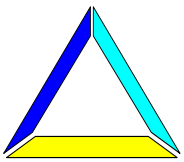
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE
GERMAN ADVISORY GROUP ON ECONOMIC REFORM

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 228-6342, 228-6360, Fax 228-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



S18

Comment on the "Concept of the Development of Agricultural Policy in Ukraine"

1. Introduction

In late 2002, a group of respected analysts released a set of far-reaching proposals for the future course of agricultural policy in Ukraine. In this 'Concept of the Development of Agricultural Policy in Ukraine' (the '*Concept*'), reference is made to a first phase of agricultural reform that culminated in 2000-2002 with a return to growth in Ukrainian agriculture. The authors then list a number of areas that they argue have been neglected in the course of this first phase of reform. These include the failure to ensure price parity and a system of equivalent exchange between agriculture and other sectors of the economy. Based on this diagnosis, the authors go on to suggest a set of policy measures that would make up what they refer to as the second phase of agricultural reform in Ukraine.

In the following we attempt to provide some analysis on the *Concept*. As the authors of the *Concept* are respected and influential, their analysis and prescriptions carry considerable weight and are worthy of careful consideration. Indeed, the *Concept* is the analytical basis of a Draft Law 'On the Stable Development of Agriculture in Ukraine' that has been introduced in the Verchovna Rada. For these reasons, the *Concept* deserves to be taken very seriously. The *Concept* contains many suggestions for the future course of agricultural policy in Ukraine, and it is not possible to deal with all of these in detail. Indeed, it contains many suggestions that we endorse fully, such as the need to accelerate the development of infrastructure for a functioning land market (land registration, mortgage, etc.). The fact that we concentrate in the following on a number of key provisions of the *Concept* that we consider misguided should not distract from the fact that there is broad agreement on many other provisions.

2. Phases of agricultural reform in Ukraine

Realistic diagnosis is a necessary condition for effective prescription. The authors of the *Concept* refer to a first stage of agricultural reform in Ukraine that must now be succeeded by a second stage. We suggest that this interpretation of history is wrong and propose, instead, the following alternative interpretation. In our view, the first stage of agricultural reform in Ukraine already ended at the end of 1999. This stage was largely ineffective

because in many important respects it was poorly designed and poorly executed. While some important and difficult changes were instituted, production structures remained largely unchanged and state intervention in input supply and output marketing remained prevalent. Since the state was more or less bankrupt, it could not continue the massive implicit and explicit subsidies that had flowed into agriculture in Soviet times, subsidies that were necessary to hide the massive inefficiencies caused by outdated production and marketing structures and misguided state intervention. As subsidies were removed in the early 1990s, these inefficiencies became visible and production fell dramatically. The situation can be compared with that of an athlete who is fundamentally unfit but kept in action by drugs: Take away the drugs and performance deteriorates.

While the agricultural subsidies that were a key element of central planning inevitably fell, policy makers did not clearly formulate or commit themselves to an alternative to central planning. In particular, the first phase was characterised by a lack of clear consensus on the need for and the true nature of market oriented reforms. While (some of) the rhetoric prior to late 1999 may have been market-oriented, the reality in Ukrainian agriculture was clearly not. Most accurately, this first phase was not one of reform, but rather one of indecision and stagnation. Symptomatic of this phase was the lethal combination of state grain orders and state intervention in grain marketing. This set of policy 'fossils' from the age of central planning maintained old structures and inefficiencies and effectively destroyed incentives for desperately needed investment in grain production, processing and marketing.

In late 1999, a second phase of agricultural reform was introduced by Presidential Decree "On accelerating reforms in Agricultural Sector of Ukraine" and the announcement by the new government under Prime Minister Jushenko that it would no longer be involved in state grain orders (input supply on the one hand and the resulting export controls and bans on the other). The first of these policy measures made it possible for farms to begin effective (as opposed to the earlier largely superficial) restructuring. The second measure gave farms incentives to carry out such restructuring, as it for the first time provided farms with a reasonable guarantee that they would be able to both realise profits in grain production and dispose of these profits freely (i.e. invest, expand, purchase inputs, etc.). Spurred by this fundamental change in Ukraine's agricultural policy orientation, and supported by overall economic growth, Ukrainian agriculture has responded impressively since 2000, as outlined by the authors of the *Concept*.

