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Reforming government support of agricultural sector in Ukraine

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In the light of pressing need for budget sequestration, on the one hand, and poor effectiveness of government spending in agricultural sector, on the other hand, general approach to planning and allocation of state aid needs reconsideration. First of all, state aid should be better targeted to ensure the most effective use of limited resources. Secondly, allocation mechanisms should be more transparent so that all eligible agents have the same access to government funding. At the same time, there are attempts by the government to reform the preferential taxation regime. Although, this should be done very carefully, step by step, not to undermine competitiveness of Ukrainian enterprises at the international market.

Budget outlays

Government support in agricultural sector includes both direct disbursements from the budget and other types of support such as market price support schemes and budget revenue foregone (e.g., different types of tax preferences).

German-Ukrainian Agricultural Policy Dialogue publishes annual reviews of the planned and executed budget outlays in agricultural sector (see AFPRs 1/12, 1/13, 1/14). The largest amount of government support, particularly, UAH 13 bn, was allocated to the agricultural sector in 2008. Since then the Government had to reduce its spending on the sector (to about UAH 9-10 bn) due to difficult economic situation and resultant budget austerity. In the last three years, considerable underfinancing of the planned agricultural budget was observed. In particular, the gap between planned and executed expenditures in agrisector was at 26% and 27% in 2011 and 2012, respectively. Last year the gap shortened to 21% but it is still quite large to ensure favourable investment climate in the sector. There is also a positive tendency of gradual restructuring of state support towards "growth-enhancing" measures, i.e., measures that do not distort trade or cause minimal distortion (e.g., agricultural research and training, environmental protection and regional development programs, etc.) on the expense of "growth-hampering" measures, which distort production and trade (production subsidies and market price support measures). In particular, total

amount of production subsidies decreased by about 70% for the last 7 years and the share of "growth-enhancing" measures in the total agricultural budget increased from 55% in 2007 to 84% in 2013.

Agricultural budget for 2014 was initially planned at about UAH 8 bn, however, government expenditures in all sectors, including agriculture, had to be cut within a package of anti-crisis measures approved by the Government in March and in June. In particular, funding of measures in agrisector was cut by about 21% (to about UAH 6 bn). In comparison, state support in fuel and energy sector was shortened by 28%, other industrial sectors and construction - by 7%. However, outlays on transport sector were increased by 63%.

In relative terms, reduction of government spending in agricultural sector is comparable with underfinancing of planned budget outlays last year and should not have serious negative effects, if planned budget is used comprehensively and further cuts are avoided. Moreover, it should be noted that simplification of administrative procedures¹, elimination of corruption and liberalisation of trade with the EU should help agricultural sector to overcome economic difficulties.

However, several subsectors might suffer more than others as funding of certain measures was reduced significantly or completely eliminated (e.g., measures on the control of pests and diseases of crops, state-funded agricultural exhibitions, development of the wholesale markets, selection in fisheries, reproduction of aquatic resources, etc.). About 42% (UAH 2.6 bn) of envisioned support to agricultural sector in 2014 was allocated as of 1st of August.

Preferential taxation

At the same time, preferential taxation (namely special VAT regime as well as the fixed agricultural tax- FAT) are much more important for agricultural business than direct transfers from the budget. This is the case because tax preferences provide significantly larger total amount of support and ensure equal accessibility to all eligible companies. According to the State Statistics Committee of

¹New Government has already taken important steps on the deregulation with approval of the Law which canceled 113 unnecessary permits and procedures.

Ukraine, total amount of tax preferences (both VAT and FAT) increased from UAH 1.5 bn in 2001 to UAH 18 bn in 2012². Hence, any reform of the preferential taxation system with the aim to cut down benefits and to generate state income should be planned and undertaken very carefully, taking into an account the interests of different stakeholders and by that avoiding uncertainties for producers and traders. A first right step in this direction was undertaken in March 2014³. In particular, the base of the FAT was broadened resulting in FAT's increase on average from UAH 6 to UAH 19.2 per ha. Minimum land rent was also increased. Certain amendments of the current VAT regime for operations with grains and technical crops are expected to come into force in October, 2014⁴. However, Prime Minister reassured that preferential taxation will be preserved at least by the end of 2014⁵.

