee to monitor the situation on agricultural markets and make recommendations for the implementation of the state mechanisms outlined elsewhere in the Draft Law. Furthermore, section 5 also foresees the establishment of a state market and price information and monitoring system. Finally, section 6 defines the proposed sources of funding for financing the measures proposed in the Draft Law, while section 7 stipulates that the Draft Law should come into force on January 1, 2004 and outlines steps that should be taken to ensure that existing laws are amended to ensure conformity with the provisions of the Draft Law.

## 2. Assessment

As it stands, the Draft Law contains many points that are worth pursuing. These include the introduction of a market and price information and monitoring system that would make information available free of charge to all market participants. Other interesting provisions are aimed at preserving and improving soil fertility, at guaranteeing quality and safety standards for agricultural and food products and the compliance of quality standards with international norms.

At the same time, however, the Draft Law suffers from several important shortcomings. These shortcomings, which will be briefly discussed in turn below, include the following:

1) The effective abandonment of market-based reforms in Ukrainian agriculture;
2) The incompatibility of key provisions of the Draft Law with the requirements of WTO membership;

[1] See for example the recent "*Concept on the Development of Agricultural Policy in Ukraine*", commented on by the German Advisory Group in Paper S18.

3) The Draft Law's reliance on poorly targeted and highly inefficient mechanisms
4) The creation of a parallel budget for agricultural spending funded by earmarked taxes and levies.

## 2.1 Ukrainian agricultural policy at a crossroads

If the provisions of the Draft Law are adopted, Ukrainian agricultural policy will clearly leave the path of market based reforms and, instead, move in the direction of increased *dirigisme*. Various provisions of the Draft Law call for considerably more direct state intervention in agricultural production and price determination than is currently the case. On output markets the state will determine minimum prices and support and stabilise prices via intervention purchases and sales. According to section 2, article 3.2, the state will even interfere in the regional distribution of production of "strategic agricultural commodities". Input markets will be subject to considerable state interference as well.

The evidence on the efficiency of such policies that has accumulated worldwide over the last decades is overwhelming. Without exception, such policies have proven

- to be highly inefficient and difficult to target,
- to place a significant burden on consumers and taxpayers,
- to generate conflicts with trading partners,
- to unfairly burden especially developing countries, and
- to engender both heavy dependency on sustained support in agriculture ('addiction to subsidies') as well as significant administrative costs and, often, corruption and fraud.

For all of these reasons, the international trend in agricultural policy is clear: Away from price support and intervention on agricultural output and input markets. Figure 1 below summarises this trend. For each country included in Figure 1, an arrow begins at the point that represents this country's agricultural support in 1986-88, and ends at the point that represents this support in 1999-2001. Two dimensions of support are depicted in Figure 1. The first, on the x-axis, is the PSE or producer support equivalent that measures the percentage of total farm income that is generated by agricultural policy mechanisms. The second dimension, on the y-axis, is the percentage of total agricultural support that is provided in the form of market and price support. This second dimension of support is important because market and price support is the most inefficient type of agricultural support, creating less benefits for farmers and more waste per unit of spending than other measures (such as direct income subsidies, for example).