We propose this alternate, two-phase interpretation of past agricultural policy in Ukraine not as a purely academic exercise, but because an accurate understanding of the past is a necessary basis for effective decisions on future policy. It is important to recognise that recent agricultural success in Ukraine is largely the product of policy measures that represented a fundamental change from reforms reached in the late 1990s. These new measures did not increase state regulation and intervention in agriculture; instead they encouraged farms and farm members to reorganise themselves on the basis of private contracts

and incentives, and they effectively deregulated much of the crucial grain market, thus strengthening the role of markets and entrepreneurial decision making.

Hence, we do not feel that a new phase of reform is necessary for the simple reason that this new phase already began 3 years ago. This phase pointed in the right direction; it does not need to be supplanted by a new phase but rather needs to be confirmed and strengthened. Some measures introduced since late 1999 – for example the adoption of the new Land Code – have continued in the right direction, confirming that Ukraine is committed to agriculture based on free markets and entrepreneurial decision making. Other measures – for example Decree 832 of July 29, 2000, and later normative acts calling for the introduction of pledge price and intervention systems for grains – indicate that the old urge to regulate and interfere in agriculture is still strong. Agriculture has not grown in recent years in Ukraine because of better state regulation, it has grown because some policy makers were wise enough to recognise that there are limits to what regulation can achieve, and that misguided regulation often stifles growth. Recommendations for future agricultural policy must therefore be judged according to whether they nurture and support the tender seedling of market-oriented reform that was planted in late 1999, or whether they represent an attempt – conscious or otherwise – to revive the failed policies of earlier years.

3. Price parity and equivalent exchange between sectors

We are concerned that the references made in the *Concept* to 'parity' and 'equivalent exchange between sectors' represent just such an attempt to turn back the clock. In agricultural policy debates, parity usually refers to some historical level of prices or profits in agriculture relative to other sectors that is considered 'fair'.[1] While it is possible to arbitrarily choose some point in time at which 'parity' existed, and to consider any ensuing changes as 'violations' of parity, there is no objective scientific basis for doing so. Relative prices change over time in response to economic forces such as technological progress, resource scarcity and shifting consumer preferences. In a market economy, changes in relative prices are signals that indicate that it is becoming relatively more or less costly to produce certain goods and/or that relative consumer preferences for these goods are changing. In response to these signals, producers and consumers adapt their economic behaviour, producing more (less) and consuming less (more) of products that have become more (less) expensive. As a consequence, resources have to be reallocated from shrinking to growing sectors, otherwise rates of profitability will fall in the latter and grow in the former. This reallocation, especially when it involves people, is

[1] Several publications by the German Advisory Group and the Institut for Economic Reform and Policy Consulting deal with the history and scientific basis of the concept of parity in agriculture. See, for example: DEMYANENKO S: *On the Concept of National Agrarian Policy*, in *Economy of Ukraine*, 1998, No. 1, pp. 22-30; and SIRIN, K. & ZORYA, S.: *Can the Crisis in Ukrainian Agriculture Be Attributed to Price Disparity?*, in VON CRAMON-TAUBADEL, S., ZORYA, S. & STRIEWE, L. (eds.): *Policies and Agricultural development in Ukraine*, Shaker, 2001, pp. 87-102.

painful, and finding the right balance between the benefits it brings on the one hand (economic efficiency, growth and welfare), and the costs it entails to individuals and the social fabric on the other, is perhaps the single most important challenge facing policy makers in market economies.

If we really wanted to maintain constant parity, we would have to forbid technological change and 'freeze' preferences for all ages. This is clearly impossible. Even if it were possible, the unavoidable progressive depletion of natural resources would inevitably continue to trigger changes in relative prices. In any event, maintaining parity at some fixed level would be very expensive. Take the case of agriculture, for example. Over time, as economies grow and develop, the prices of agricultural products tend to fall relative to prices for other goods and services.[2] This is because technological change tends to be quite rapid in agriculture relative to other sectors on average, and because the demand for food increases less rapidly than the demand for most other goods and services, once basic nutritional requirements have been met. This tendency towards declining agricultural parity may appear unfair, but it is important to be realistic about the prospects for stopping it:

