Comments on the Draft Law “On supporting the production and development of agricultural markets”

1. Introduction

This Draft Law is just another attempt to strengthen the legislative base behind the state support of the agricultural sector in Ukraine. As the preamble of the Draft Law suggests, its main purpose is “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 the following:

- **Increased expenditures to support agricultural production** (section 2). As it is stated in the Draft Law, the government shall support production of agricultural products through the development of agricultural market structures, state purchases of agricultural commodities in quantities necessary to ensure minimum food consumption requirements for the most vulnerable groups of the population, financial support of crop selection and livestock breeding activities, control over input prices, protection of the domestic market, the reduction of the tax burden on agricultural producers, provision of subsidies to producers of animal products, and similar measures.

- **Price support and market regulation** (Section 3). The Draft Law envisages the introduction of minimum and maximum prices (i.e. a price corridor), intervention purchases and sales, and the regulation of wholesale and consumer prices through restricting markups and profitability rates.

- **State guarantees and subsidized credit** (Section 4). The Draft Law says that the state shall facilitate access of farmers to credits through the establishment of the 'Agrarian Fund' which would create favorable conditions for crediting agriculture, partial compensation of the interest on credits, and the provision of state guarantees.

- **Subsidized insurance schemes for farmers** (Section 5). This section provides for mandatory crop insurance for producers who get state

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1 The Draft Law has been passed in the second reading and is being prepared for the third one.
subsides, subsidized interests or state guarantees on credits. Crop insurance is subsidized by the state.

2. Should Ukrainian Grain Prices be Forced into a Price Corridor?

As it stands, the Draft Law contains many points that are worth pursuing. 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. The Draft Law, however, suffers several important shortcomings. The most important one is the lack of objective reasoning in determining the level of support and maximum prices. The Draft Law calls for determining minimum prices as “90% of the average price prevailing over the last three years inflated by the GDP deflator” (section 1, point 13). Furthermore, it is stated that the minimum price should guarantee a profitable or break-even production in the agricultural sector on average (Section 3, Point 8.2) These two criteria do not necessarily harmonize. 90% of the average price prevailing over the last 3 years may not be high enough to guarantee profits, on average! The maximum prices are set at “115% of the average price prevailing over the last three years inflated by the GDP deflator” (Section 1, Point 14). There are some problems with the minimum and maximum price set in a way provided for in the Draft Law. In the following we will discuss all of them in turn.

First, any minimum price which is really defended by the government at a level above the free market price leads to surpluses which cannot be sold domestically at this high price. In this case, the government can do three things:

1.) Pile up ever higher grain stocks. This is not a viable strategy when we assume that Ukraine will become more and more productive, making deficit years when stocks can be released rather the exception than the rule.

2.) Sell the grain on the internal market. This is probably not viable as Ukraine produces such considerable surpluses under normal circumstances that these surpluses can only be sold at a very low price close to zero.

3.) Sell the grain from intervention stocks on the world market, being the most common strategy, also still used by the EU. This may work without losses only when world market prices are considerably higher than in the years during which the stocks have been built up. This is not very likely, but

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2 It is not clear whether this provision would implicitly mean a relaxation of the Law “On stimulating agricultural development in 2001-2004”, where it is stated that insurance of grains and sugar beet crop is mandatory for all agricultural producers, irrespective of whether they receive state support or not.

3 The EU Common Agricultural Policy introduced minimum grain prices in 1968 above world market levels. Soon after this, grain surpluses that had to be disposed of on world markets with export subsidies caused serious trouble to the EU budget.
rather that the government will have to subsidize this disposal of grain surpluses. This is ruled out for WTO members, and all the more for WTO applicants.\textsuperscript{4} Defending minimum prices in a country which can be expected to become a grain exporter during most years is thus a very costly option, endangering not only agricultural exports, but also other exports like steel or machinery, and not feasible option if the WTO membership is a true goal.

Second, the price corridor on the basis of the average prices over the last three years may be difficult to determine. As was emphasized in the papers by the Germany Advisory Group the domestic price in an export situation is determined by the world price less transaction costs, while in an import situation – the world price plus transaction costs. In Table 1 in the Appendix we present calculations for 3 possible scenarios, each of which is likely to occur in the future.