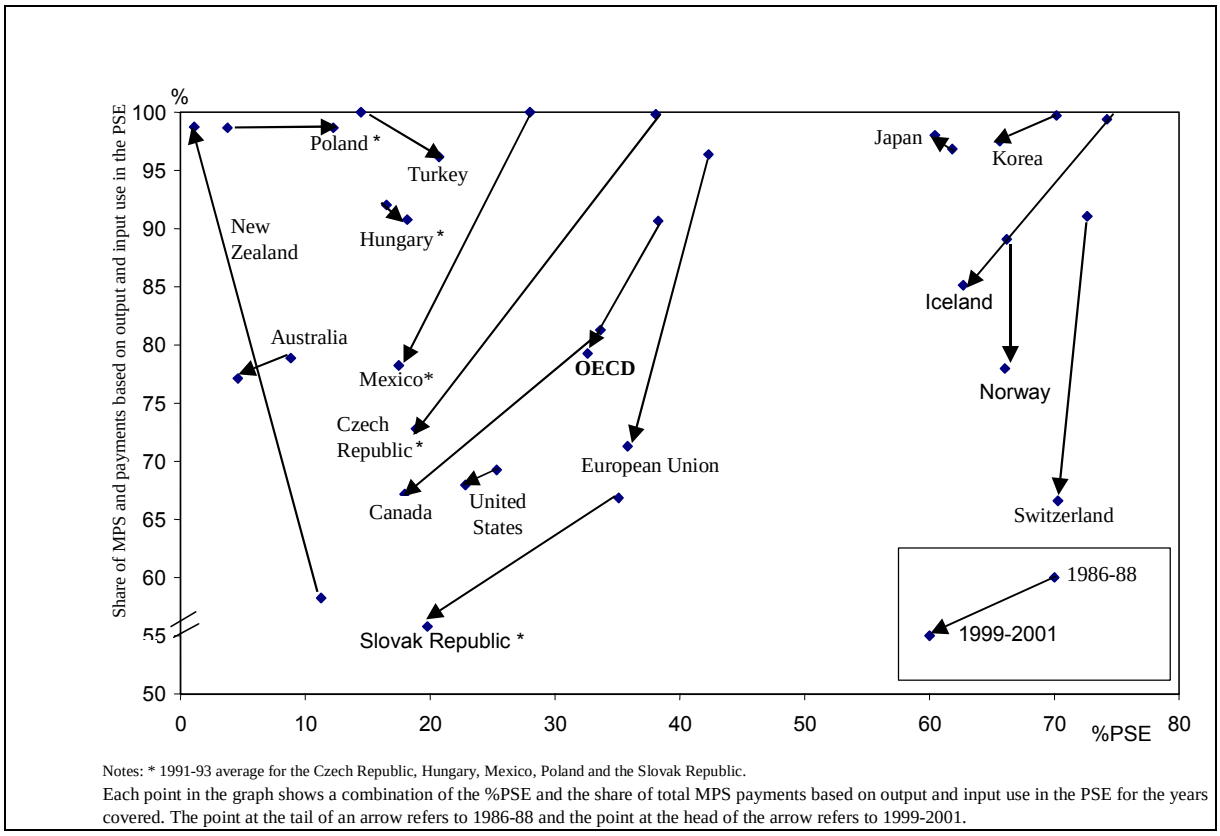
As Figure 1 makes clear, the overwhelming movement in agricultural policy over the last roughly 15 years has been from 'top right' to 'bottom left', i.e. towards lower total agricultural support and towards a lower share of market and price support in this total. The only notable exceptions to this trend are Poland and New Zealand. However, Poland is a special case because it has been adapting its agricultural policy in anticipation of EU membership. And while it is true that New Zealand has increased the share of market and price support in the total support that it provides to agriculture, Figure 1 shows that this total support has fallen to almost zero over the same period.

There can be little doubt that the trends depicted in Figure 1 will continue. In the ongoing Doha Round WTO negotiations, additional disciplines on domestic agricultural policies (such as further tariff reductions, reductions in domestic support and increases in market access) are being discussed. These disciplines will force WTO

members to continue to dismantle support and reduce the use of especially wasteful market and price support tools.

Against the background of this international trend in agricultural policy it makes little sense for Ukraine to adopt laws that would move it in the opposite direction. Market and price support in the EU and other developed countries should be taken for what they are; relicts of policies that were made decades ago under very different conditions, policies that have proven costly and inefficient and have generated much international strife. Ukrainian policy makers would be well advised to chart an agricultural policy course that anticipates international trends and puts Ukraine at the forefront of these trends over the next decade. The Draft Law, however, would put Ukraine at the tail end, adopting measures that its major competitors on world agricultural markets are, with good reason, abandoning.

**Figure 1: The evolution of the level and composition of agricultural support in OECD countries, 1986-88 to 1999-01**




Notes: * 1991-93 average for the Czech Republic, Hungary, Mexico, Poland and the Slovak Republic.
Each point in the graph shows a combination of the %PSE and the share of total MPS payments based on output and input use in the PSE for the years covered. The point at the tail of an arrow refers to 1986-88 and the point at the head of the arrow refers to 1999-2001.

