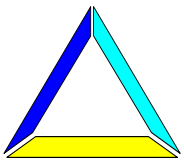
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE
GERMAN ADVISORY GROUP ON ECONOMIC REFORM

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



Q16

Ukrainian Trade Policy: A turn for the worse?

1. Introduction

In recent weeks there have been many indications that Ukrainian policy makers are surrendering to protectionist impulses. In agriculture, there are rumours that a variety of tariffs are being contemplated (for example, an 80% tariff on yoghurt imports). Talks aimed at reducing tariff and non-tariff barriers to trade in agricultural machinery have become bogged down and assurances that certification procedures etc. would be simplified have not been translated in to practical reality. Discussions aimed at reducing the often very high barriers to Ukrainian imports of seed (for example sugarbeet and potato) also seem to have produced little concrete progress.

There have also been reports of two types of protection for Ukrainian producers of pesticides and herbicides. First, Ukrainian policy makers have allegedly been planning to introduce or increase import tariffs on these products. Second, it is rumoured that Ukrainian policy makers are contemplating measures that would give domestic producers of herbicides and pesticides unfair advantages in the area of product testing and certification, advantages that would be in clear contravention of international standards for the protection of intellectual property rights.

Let us state clearly at the outset that the German Advisory Group does not trade in yoghurt, agricultural machinery, seeds or herbicides. We are not present when detailed discussions take place between representatives of the German Government and/or of German agricultural enterprises on the one hand, and representatives of the Government of Ukraine on the other. So we cannot be sure which of the points mentioned above are more than just rumour. In the following, however, we will assume that where there is smoke there is also fire. The purpose of this paper is to discuss the merits of different arguments for and against protectionism, with a focus on the current situation in Ukrainian agriculture.

2. The motivation for protection

Why might the temptation to implement protectionist measures be especially high in Ukraine at the moment? First, politicians often resort to protectionist measures in the run-up to elections. They argue that these measures support domestic production and create or save domestic jobs. These arguments are, of course, ideally suited to currying favour with voters. At election time, politicians all over the world want to appear patriotic, concerned with protecting voters from foreign competition, which is often characterised as being ‘unfair’. Why should politicians in Ukraine be any different?

Second, protection is also motivated by what is referred to as ‘rent seeking’. Specific firms or industries stand to benefit a great deal from protection (these

benefits are referred to as 'rents'). Thus, they have a clear interest in investing resources in lobbyists, publicity measures and, in some cases bribes, to persuade policy makers to implement measures that generate such rents (so-called 'rent seeking activity'). In an earlier paper, for example, the German Advisory Group demonstrated that import tariffs on raw sugar coupled with tariff rate quotas provided 5 sugar refining enterprises in Ukraine with an estimated 'rent' of roughly 28 million US$ in 2001. We do not know what actions these enterprises did or did not take to obtain the tariff rate quotas, but it is clear they had powerful incentives to attempt to secure them.

Note that rent seekers need not necessarily be domestic enterprises or industries. For example, a foreign firm might establish a joint venture processing facility with a domestic partner in Ukraine and then persuade policy makers to 'protect its investment' by implementing measures that make it very difficult for other foreign firms to establish their own facilities or import competitive products. A case in point is the automobile manufacturing joint venture involving the Korean enterprise Daewoo, and the infamous 'Lex Daewoo' that was passed to reduce the competition faced by this joint venture. This strategy can be very effective because there are many high-tech products – for example agricultural inputs such as pesticides or hybrid seed – that Ukraine cannot produce (yet) without the assistance of foreign firms. These firms have an incentive to create monopolies for themselves by 'getting inside first and slamming the door shut' with the help of Ukrainian policy makers.

Third, in Ukraine, there is reason to suspect that some protectionist measures may be designed to generate campaign funding for specific individuals and political parties or alliances as election time approaches. This suspicion is fuelled by:

- the high concentration of ownership in some branches of industry,
- the fact that many politicians have direct or indirect links to specific enterprises, and
- the fact that many protectionist measures that appear to benefit entire industries are in practice tailored to providing benefits to specific enterprises.