As can be seen from the table in case if ...

- ... two out of the three preceding years were import years and only one was an export year (**Scenario 1**) the average domestic price (the base for minimum and maximum price) is relatively high. If the forth year happens to be an export year in order to increase the domestic price to the minimum level the government would have to purchase about 12.6 m tons of grains, which would require 5.5 bn UAH. It is hardly credible that the government will really spend this money, judging upon other experiences with minimum prices. Thus, the government is unlikely to be able to ensure the minimum price for farmers.

- **Scenario 2** looks more feasible, however, intervention sales would reduce farmers’ revenues by 4.2 bn UAH, which is about twice the current budget expenditures on agriculture.

- In **Scenario 3** the government would have to sell about 6.6 m tons in order to reduce the domestic price to the maximum level. To do this, the reserves should be relatively large: but the government is unlikely to have such reserves and, consequently, to succeed in pushing the domestic price down to the maximum level. Under this scenario the loss in farmers’ revenues would account for about 10 bn UAH.

It should be born in mind that revenues and profits of farms are ‘automatically’ stabilized somewhat by the fact that as Ukraine moves from good to bad harvests and back, it also moves from a net export to a net import situation and back. As a result, prices tend to be negatively correlated with harvests, which stabilizes returns\textsuperscript{5}. If, however, in years of bad harvest prices are administratively pressed down to the level of a 'maximum price' the price mechanism no more fulfills its stabilization function and the Draft

\textsuperscript{4} The EU is struggling to internally to dismantle its policy of export dumping in order to bring the Doha round of the WTO negotiations forward.

\textsuperscript{5} In 2003, for example, profitability of grain production was 45% as against 19% in 2002.
Law designed to foster agricultural production would work against farmers. These examples show why the minimum/maximum price set as envisaged in the Draft Law may cause more harm than good and why their implementation is incredible. The situations similar to those described above will occur in the future: there will be some years of relatively good grain harvests followed by a year of an extremely bad harvest in which it would be natural for the domestic price to overshoot the maximum to stabilize farmers’ returns, and putting a downward pressure on the domestic price through intervention sales will reduce farmers’ profits and revenues.

Third, as is stated in Point 8.1, Section 3 “the minimum price should be such that on average farms make no loss”. Since the minimum price is set at a nation-wide level, it fails to account for the great heterogeneity in agriculture, especially in transformation economies. A price that guarantees zero profits for the average farm will provide insufficient support to farms that are less efficient than the average, and will simultaneously provide unnecessary support to those that are more efficient.

And finally, the Draft Law contains no provisions for enforcement mechanism. The evidence from the sugar market shows that the minimum price is not enforced (Figure 1). Why design the Law to introduce the minimum price that does not work anyway? The same point could be made vis-à-vis stocks. The mechanism proposed above could lead to the need to purchase many million tons of grain. This has been promised many times in the past, and never fulfilled.

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Summarizing our discussion regarding the minimum/maximum price we can conclude that as Ukraine finds itself in a situation different from what it was over the last three years (for example, net import situation following net export situation) the minimum/maximum price determined on the basis of the average prices in the past may make no sense. What matters in the formation of the domestic price is the world price, exchange rate, transaction costs and the net trade position. With this regard the world price (in the previous year or projected) could serve as a basis for determining the support and maximum price. Support (minimum) prices could be established at the level of the world price at the border minus the costs of moving products to the border, while minimum import prices (the world price at the border plus transaction costs) could create a top level for prices. Support prices determined in this way have certain advantages. First, they are at the level that would prevail under competitive conditions. Second, there will probably be a necessity to make intervention purchases only in the after-harvest period (thus minimizing government intervention) when there is a high degree of uncertainty about supply and in an export situation farm gate

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7 Minimum import prices serve as a top level for prices in the EU and Hungary. Elekes, A. "Comparative analysis of the Hungarian and EU agricultural support systems", Szent Istvan University.
prices may fall much further than they should\textsuperscript{8}. Third, the domestic price should not exceed the minimum import prices as in this case an import substitution may occur. However, it should be mentioned that if the main goal behind the introduction of the price band is to avoid price collapses post-harvest then financial instruments, loans and pledges make more sense than a full-blown price support system.