Source: OECD (2002): *Agricultural Policies in OECD Countries: A Positive Reform Agenda*. Paris. (see http://www.olis.oecd.org/olis/2002doc.nsf/linkto/com-agr-td-wp(2002)19-final).

## 2.2 WTO compatibility

The President of Ukraine, Leonid Kuchma, and numerous other high-ranking state officials have clearly stated that membership in the WTO is a clear policy priority for Ukraine. The Draft Law, however, would at very best make WTO membership a much more distant prospect. At worst it would make WTO membership impossible.

As the German Advisory Group has argued elsewhere[2], it is important to recognise that Ukraine is a net exporter of many important agricultural commodities, primarily grains and oilseeds. As agriculture continues to restructure and recover from the transformation crisis of the 1990s, Ukraine's export position is likely to grow and expand to other products, especially livestock products such as milk products and meat. At the same time, it appears certain that a precondition for Ukraine's WTO membership will be that it commits itself to use no export subsidies in the future. Price support for commodities that are exported inevitably involves the use of either implicit or explicit export subsidies. In other words, a WTO member that is not able to use export subsidies cannot implement price support measures. However, the Draft Law calls for price support. It even makes indirect reference to the use of export subsidies in article 8.2.3 of section 3 in which it is stated that commodities that have been purchased into intervention can be exported if they are not required on domestic markets. If these intervention purchases took place at a supported price, then the commodities in question will inevitably have to be sold for a loss on world markets, and the difference between the prices of purchase and sale will be an export subsidy.

The Draft Law therefore clearly and directly contradicts the goal of WTO membership for Ukraine. If the proponents of the Draft Law are aware of this implication, they should clearly state this. If not, then they should first take a close look at the implications of WTO membership for agricultural policy making in Ukraine and modify the Draft Law accordingly.

### 2.3 Mechanisms that can not and will not work

Let us assume that some policy makers in Ukraine have decided to abandon the goal of WTO membership in order to clear the way for the implementation of the Draft Law. Would this implementation lead to efficient and targeted support of agriculture? For a variety of reasons the answer is probably 'no'.

First, most of the policy mechanisms foreseen in the Draft Law are quite expensive. Increasing the price of grain in Ukraine by only 10% would cost society roughly 2 billion UAH, given a total harvest of 38 million tons and an unsupported price of 500 UAH/ton. Consumers could be forced to pay part of this in the form of higher food prices in Ukraine, but taxpayers (i.e. the state budget) would have to pay for price support on at least that part of the harvest that is exported. Assuming that 10 of 38 million tons are exported, roughly 500 million UAH would have to be found in the budget to support grain prices alone. Sugar, oilseeds and livestock products would add to this burden.

A glance at Figure 1 demonstrates that the countries that have traditionally provided generous support to their agricultural sectors share some important characteristics. First, they tend to be wealthy; countries such as Japan, Norway, Switzerland and the EU provide the highest levels of support. Relative to Ukraine even South Korea and Iceland are very wealthy. Second, the highest levels of support are provided by net importers; net exporters such as New Zealand, Australia and Canada are concentrated on the left of Figure 1 while the right is the exclusive domain of net importers such as Switzerland and Norway. The reason for these patterns is simple: Agricultural support is expensive, so it is a 'luxury' that only wealthy countries can indulge in. And the more a country exports, the more expensive support becomes. As a matter of fact, in a net import situation, agricultural support in the form of import tariffs actually translates into budget revenue, making support attractive from the taxpayer's point of

[2] See paper S25 „*The implications of WTO-Accession for Ukrainian Agricultural Policy*".

view (although it continues to burden consumers considerably). In a net export situation support agricultural support drains the budget.

Hence, the Draft Law is yet another proposal that makes promises that cannot be kept. It calls for Ukraine to join a 'rich man's club' but does not specify how it will pay the membership fees.[3] If passed, it will raise expectations, only to disappoint them, undermining citizens' trust in policy makers and the policy making process.