Proper targeting of the state aid

Proper targeting of limited government support is especially important in light of aggravating economic crisis due to continuous political instability. It is not likely that Ukrainian Government will be able to increase budget spending in the next 2-3 years. It is thus essential to develop key priorities and principles for the allocation of limited resources.

The Law #1877-15 "On the state support of the agricultural sector of Ukraine" defines the framework for public policy on various kinds of the state support, particularly, price support mechanisms, state mortgage purchases of grain, mechanisms for interest rates reduction and compensation of lease payments, subsidies for animal production. However, no guidelines are provided on the key priorities and principles of the state aid allocation, i.e., what sectors or measures should receive government funding and what enterprises should be eligible for this support. In this regards, the EU experience might be useful for Ukraine.

² See AFPR#5/2013 for more details: http://apd-ukraine.de/wp-content/uploads/2013/09/APD_AFPR_5_2013_ukr.pdf

³ Law of Ukraine, № 4576, from March 27, 2014.

⁴ See AFPR 04/14 for more detailed analysis of changes in taxation. <http://apd-ukraine.de/uk/oglyad-agrarnoyi-politiki/>

⁵ <http://apd-ukraine.de/uk/regierung-der-ukraine-will-steuernachlasse-fur-landwirte-beibehalten-23-03-2014/>

European Commission developed clear and comprehensive guidelines⁶ for different types of allowed state aid in the agricultural sector considering the need for promotion of food quality improvement, preservation of environment and traditional heritage in the countryside. Key principles of the state aid measures include (1) compliances with general competition policy requirements, (2) coherence with the EU's common agricultural and rural development policies; (3) compatibility with the EU's international obligations. Another important requirement to any state aid measure or policy is that it should contribute to improvement in a particular economic sector or a region. Thus, support schemes which might benefit only particular recipient will not be considered as compatible with the EU guidelines. Moreover, several support measures (e.g., aid for producer groups, aid for land re-parcelling, technical support in the agricultural sector, maintenance and improvement of the genetic quality of livestock) favour small and medium-sized enterprises (SMEs) compared to large ones as it is believed that the latter can finance these expenditures themselves.

Overall, there is a striking difference between the Law of Ukraine on the state support in agriculture described above and regulations of the European Commission. The former one is largely focused on market-distorting policies and measures, while the EU regulations are causing minimal negative effects on the EU agriculture and food markets.

Effectiveness and transparency of state aid allocation

Another aspect is effectiveness and efficiency of spending. Accounting Chamber of Ukraine, which is responsible for control over the use of budget funds, conducted audits of state support programmes in 2012 and came to conclusion that desired targets were not fully achieved, particularly, social infrastructure continued to degrade, demographic crisis worsened and extinction of the villages continued. One of the key reasons of low

⁶ Principles of state aid allocation in the EU are described in the following legal documents: Community Guidelines for State Aid in the Agriculture and Forestry Sector 2007 to 2013 (2006/C 319/01); Agricultural Block Exemption Regulation ("ABER"); Specific forms for State aid in the agricultural sector contained in the Regulation on notification forms (PART III.12.A until PART III.12.T of Annex I of Regulation (EC) No 794/2004); Agricultural de minimis Regulation

effectiveness is chronic underfinancing of activities envisioned in the programmes. Rural development programme received 68.6% of planned funding (from 2008 to 2011) while technology policy programme was funded by 45.6% (from 2007-2011). Moreover, Accounting Chamber also noted the lack of coordination (in terms of implementation schedule, used resources, cooperation among responsible bodies, etc.) between these two programmes, despite common goals, which also undermined their effectiveness.

Intransparent and unequal allocation of state aid is often discussed during agricultural events, participants of which complain that budget support is allocated to a limited number of preferential producers. According to the APD study, farmers with lower herd size usually receive less support per head or kg of milk produced⁷. At the same time, farms with more than 300 cows, which produced about 56.2% of the total production volume, received about 64% of subsidies in 2005. Unfortunately, more recent estimates are unavailable but regular complains from businesses (about transparency of state support allocation) suggests that situation did not improve considerably since then.