The overwhelming movement over the last roughly 15 years is from price support and total agricultural support towards more efficient methods of government support such as direct payments. The improvement of the functioning of the pledge system and warehouse receipts as well as the improvement of the functioning and transparency of the agricultural exchanges would make more sense and would be a less costly policy option.

3. Other Important Aspects of the Draft Law

The Draft Law also contains a number of other points that could be debated and we will dwell on these in the following.

\textbf{Section 2} provides for increased expenditures to support agricultural production. Such points as financing selection activities in agriculture (Article 2, point 1.4), preserving and improving soil fertility (Article 2, point 4) and promoting crop insurance (Article 2, point 6) are worth pursuing. Section 2, however, contains some points one can hardly agree with. Article 2, point 1.6 states that agricultural production shall be supported through “ensuring lower tariffs for electricity used for irrigation”. First (even though this statement may be not very popular), electricity is already very cheap in Ukraine and it is elsewhere a stated policy goal of the government to increase the level of cost recovery in electricity generation. Thus, there is no reasonable argument to make it even cheaper for farmers who use it for irrigation purposes. Such subsidies usually make other sectors claim such subsidies as well, and it is exactly this struggle for easy taxpayer money which distracts many sectors from doing their homework and become competitive using their own means. Moreover, it is not appropriate to write such details into a law. They always very much look as if they were brought in by the proponents of special interests, or reflect the "hobby" of an agricultural scientist who has been consulted during the drafting of the law. It is difficult to imagine that electricity costs should be the major problem for using irrigation. We rather assume that unresolved issues of property and access rights are the reason for the deteriorating use of irrigation. Thus, it would be worthwhile investing money into establishing new irrigation

\textsuperscript{8} Regarding grain as the evidence suggests there is a considerable reduction in prices just after the harvest, followed by an increase in prices as information on grain stocks becomes available. On average for the crop year, the path of price developments follows the rule of thumb: Domestic price = World Price – Transaction costs (net export situation).
institutions (e.g. user groups) which are adapted to the new property structure which has emerged after the end of communist agriculture.

Point 2 envisages “increased control over prices and tariffs of natural monopolies and regulation of the ratio of output prices to input prices ratio”. This provision clearly indicates that Ukraine will leave the path of market-based reforms and, instead, move towards more intense government regulation of both input and output prices. This provision is likely to make permanent the bureaucratic nightmare with which decent farmers, processors and traders are confronted since last year. There exists a market-oriented way to reduce input prices and increase prices received by farmers: investments into infrastructure (roads, etc.) and development of the marketing chain could facilitate access to inputs markets, thus contributing to a reduction in production costs, and open better opportunities for sales.

Point 3 provides for “introduction of mechanisms to protect the domestic food market”. Numerous high-ranking officials have clearly stated that membership in the WTO is a clear policy priority for Ukraine. WTO membership implies that Ukraine will have to ensure better access to the domestic market, and in return it will have better access to the foreign markets. However, Article 3 suggests that Ukraine will not be able to commit itself to facilitate access to the domestic market. This protectionism is hardly necessary, as Ukraine’s agriculture is becoming more and more productive and export-oriented. In an export situation, no imports take place, and thus there is no need for import tariffs. On the other hand, in the case of a harvest failure, a protection of the domestic market means that prices increase much more than needed, thus hurting consumers. This is exactly what happened during last year’s ‘wheat crisis’.

Point 10 states that agricultural production shall be supported through “increasing effective demand of Ukrainian population for food”. However, no specific measures to achieve this goal are stated.

In general, article 2 is designed to alleviate farmers’ access to inputs and credit resources. Nothing is said about human capital. Even though management skills and qualification of employees are intangible, they are as important as physical capital such as machinery. Thus, the Draft Law should contain provisions for increased expenditures and new concepts on agricultural education and training to improve human capital, and, consequently, expand agricultural production through increased labor productivity.

Article 4 deals with subsidization of animal production. Point 4.2 calls for determining the level of subsidies to support milk, beef, pork and poultry production as “a difference between the average sales price and the average production costs” and “that guarantees a rate of profitability of 5%”. The idea that a subsidy can be objectively determined to compensate the difference between the sales price and production costs is too ambitious, as it does not
take into consideration the great heterogeneity among agricultural producers.  

