German Advisory Group Ukraine

NEWSLETTER

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Challenges to agricultural budget support policy

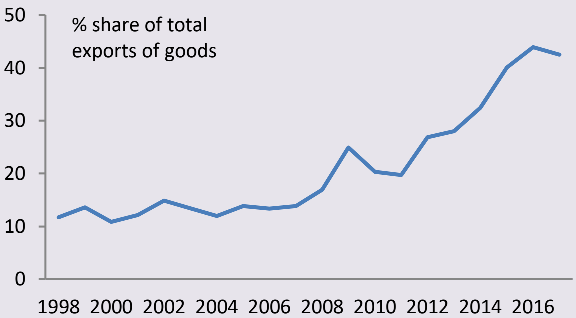
Over the last years, Ukraine's agri-food sector demonstrated resilient growth and developed into a key source of foreign exchange for the economy. In 2017, it accounted for 14.5% of GDP and more than 42% of total goods exports. This positive development came against a significant reduction in the volume of agricultural budget support over the recent years. The structure of the support also changed, moving from tax benefits to direct support in the form of input subsidies. However, the way the direct support programmes are designed and implemented, as well as the negative effects of input subsidies on efficiency and productivity, raise serious concerns about their sustainability and effectiveness. A more targeted and modern approach is needed in order to address the current major problems of the sector (shortage of workers and financial constraints) under severe fiscal constraints facing the country.

Growing role of agri-food sector

Ukraine's agriculture demonstrates one of the highest growth rates across sectors, even during crisis periods. Over the last 20 years it grew at about 3.4% annually, while services and industry grew at only 3.2% and 1.0%, accordingly. Primary agriculture and food processing ("agri-food") accounted for 14.5% of GDP in 2017.

Agri-food exports developed in parallel into a key source of foreign exchange earnings for the Ukrainian economy, representing more than 42% of total goods exports in 2017. Ukraine is the world's largest exporter of maize, the third largest exporter of grain after the US and the EU, and a large producer and exporter of sunflower seeds and oil. In 2018, Ukraine harvested more than 70 m tons of grain crops.

Development of Ukrainian agri-food exports

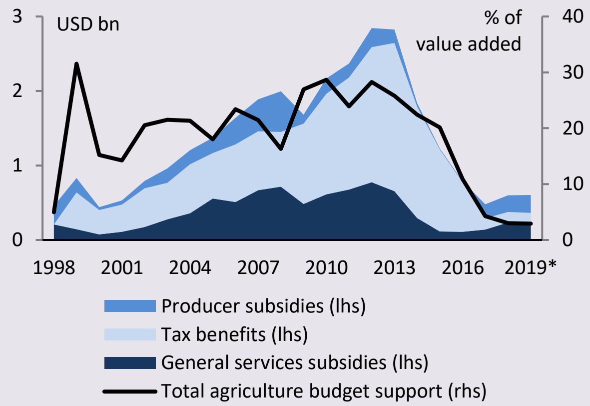


Source: WDI (2008) and Ukrstat, own calculations

The role of agricultural budget state support

The volume of agricultural budget support was historically quite significant in Ukraine, amounting to a third of the sector value added in some years. Since recently, however, it has undergone substantial changes and decreased significantly. Before 2017, tax benefits made up more than 90% of the total budget support. Tax benefits accrued from a so-called single tax and a special value-added tax regime in agriculture (AgVAT). In 2017, AgVAT was terminated and replaced by direct producers' subsidies. In 2018, the volume of direct budget subsidies to agriculture amounted to UAH 6.3 bn. These funds financed so-called input subsidies, which are envisaged to compensate in various forms the cost of inputs (concession credits, partial compensation of seed costs, construction works, agricultural machinery etc.).

Development of agricultural support



*Source: OECD PSE tables for Ukraine and the Law of Ukraine on State Budget for 2018 and 2019, own calculations; * Projections*

Direct agricultural producers' subsidies

A growing role and volume of direct producers' subsidies in the total budget support raises concerns about their effectiveness and sustainability, especially considering existing fiscal constraints. The following issues make a case to reconsider fundamentally the whole concept of supporting agricultural producers:

Fairness of subsidies' distribution. Current input subsidies programmes are heavily criticised for favouring primarily large agri-holdings, receiving from half (2017) to third (2018) of all the subsidies.

Absence of clearly defined agricultural policy goals. Ukraine still lacks a strategy for agricultural development. Therefore, goals are not clearly defined and justified and, as a result, it is not possible to evaluate the effectiveness of the programmes.

Poor design and implementation. The new direct support programmes are constantly evolving, designed and implemented without an open and evidence-based discussion of the goals and instruments. Such a pattern is unlikely to help farmers in any way. Support programmes need to be stable and in place for a significant time span (3–5 years), so that farmers could incorporate them in their decisions and activities.

Unintended beneficiaries of input subsidies. Even if one assumes that such programmes were designed and implemented properly and sustainably, there is evidence that agricultural producers would be the least beneficiaries in case of input subsidies. Input suppliers will end up as the major beneficiaries, receiving more than 80% of each US dollar transferred to producers in this form. Between 5%–6% of the budget would be wasted in the form of dead weight losses.

Input subsidies do not stimulate growth. Increasing sector productivity and competitiveness should be an ultimate goal of state support. There is, however, a significant body of literature suggesting a negative effect of input subsidies on efficiency and productivity.

New approaches to agricultural budget support

Sector growth is a well-justified goal of agricultural policy. It could be further specified as either growth of competitiveness or productivity, both terms being interchangeable. The goal of increasing productivity is especially relevant for Ukraine's agricultural sector, which is almost 2–3 times less productive than in the US or Argentina.

A major conclusion from the discussion above is that input subsidies are not an appropriate instrument for achieving higher agricultural growth. Moreover, they come with some significant negative side effects.

Designing an appropriate budget support model to achieve higher agricultural growth should also be weighed against still existing fiscal constraints. In other words, Ukraine will not be able to afford a very expensive EU system of farm support in the form of single farm payment (i.e. per hectare payments).

One option in these circumstances would be to abandon the current system of direct budget support. However, this option does not look realistic, especially if one recalls the outcome of the fight for the hugely beneficial AgVAT regime for agriculture.

Another option is to focus the existing resources on tackling the most significant problems. Arguably, the shortage and quality of workers and financial constraints (access to and costs of finance) are the two main problems from the farmers' perspective.

Human capital in agriculture

The issue of rural to urban emigration is a globally continuing trend that is difficult to reverse. What the government can do is to increase the productivity of people remaining in agriculture by improving their education and qualification, financing R&D and developing extension services. The Ministry of Agricultural Policy and Food has been financing such activities (about USD 7 m in the 2019 budget), but the funds are distributed on a non-competitive basis and are pre-allocated to the very inefficient old-style structures. A fund for agricultural education, science and extension services could distribute already available funds on a competitive basis (with independent and international selection committee) and this could trigger positive selection and changes.

Financial constraints

This problem is especially relevant for small farmers that do not have sufficient collateral and use the simplified tax reporting system. This makes small farmers too risky for commercial banks as clients. A standard tool to facilitate their access is a risk-sharing facility. The commercial sector is already using some of the tools available, e.g. crop receipts. Budget resources could be used to establish a partial credit guarantee (PCG) scheme that would issue such guarantees for obtaining loans. Since the farmers in Ukraine have one of the lowest shares of non-performing loans across all sectors, the PCG can achieve a high leverage to generate loans. This should be accompanied by lifting the moratorium on farmland sales (allowing to use farmland as a collateral) and the development of the agricultural insurance market.

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