Of course, not all of the protectionist measures that are the topic of rumour at the moment are suited to generating campaign funding. Some measures, such as the imposition of import tariffs, cannot be implemented without parliamentary consent, and it is unlikely that the Verchovna Rada will get around to granting this consent prior to the up-coming elections. Hence, many measures could be implemented, if at all, only after these elections. Indeed, one might even argue that rumours of protectionist measures should, as a rule, not be taken very seriously prior to elections. According to this line of argument, few of the measures that are being proposed today have a chance of being implemented, and making such proposals prior to elections is simply part of the 'political game'.

This is a dangerous line of reasoning, however. Not all of the measures that have been discussed in recent weeks require parliamentary consent. Many are examples of so-called 'non-tariff' trade barriers that that can be enacted by administrative order. For example, it is well known that customs and certification procedures in Ukraine can be manipulated towards protectionist ends. Furthermore, by proposing or entertaining protectionist measures in public or behind closed doors,

policy makers give these measures an air of legitimacy. They also generate expectations that have to be dealt with at some later date.[1]

In the final analysis, different combinations of the various factors discussed above will be the motivation for different protectionist measures. As outlined below, however, these protectionist impulses all have one thing in common: they should be resisted.

3. Does protection really create jobs?

To begin with, there is little evidence that protection boosts production or creates jobs. On the contrary, it tends to reduce both in the long run. The problem, put simply, is that support for one sector or enterprise always implies taxation of other sectors or enterprises. When considering the impact of protection on domestic employment, therefore, it is important to look beyond the sector or industry that is the immediate beneficiary of this protection, and to account for employment effects elsewhere in the economy as well.

Increasing tariffs on imported agricultural chemicals and spare parts for agricultural machinery, for example, may save jobs in the domestic chemical and machinery industries. But what of the jobs they destroy on domestic farms that are forced to reduce production or even shut down due to the resulting increased costs? And what of the jobs that are lost or fail to be created in the food processing and marketing industries as a result of reduced farm production? How many more tonnes of grain would have been harvested and either consumed, processed or exported in past years, if Ukrainian farmers had had access at lower cost to Western combine harvesters? Similarly, while an import tariff on yoghurt may save some jobs in the domestic dairy industry, how many jobs will it destroy in other industries that produce consumer goods because consumers are forced to pay more for yoghurt and must reduce expenditure on other goods as a result. What appears to be a patriotic bid to save jobs in a specific factory or branch of industry almost always proves, on closer examination, to be a job destroyer for the economy as a whole.

Note that the jobs that are created or saved by protection are generally relatively easy to measure; these jobs are often concentrated in a particular industry and/or region, indeed often in a specific enterprise. The jobs that are destroyed elsewhere are often spread out over sectors and regions and, therefore, tend to go unnoticed. This might make it tempting for policy makers to attempt to score political points by implementing protectionist measures; the ‘good’ they do is highly visible while the ‘bad’ is hidden. If all policy makers attempt to make use of this illusion, however, employment and the economy as a whole will suffer.

Sometimes policy makers try to counter this argument by appealing to the economic equivalent of perpetual motion. For example, policy makers might agree that protecting the farm machinery industry with import tariffs has a negative impact on the farm sector, but they will argue that this negative impact can be compensated by protecting the farm sector as well. For example, they might provide farmers with subsidised credit, tax exemptions, and/or price support for farm products in the form of intervention purchases of grain. Of course, all of these measures require government spending (which increases taxes elsewhere in the economy) and the latter measure increases bread prices (which increases the cost of living for consumers). Again, policy makers could attempt to reduce this burden on taxpayers

[1] Finally, even if the measures in question ‘only’ represent idle pre-election promises that policy makers have no intention of keeping, is it wise to waste political credibility in this manner?

and consumers – for example by allowing them to use electricity without paying for it or by dictating price ceilings for foodstuffs – but by now the principle should be clear: The cost of protection does not disappear, it is simply passed on to someone else. In the end, someone has to pay the bill.