**Section 3** raises several issues. First, Article 7, point 7.9 states that “when exporting agricultural commodities that are subject to government price regulation, the custom value of these commodities shall not be less than the value calculated using maximum prices”. It should be born in mind that the traders cannot determine the price at which they sell the grain on the world market, and what Article 7 implies is that the grain should not be exported as long as world prices are too low for Ukraine. However, retaining grain means the downward pressure on the domestic price, and, consequently, lower prices for farmers. Furthermore, as Ukrainian agriculture continues to recover, Ukraine’s export position is likely to become more frequent and quantitatively significant. 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. If the maximum price is set at the level above the world price, Point 7.9 indirectly makes reference to the use of export subsidies.

Point 7.11 entitles the Cabinet of Ministers to employ administrative measures such as restricting markups, restricting profitability rates and establishing non-tariff barriers to imports and exports. The main idea behind the two former measures must be to keep food prices low, thus making food more affordable. However, as was mentioned in the paper by the GAG\(^{10}\) these measures may result in quite opposite outcomes. Restricting mark-ups in rural stores can be especially harmful for the rural poor. In view of poor infrastructure the cost of transporting products is rather high, which is translated into a higher retail mark-up. Limiting the mark-up to a level that makes transportation unprofitable cuts rural residents off from food supplies and forces them to incur additional costs by traveling to neighboring centers for bread, pasta and other foods or by buying products on black markets at much higher prices. Thus, the rural poor can end up paying more than they would without the government policy. Further, to ensure that the profitability or a mark-up does not exceed the legislatively set level, the government is obliged to organize permanent inspections, which means that the government bureaucracy controlling prices tends to get bigger, more intrusive and more expensive.

*Article 10* describes the mechanism of implementation of intervention purchases. Point 10.2.3 asserts that “if the price is less than 50% of the minimum price, trade in this specific product is suspended and the Agrarian Fund conducts consultations with the participants of the exchange market”.

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“If no agreement is reached, the Agrarian Fund turns to the Cabinet of Ministers and asks for a permission to administratively control prices” (Point 10.3.3). If the mechanism works as it is in the Law it might happen that there will be no trade for weeks, as the Cabinet of Ministers and the Agrarian Fund attempt to set prices “right”. Many farmers do not trust exchanges, and in order to persuade them that they can benefit by trading through exchanges,11 the Draft Law should clearly show that the exchange is a transparent and easy way of selling products. Points 10.3.1, 10.3.2, 10.3.3 and 10.3.4 contradict this goal. Similar remarks should be made with regard to intervention sales.

Conclusions
The Draft Law “On supporting the production and developing of agricultural markets” would condemn Ukraine to repeat policy experiments that have proven to be costly and inefficient elsewhere. Ukraine is going to move towards higher agricultural support and higher share of price support, while the overwhelming movement over the last 15 years has been from price support towards more efficient methods of agricultural support such as, for example, direct payments.

There had been developed many Laws in the past to support agricultural production but they hardly worked. At the current stage the Ukrainian government must have two options. One is to develop a new price support mechanism, which is provided for in the Draft Law. The other is to make the Laws designed in the past work, that is, to make pledge system and warehouse receipts work properly, improve the functioning and transparency of the agricultural exchanges. The latter should be given a priority if the state support is to be enhanced.

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11 According to the First Deputy-Minister of Agrarian Policy only about 3% of grains are traded through exchanges. Since the Draft Law concerns only deals made through the exchange, in order to make intervention effective it is important to ensure that the largest share of products is traded through exchanges.
Appendix.

For a discussion we are considering 3 situations:

1. **Scenario 1** – Out of the three years, which are used for the determination of the price band, two are import years and one is an export year. Assume that these three years are followed by an export year.

2. **Scenario 2** – Out of the three years 1 is an import year and 2 are export years. The three years are followed by an import year (for example, 2000 – an import year, 2001 & 2002 – export years, 2003 – import year).