Second, as mentioned above, price support, which is one of the main mechanisms called for by the Draft Law, is an especially inefficient way of supporting agriculture. The OECD has recently published evidence of this inefficiency, demonstrating that only roughly 40% of price support payments end up in farmers' or land owners' pockets – the remaining 60% end up either wasted or in the hands of input suppliers. Decoupled payments are considerably more efficient as roughly 90% end up benefiting farmers. The Draft Law (section 2, articles 3 and 4) does make reference to subsidy payments per hectare of land or head of livestock, payments which are less inefficient that price support but nevertheless not as efficient as decoupled income transfers. Note, however, that payments per hectare and per head would be considered yellow box payments by the WTO, and that Ukraine would presumably have to reduce these over time.

Third, other mechanisms outlined in the Draft Law are also questionable. Consider for example the mechanisms designed to increase the supply of agricultural inputs outlined in section 2, article 5 of the Draft Law. These mechanisms include a state credit guarantees and the leasing to farmers of agricultural machinery purchased by the state. Both mechanisms have been attempted in the past in Ukraine and proven unsuccessful. According to Presidential Decree #540/99 of May 20, 1999, a credit guarantee fund was established by the State Committee on Entrepreneurship and the National Bank of Ukraine. Its activity has been ineffective and has been criticised by President Kuchma himself. In the area of leasing, a State Leasing Fund to re-equip agriculture was established in 1997, and later the state-owned stock company 'Ukragroleasing' became active, with limited success at best. Despite the activity of this company, farms remain poorly supplied with agricultural machinery. Indeed they are probably less well supplied than if there had been no state interference at all, because this interference has also included measures designed to support the domestic agricultural machinery industry (largely ineffective) by erecting barriers to imports of foreign machinery (effective).

Finally, the Draft Law calls for determining minimum prices on the basis of "product specific normative costs" and that "guarantee a rate of profitability of 5%" (section 1). The idea that it is possible to objectively determine the 'correct' price level for a group of producers in agriculture is one of the most tenacious myths in agricultural economics. It is a myth because in a market economy the causality does not simply run from costs to prices in agriculture. Instead, product prices also determine costs, in particular the cost of land. Increasing output prices and profitability in agriculture will inevitably lead to increasing prices for agricultural land. These, in turn, are used to justify further increases in output prices, which lead to further land price increases, and so on. The result is an endless spiral which benefits land-owners but not necessarily farmers.

The idea that prices can be objectively determined to cover 'normative' costs is also a myth because it fails to account for the great heterogeneity in agriculture, especially

[3] For more on the financing of the measures in the Draft Law, see section 2.4 below.

in transformation economies. A price that guarantees 5% profitability for the average farm will provide insufficient support for farms that are less efficient than the average, and will simultaneously provide unnecessary support to those that are more efficient. It is an illusion to think that the 'normative' cost level can be objectively determined on purely technical grounds; costs depend on myriad non-technical factors such as management skill and the motivation of employees that are intangible and impossible to measure.

### 2.4 Funding issues

As outlined above, the measures called for in the Draft Law would be exceedingly costly to implement. It comes as no surprise, therefore, that the Draft Law includes a long list of possible sources of funding.

In general it is important to recognise that Ukrainian agriculture already receives generous subsidies. Ukraine's AMS (Aggregate Measure of Support – a measure of trade distorting support used by the WTO) amounted to 1.88 billion UAH in 2001. In addition, 1.06 billion UAH of green box (non-trade distorting by WTO definition) spending also took place in Ukrainian agriculture, for a total of 2.94 billion UAH of agricultural support (equivalent to roughly 0.55 billion US$).[4] Furthermore, although agriculture accounts for roughly 15% of Ukraine's GDP, it contributes only 1.5% of total government tax revenue, meaning that it receives significant hidden or implicit subsidies in the form of tax exemptions on top of the explicit spending. So altogether, agriculture receives a great deal of support from (and represents a significant burden on) other sectors of the Ukrainian economy.