What is worse, the costs of protection to the economy as a whole are usually much higher than the benefits received by those that the protection is meant to help. The reason is simple. All of the interventions listed above – collecting tariffs on imported machinery, providing interest rate subsidies, carrying out intervention purchases on grain markets, etc. – cost money. To implement them, the government has to hire customs officials, process applications for interest rate compensation, maintain grain storage facilities, monitor retail prices of bread etc. This requires personnel and other resources such as vehicles and office space, all of which have to be paid for. Due to the resulting costs, protection is not a zero-sum game; it costs more than one Hryvnia to transfer one Hryvnia worth of protectionist benefits to domestic producers of agricultural chemicals, agricultural machinery, or whatever.

Similarly, recall the rent seeking activities that were mentioned above. Rent seeking – i.e. attempting to persuade policy makers to protect certain industries or enterprises – also requires the use of resources (for example, lobbyists and all of the infrastructure that they use such as offices and telephones). From the point of view of the economy as a whole, these resources are wasted because they do not produce any goods and services that anyone would voluntarily choose to consume. It is safe to assume, for example, that most lobbyists are clever people with above average education and abilities. But rather than contributing to the production of new or better goods and services in the economy, they spend their time trying to influence the distribution of the existing goods and services; rather than helping to 'bake a bigger cake' they argue about who should get which 'crumbs'. From an economic point of view, therefore, they represent wasted productive capacity.

4. The political costs of protection

Often, protection leads to a considerable waste of political resources as well as economic resources. Consider the immense backlog of important legislation that Ukraine's Verchovna Rada has failed to pass in recent years (or that could have been passed sooner than it was), and consider as well the amount of time that the Rada has spent debating the export tax for oilseeds, tariff rate quotas for sugar, countless programmes for the support of the domestic farm machinery industry etc. In the same vein, how much valuable time have high-ranking policy makers in Ukraine spent over the years listening to the grievances and lobbying of individual firms and branches, each complaining that it is being treated unfairly or trying to secure some form of special treatment? Policy makers who spend too much time considering whether firm X should benefit from tariff rate quota Y or be exempt from certification procedure Z have too little time to think about overall principles, strategies and long term goals. Only by thinking about such principles, strategies and goals is it possible to design a consistent policy, one that does not give with one hand (interest rate subsidies) and take away with the other (oilseed export tax), one that does not 'step on the gas' with one foot (pledge prices for grain) and on the brakes with the other (import tariffs and lengthy certification procedures for agricultural machinery).

5. Conclusions

Most analysts agree that Ukraine's agricultural future lies in exports. At the moment Ukraine imports many agricultural inputs and outputs, so import protection appears to be a convenient way of both helping domestic producers and raising

budget revenue. For a net exporter, however, protection does not increase budget revenue: on the contrary, it can quickly become very expensive. The EU spends billions of Euro every year on the export subsidies that result from the combination of domestic price support and net exports. So surrendering to the protectionist impulse today could prove very costly in the future for Ukraine. This year, 1.9 million tonnes of grain have been bought by agencies of the Ukrainian government in an attempt to support grain prices. This is considerably less that the 3 million tonnes that were to have been bought, but it is already enough to exhaust the available financial resources. What will the costs be when Ukraine produces an export surplus of 15 or 20 rather than 'only' 7 million tonnes of grain?

In the short run, Ukrainian policy makers should do everything possible to withstand the protectionist impulse. Some of the reasoning presented above may help policy makers counter populist arguments and turn down requests for protection in the coming months. To increase resistance to protectionism in the long run, however, Ukraine would be well advised to join the WTO as quickly as possible. To become a WTO member, Ukraine would have to promise to adhere to a series of policy disciplines. For example, it would have to commit itself not to increase import barriers beyond a given, fixed, historical level. WTO membership would therefore provide policy makers in Ukraine with support and a source or resolve when faced with the temptation to implement protectionist measures in the future. Moreover, as a WTO member, Ukraine could join forces with other small, export-oriented agricultural exporters such as Canada and Australia (members of the so-called Cairns Group) who are trying to create a 'level playing field' on world agricultural markets. Ukraine cannot hope to compete with the 'big subsidisers' such as the EU and the USA; it must do what it can to ensure that these subsidisers 'play fair' in the future. By dabbling in short-sighted protectionism, Ukraine is not only threatening its own economic growth, it is providing those who argue that Ukraine is not committed to joining the world trading system with cheap ammunition.

S.v.C.-T., Lector L.S.

January 2002