3. **Scenario 3** – All of the three years are export years and they are followed by an import year (for example, 1997-1999 – export years, 2000 – an import year)

In each of these situations the average domestic price (on the basis of which the price band is determined) over the three years will be different. In an export year the domestic price is determined by (the world price-transaction costs). Thus, conditional on the exchange rate of 5.33 UAH/$ and the world price of about $110 per ton, the domestic price in an export year is 110*5.33 - 254^{12} = 332.3 UAH/t. The domestic price in an import year is determined by (the world price + transaction costs): 110*5.33 + 325 = 911.3 UAH/t. Thus, under the first scenario the average domestic price over the previous three years is 718.3 UAH/t [(911.3+911.3+332.3)/3] (row 4 in the table). The minimum and maximum prices are 769 UAH (0.9*718.3*1.19) and 983 UAH (1.15*718.3*1.19), respectively. Under the first scenario the fourth year (the year when the price band is introduced) is an export year. Consequently, the domestic price should be 332.3 UAH/t (row 9 in the table). As is evident, intervention purchases are required to lift the domestic price (332.3 UAH) to the minimum level (769 UAH). Using the value of the grain demand elasticity one can find the quantity of grain to be withdrawn from the market to push the domestic price up: \[ \Delta Q = -0.3 \cdot \Delta P \cdot \frac{Q}{P} \]. Assuming that an average harvest in an export year is about 32 m tons and taking into consideration that the change in price should be 769-332.3=436.7, the government would have to purchase 12.6 m tons of grain [0.3*436.7*(32/332.3)]. In a similar pattern the calculations are done for two other scenarios. The results are presented in Table 1.

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^{12} For transaction costs see “Coping with the good harvest 2004”, the Institute for Economic Research and Policy Consulting, S28, April 2004.
### Table 1. Possible outcomes of intervention purchases and sales

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<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
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<tbody>
<tr>
<td>World price</td>
<td>110 $/t</td>
<td>110 $/t</td>
<td>110 $/t</td>
</tr>
<tr>
<td>Exchange rate</td>
<td>5.33</td>
<td>5.33</td>
<td>5.33</td>
</tr>
<tr>
<td>Average domestic price</td>
<td>718.3 UAH/t</td>
<td>525 UAH/t</td>
<td>332.3 UAH/t</td>
</tr>
<tr>
<td>Inflation over 3 years*</td>
<td>1.19</td>
<td>1.19</td>
<td>1.19</td>
</tr>
<tr>
<td>Grain demand elasticity</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>Minimum price</td>
<td>769 UAH</td>
<td>562 UAH</td>
<td>356 UAH</td>
</tr>
<tr>
<td>Maximum price</td>
<td>983 UAH</td>
<td>718 UAH</td>
<td>455 UAH</td>
</tr>
<tr>
<td>Domestic market price in a year when the price band is in place</td>
<td>332.3 UAH</td>
<td>911.3</td>
<td>911.3</td>
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**Consequences:**

<table>
<thead>
<tr>
<th></th>
<th>Intervention purchases</th>
<th>Intervention sales</th>
<th>Intervention sales</th>
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<tbody>
<tr>
<td>Purchase (+) or sales (-) of</td>
<td>+ 12.6 m tons</td>
<td>- 1.4 m tons</td>
<td>- 6.6 m tons</td>
</tr>
<tr>
<td>Budget expenditures (-)/revenues (+)</td>
<td>- 5.5 bn UAH</td>
<td>+ 1.3 bn UAH</td>
<td>+ 6 bn UAH</td>
</tr>
<tr>
<td>Farmers' revenues at market prices</td>
<td>10.6 bn UAH</td>
<td>20 bn UAH</td>
<td>20 bn UAH</td>
</tr>
<tr>
<td>Farmers' revenues under the 'price corridor regime'</td>
<td>24.6 bn UAH (=&gt; min. price)</td>
<td>15.8 bn UAH (=&gt; max. price)</td>
<td>10 bn UAH (=&gt; max. price)</td>
</tr>
<tr>
<td>Change in farmers' revenues</td>
<td>+14 bn UAH</td>
<td>-4.2 bn UAH</td>
<td>-10 bn UAH</td>
</tr>
</tbody>
</table>

Average harvest in an import year – 22 m tons of grain