1. On the demand side of the equation, the state cannot force Ukrainian consumers to eat more.
2. On the supply side, the state could, perhaps, put a halt to technological progress in agriculture. However, this would put Ukrainian farmers at a significant and growing disadvantage vis á vis their competitors in other countries who would continue to use the most efficient technologies (unless of course Ukraine also decided that it no longer wanted to compete on international markets and export agricultural products).
3. The state could provide farmers with price support to compensate for declining agricultural parity. In the *Concept*, for example, reference is made to a price policy that equalises profit rates across sectors. The Law 'On the Stable Development of Agriculture in Ukraine', call for the use of pledge price and intervention purchases to ensure that prices remain within upper and lower bands that ensure the maintenance of 'profits norms'. These concepts are not well conceived. Such support is expensive and it inevitably becomes more expensive over time. This is because as relative agricultural prices continue to decline over time worldwide, the support required to maintain a given profit rate in an individual country such as Ukraine will progressively grow. Ukraine cannot afford to provide agricultural producers with this type of support; the required money does not grow on trees, it has to be taken either from consumers in the form of higher food prices (and inflation) or from other sectors in the form of higher taxes. Making promised that obviously cannot be kept unnecessarily damages the credibility of policy making and policy makers in Ukraine.

[2] We are not referring here to short run (month to month and year to year) price fluctuations that occur as a result, for example, of weather. The German Advisory Group recently discussed options for stabilising such fluctuations in paper S6: *Grain Market Regulation in Ukraine: Options and Evaluation*.

Maintaining 'profit norms' via price support is not only unaffordable; it contradicts Ukraine's goal of WTO membership. If Ukraine wishes to be an agricultural exporter, then supporting domestic prices to maintain some desired level of parity will inevitably require the use of export subsidies. However, all indications are that as a WTO member Ukraine will not be permitted to use export subsidies. Therefore, proponents of parity and equivalent exchange between agriculture and other sectors should be very clear about one thing: What they are calling for – for example in the 'Law on the Stable Development of Agriculture in Ukraine'- clearly contradicts the goal of WTO membership. In this respect, the *Concept* is inconsistent when it calls for steps to be taken to achieve WTO membership on the one hand, and recommends that price policy and subsidies be used to equalise profit rates across sectors on the other.

As mentioned above, Ukrainian experts usually refer to so-called 'norms of profit' when they discuss parity. The norm of profit is defined as the ratio of profit to the value of fixed assets plus inventories plus land. Evaluating the value of agricultural fixed assets and especially land is notoriously difficult, even in an established market economy. In Ukraine, land markets are just beginning to emerge. So experts often use theoretical or 'potential' land values based on values of similar land qualities in other countries. This is a highly subjective and questionable approach, and it is not based on a theoretically solid understanding of how agricultural land values are determined in market economies.[3] In particular, it ignores an important chain of causality: agricultural land values are largely determined by agricultural profits. If policy makers increase the profitability of agriculture (for example, by supporting prices), then land values will automatically increase as well, reducing profits in turn.

Of course, the issue of price parity in Ukraine (as in other Central and Eastern European countries) is especially sensitive because, as mentioned above, the elimination of the massive subsidies provided to agriculture under central planning led to a very dramatic decline in price parity in the early to mid-1990s. Farmers and other members of the agrarian lobby are fond of citing how much more wheat is required to purchase one tractor today than, for example in 1985. What they don't add, however, is just how expensive wheat would have to be today to replicate the parity conditions that prevailed in 1985, or how inexpensive tractors would have to be. Consumers and/or tractor producers would not be amused, to put it mildly. The extreme distortions and inefficiencies of central planning simply do not provide a meaningful point of reference when discussing economic policy in a market economy.

Agricultural terms of trade in Ukraine today do not differ significantly from agricultural terms of trade in other countries such as the EU. EU farmers receive more for their produce, but they also pay considerably more for inputs such as energy and land. Furthermore, even if agricultural price parity is

[3] See VON CRAMON-TAUBADEL, S. AND STRIEWE, S.: A Market for Agricultural Land in Ukraine in VON CRAMON-TAUBADEL, S., ZORYA, S. & STRIEWE, L. (eds.): *Policies and Agricultural development in Ukraine*, Shaker, 2001, pp. 201-213.

perceived to be low in Ukraine today, the most efficient farms are nevertheless able to make considerable profits. The authors of the *Concept* make the common error of focussing on average profit rates across sectors, when they call for equivalent exchange. As we discuss elsewhere in detail[4], averages can be very misleading, especially when the variation about the average is as large as it is in Ukrainian agriculture.

