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AGRI-FOOD POLICY REVIEW

State-led localization of agricultural machinery manufacturing: a pro-growth strategy for agriculture?

Authors

Oleg Nivievskyi
nivievskyi@ier.kiev.ua

Yulia Ogarenko
ogarenko@ier.kiev.ua

German-Ukrainian Agricultural Policy Dialogue (APD)
Institute for Economic Research and Policy (IER)
Consulting

Reytarska 8/5 A, 01030 Kyiv
Tel. (+38044)235-7502, 278-6360

The government of Ukraine (GoU) has been intensively promoting domestic production/assembly of the foreign agri-machinery. The GoU believes this should make agri-machinery more physically and economically available to farms and thus contribute to agricultural sector growth. Recent policy decisions and statements indicate that this is mainly to be implemented by limiting competing imports and changing local content requirements. This policy toolbox, however, completely ignores farmers' interests, as import restriction will increase the costs of agri-machinery, slowdown the process of modernization and expansion of agri-machinery fleet and thus hamper the overall agricultural growth. International experience proved this policy to fail and to harm economic development. Moreover, this policy is against WTO rules as it clearly discriminates among domestic and foreign products.

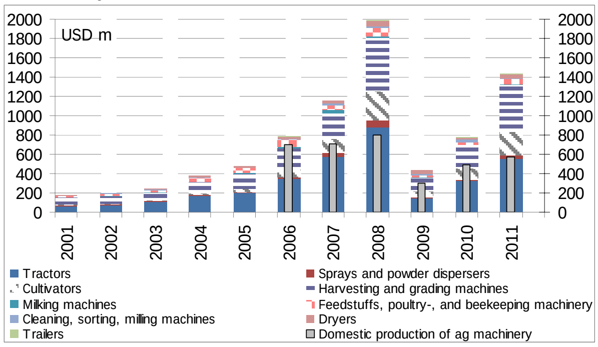
Lack of physical capital is reported to be one of the key constrains for agricultural sector growth in Ukraine. According to the FAO estimates, Ukrainian farmers have only 48- 66% of various kinds of agri-machinery they need to ensure timely farm operations; nearly 80% of existing agri-machinery has depreciated and needs immediate replacement.

High demand for a modern agri-machinery and equipment is well illustrated on the Figure 1, where imports of new and used agri-machinery and equipment demonstrate an exponential growth. The 'reload' in 2009 was due to the financial crises. Domestic production of agri-machinery has clearly not been able to keep up with imports. This indicates that Ukrainian farmers usually prefer the imported agri-machinery and equipment.

The GoU, however, has been supporting the purchase of domestically produced agri-machinery and equipment. It does this via: i) financial leasing mechanism through the state-owned company Ukragroleasing, ii) 30% compensation of the costs of domestic agri-mashinery to farmers, and iii) credit concession program for purchase of domestically produced agri-machinery and equipment. Overall pervasive corruption in distributing the state programs' funds substantially undermines the efficiency of these programs.

This pursuit for localization of agri-machinery production has been recently intensified by the GoU. This summer the Minister for Agricultural Policy and Food made the statement in the media: "*…some proposals to the Parliament will enable us to start the localization of the foreign agri-machinery production …, to create certain privileges for the import of component parts, which has been already made. …Our task is to start assembling grain harvesting machinery and heavy tractors in Ukraine*". As a result: i) the credit concession program was broadened onto the compensation of the financial lease payments on purchases of domestically produced agri-machinery; ii) the local content requirement for being considered as 'local/domestic' is increased from 50% to 60% for the whole range of agri-machineries and equipments; iii) the local content requirement for tractors and combine harvesters, however, is yet to be decided by the Cabinet of Ministers of Ukraine; iv) import tariffs for some of the tractor components parts has been reduced; v) the GoU has been advocating increase of import tariffs on tractors and combine harvesters; vi) the Minister of Agricultural Policy and Food announced about ongoing negotiations with a world's leading producer of agri-machinery to support a joint-venture in Ukraine, without any tender announcement.

Figure 1: Import and domestic production of agri-machinery in Ukraine



Source: Own presentation using the UN Comtrade and Ukrstat data.

Mentioned above measures belong to the toolbox of the so-called Import Substitution Industrialization (ISI) policy implemented by the Latin America countries before 1980s. This policy proved to be a failure for those countries as it was industry-focused and neglected agriculture and service sector. Higher import duties increased agri-machinery costs for farmers. The ISI also led to inefficient state-owned enterprises without a need to upgrade its efficiency in the protected environment. New industries did not become competitive. Above all such the ISI policy led to fiscal deficits and inflationary pressures. In the end, the countries pursuing the ISI policy grew more slowly than the others, not adopting the ISI policy.

The failure of the ISI policy has also been recorded in Ukraine, when a joint venture was established to produce passenger cars with a simultaneous eruption of prohibitive import duties on used cars in the late 1990s. Since then this industry/company has not been able to produce a single competitive car but still exists due to high import duties and at the expense of consumers - car drivers.

Why should it be different with agri-machinery? The only difference is that agriculture would pay the bill. For example, if a 10% import duty on tractor and combine harvesters were introduced in 2011, this would have additionally cost about USD 105 m to farmers, as they would have to pay higher prices. This implies unrealized investments and ultimately unrealized agricultural sector growth.

Moreover, the local content requirements and the ISI policy in general are clearly against the WTO rules as it discriminates among domestic and foreign product. The non-discrimination principle is the core of the WTO law.

We believe that GoU's desire to develop its domestic agri-machinery and equipment sector is reasonable. Investors, however, are afraid of the current high risks; they need a transparet, predictable and reliable policy framework. Therefore the GoU would be well advised to develop its agri-machinery industry on the basis of market-led and transparent approach, where the interests of all relevant stakeholders are respected.