Competitiveness considerations

As production subsidies in the long term act as a disincentive for effectiveness improvement (no incentives for producers to reduce costs), reforming of the state support should be done step by step, taking into an account overall conditions for doing business in Ukraine comparing to other countries. In this regards, a comparison of the amount of state support and accessibility of financial resources is provided below. However, additional factors (e.g., tax burden, cost of inputs, etc.) should be also considered to make a comprehensive assessment of competitiveness of agribusiness in Ukraine comparing to other countries. According to the OECD (2013)⁸, estimate of pro-

⁷ See Chapter 12 "The Determinants of Dairy Farming Competitiveness in Ukraine." for more details, available at http://apd-ukraine.de/wp-content/uploads/2012/12/18_book_2009_Agrarbook_IV_eng1.pdf

⁸ See OECD (2013), "Agricultural Policy Monitoring and Evaluation 2013 OECD Countries and Emerging Economies", available from: <http://www.oecd.org/tad/agricultural-policies/monitoring-and-evaluation.htm>

ducer support (PSE)⁹ in agricultural sector of Ukraine reached UAH 3.9 bn in 2012. The share of PSE transfers in gross farm receipts equalled 1%, which was one of the lowest¹⁰ indicators among countries considered in the OECD study. In the EU and the OECD countries this indicator is at the level of about 19%. At the same time, total support estimate (TSE)¹¹ in agricultural sector of Ukraine equalled to UAH 10 bn (0.74% of GDP) in 2012, which is nearly at the level of the EU average (0,73%) but lower than the OECD average (0,94%).

Moreover, access to financial resources is also very important for competitiveness of agribusiness at the international market. In the last three years (2010-2013) Ukrainian agricultural businesses were able to get loans at the interest rates from 15% to 20% (in UAH) and from 7% to 10% (in foreign currency)¹², which is largely explained by undeveloped banking sector, inflation and insecure political situation. EU and the US credit resources are much cheaper and more accessible for agricultural companies there; average interest rate for agricultural project in the EU is 5%¹³. Hence, US and EU agricultural companies have another competitive advantage comparing to Ukrainian companies.

Considering that preferential taxation, particularly, FAT and special VAT regime, is the only effective instrument of state support in agricultural sector of Ukraine, the Government should first focus on improving overall policy framework, which will also

⁹ Producers support estimate (PSE) - the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at the farm gate level, arising from policy measures that support agriculture, regardless of their nature, objectives or impacts on farm production or income. Percentage PSE (%PSE) reflects PSE transfers as a share of gross farm receipts (including support in the denominator).

¹⁰ The lowest is the New Zealand.

¹¹ Total support estimate (TSE) - the annual monetary value of all gross transfers from taxpayers and consumers arising from policy measures that support agriculture, net of the associated budgetary receipts, regardless of their objectives and impacts on farm production and income, or consumption of farm products (OECD, 2013).

¹² See "Doing agribusiness in Ukraine – 2014" for more details.

¹³ Pietola, K., Myyrä, S., Heikkilä, A. 2011. The Penetration of Financial Instability in Agricultural Credit and Leveraging, available from: <http://www.ceps.be/book/penetration-financial-instability-agricultural-credit-and-leveraging>

help to lower risks of bank loans, prior to introduction of significant amendments of tax preferences.

In conclusion, certain restructuring of government support does take place as the share of “growth-enhancing” measures has increased considerably in the last seven years. However, prioritisation and effectiveness of the state aid has to be further improved in light of limited budget resources. Moreover, deregulation, elimination of corruption, trade liberalization with the EU and improved access to financial resources is also critically important for the development of agricultural sector and should be preferred to market-distorting direct subsidies. At the same time, fundamental reforms of tax preferences in agricultural sector should start on the base of a comprehensive stakeholder approach. They should follow only after considerable improvements of the general policy framework and stabilisation of overall conditions for doing agribusiness in Ukraine.