4. The 'European example'

Having read all of the above, many Ukrainian readers may feel the undeniable urge to say: 'But in the EU farmers receive generous support'. Indeed, the authors of the *Concept* refer at one point to "… economic development according to the European model." A few comments on agricultural policy and specifically the issue of price support and price parity in the EU may help to clear up some misconceptions at this point:

- As stated above, relative agricultural prices in the EU do not differ significantly from those in Ukraine. Following major reforms, prices for grain and many livestock products in the EU have fallen considerably since the early 1990s. Exceptions are sugar and milk prices, which remain very high in international comparison. But these are precisely the two sectors in EU agriculture that are under the most pressure for reform, in particular because, as described above, maintaining this price support requires the use of export subsidies that are coming under increasing attack in the WTO.
- The experience with agricultural price parity in the EU is exactly as described above. Up to the early 1980s agricultural policy makers attempted to follow what was referred to as an 'active' or 'objective' price policy that guaranteed what were considered to be fair rates of profitability in agriculture. The result was an exploding budget for subsidies and huge surpluses of agricultural products that could only be exported with subsidies. As predicted by theory (see footnote 3 above), land values increased to reflect increased returns to farming, leaving profits in agriculture more or less unchanged. Land owners may have been happy, but farmers who rent land received no tangible benefits. As a result, the active price policy had to be abandoned, and since the mid-1980s relative agricultural prices in the EU have been falling.
- The EU is no paradise for farmers. It is true that generous subsidies are paid out, but these are poorly targeted and largely end up making large and wealthy farmers even wealthier. Despite billions of Euro of subsidy spending, the number of farms in Germany has fallen by roughly 3% per year since 1950, as smaller, less efficient farms have been forced to leave the sector. In recent years this rate of decline has even increased.
- All relevant groups in the EU – farmers, consumers, taxpayers and policy makers – are not satisfied with the EU's agricultural policy. This policy has been in a more or less permanent state of crisis and reform since at least the early 1980s. It has been a major liability, for example greatly

[4] See German Advisory Group paper S-16: *The organisational forms and performance of agricultural enterprises in Ukraine: What conclusions can be drawn?*

complicating accession negotiations with applicant countries in Central and Eastern Europe and leading to numerous trade conflicts with partners. In a number of key areas (especially grains and oilseeds), budget pressure and WTO commitments have forced the EU to adopt a much more market-oriented approach in recent years. The EU has moved away from price support and intervention in these areas, and this trend will continue (e.g. milk and sugar) in the coming years.

Hence, the EU experience demonstrates that agricultural market regulation and price support is neither an effective nor a sustainable policy. This experience does not provide any arguments in favour of price support and market regulation in Ukrainian agriculture; on the contrary, it substantiates numerous arguments against such support and regulation. Why should Ukraine adopt policy tools that have failed and are being abandoned elsewhere?

5. Conclusions

Agricultural policy in Ukraine does not need to enter a new phase. A new phase, the first phase of market-oriented reform, began in late 1999. This phase represented a major break with the past and has been quite successful, as demonstrated by the significant improvement in agricultural performance in Ukraine since 2000. It is important to recognise that this success is due to less state interference in both the production and the marketing of agricultural products. Hence, renewed calls for increased intervention must be regarded with great scepticism. For this reason we are concerned that some elements of the *Concept* and the Draft Law 'On the Stable Development of Agriculture in Ukraine' are counter-productive and would lead Ukraine to repeat mistakes that have been made in the past, both at home and abroad.

What is needed, instead, are further steps to provide farmers, processors and traders with greater autonomy and freedom on the one hand, and a more stable and benign environment for investments on the other. Steps, for example, to eliminate the oilseed export tax, a tax that significantly reduces 'parity' in agriculture. Steps to further reduce day to day interference in agricultural production and trade by Oblast and Rajon authorities whose activities (restrictions on commodity movements, forcing farms to deliver to certain processors, etc.) significantly reduce efficiency and growth in agriculture. Steps to strengthen agricultural infrastructure, both physical (especially the transportation network) and institutional (truly transparent and open agricultural exchanges, public price information systems, etc.). And steps to open and improve the quality of agricultural education in Ukraine, especially in the areas of farm and agri-business management and agricultural market and policy analysis, to reduce the current shortage of market skills that keeps agriculture in Ukraine from reaching its potential.

S.v.C.-T., Lektor S.D., S.Z.
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