There is no objective basis for demands that this support for agriculture, and the resulting burden on the rest of the economy, should be increased. This is a purely political question, and one might very well argue that agriculture in Ukraine should receive less, not more support. Certainly, to our knowledge no one has demonstrated that spending money in agriculture would generate greater net benefits for the Ukrainian economy or society than spending the same money on education, or the health system or any of the many other imaginable uses. As a principle of economic policy, a transparent cost-benefit analysis of this short should be a precondition for any state spending.

Implementation of the Draft Law would compound an existing problem, which is that the current system of agricultural taxation in Ukraine (the unified land tax) does not create a strong link between a farm enterprise's income or profitability on the one hand and its tax burden on the other. This means that a small but growing group of more efficient and often highly profitable farms – farms that could certainly afford to pay more taxes – is receiving disproportionate benefits from the current system.[5] As it is reasonable to expect that these farms produce a disproportionate share of Ukraine's agricultural output, they would also benefit disproportionately from the price support schemes outlined in the Draft Law.[6] Hence, the Draft Law would increase the already existing inequity in Ukrainian agricultural support policy, burdening consumers and

[4] See KOBUTA, I. & O. SHEVZOV (2002): *Domestic Support of Agriculture in Context of Ukraine's Accession to the WTO*. Agricultural Policy for Human Development Project in Ukraine, Working Paper 14. These estimates are based on budget legislation. Given the degree of budget fulfilment in Ukraine, actual spending was almost certainly lower.

[5] See German Advisory Group paper S4 "Taxation and Ukrainian Agriculture after 2004", July 2002.

[6] This is a well-known phenomenon in other countries. In the EU, for example, it is a rule of thumb that roughly 80% of farm support spending accrues to the roughly 20% of the EU's farmers that produce most of the agricultural output.

taxpayers to provide support that accrues largely to farm enterprises that are already receiving significant benefits through the tax system.

A further problem with the financing provisions of the Draft Law is that they call for the earmarking of specific revenues for exclusively agricultural purposes. As a principle of sound fiscal policy, tax revenues should not be earmarked but should flow into general revenues. Otherwise, 'parallel' budgets emerge and the transparency and flexibility of the budget process is reduced. With this in mind, the Draft Law's proposal for the introduction of a 1% tax on all sales is especially questionable. This tax would generate significant revenue and represent a fairly major change to the tax system in Ukraine. Such changes should not be made exclusively with the ostensible 'needs' of agriculture in mind, but rather should be considered together with the tax system and tax reform as a whole, if at all. Otherwise policy makers run the risk of establishing a dangerous precedent. With the presidential election campaign in Ukraine perceptibly heating up, one must be especially concerned that the establishment of special 'earmarked' funds could be just a thinly disguised means of creating 'pots' of money for purely political purposes.

## 3. Conclusions

The Draft Law of Ukraine *„On supporting the production and development of agricultural markets*" would take Ukrainian agricultural policy off the path of market driven reform and condemn it to repeat policy experiments that have proven exceedingly costly and ineffective elsewhere. Ukraine cannot afford to implement these policies in the first place, and even it if could it would be ill-advised to do so. Perhaps most important is the fact that the implementation of the Draft Law would put an effective halt to Ukraine's efforts to join the WTO.

For these reasons, policy makers should reject the Draft Law in its current form. Ukraine does need a long term agricultural strategy, and the Draft Law could provide a basis for such a strategy. But before it can be given serious consideration:

- A **thorough cost-benefit analysis** of potential agricultural policy tools in a Ukrainian context should be carried out, to transparently identify who would benefit and who would lose from the implementation of these tools. This analysis should explicitly consider the **opportunity costs of agricultural support** in the form of foregone policy options in areas such as education and research, etc.;

- A thorough investigation of the **interaction between domestic agricultural policy** tools on the one hand **and Ukraine's international commitments** (i.e. WTO membership) should be carried out;

- A realistic appraisal of **Ukraine's ability to pay for agricultural policy** must be made. This appraisal should carefully consider the implications of agricultural support especially for poor consumers in Ukraine, and the fact that agriculture is already receiving significant direct and indirect support.

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March 2003