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Milk Price Regulation in Ukraine: “Manual Steering versus Free Market”

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Adoption of the draft laws #2297 and #2297 - 1 (on establishment of minimum prices for raw milk) will negatively affect economic and fiscal situation. It will lead to market monopolization, cause price increase and consumer losses and hamper restructuring processes in the dairy sector. Therefore, the draft laws should be rejected.

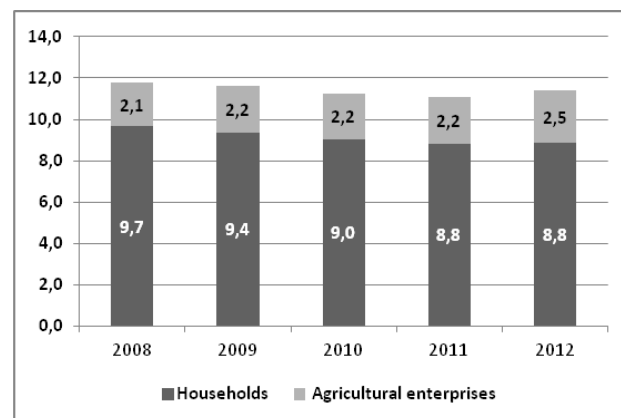
In the last years, Ukrainian dairy sector witnessed a number of intervention efforts by the government into pricing of raw milk. The main idea behind these efforts is to foster the incomes of small scale milk producers. In this context, Regulation of the Cabinet of Ministers of Ukraine (CMU) #1248 of November 4, 2009 introduced the following minimum farm-gate prices for raw milk for the year 2010:

- Extra class milk – UAH 2.60 tsd per ton;
- 1st class milk – UAH 2.50 tsd per ton;
- 2nd class milk – UAH 2.12 tsd per ton.

Furthermore, there were two initiatives by Members of parliament (MPs) to re-introduce price regulation in the milk market in 2012. (i) Significantly low farm-gate prices of early 2012 led to an introduction of the draft law "On Amendments to the Law of Ukraine on Milk and Milk products". The draft law proposed to establish minimum prices but was not adopted. (ii) However, the Regulation of CMU #807 of August 22, 2012 has approved the minimum price of UAH 2.2 tsd per ton of 2nd class raw milk according to the amendments to the Law "On State Support of Agriculture".

The latter Regulation has been heavily criticized because of the following three arguments. Firstly, state price control is a politically reasoned "manual steering" without systemic approach behind. The Regulation has been adopted three months before parliamentary elections, obviously with the foreground objective to motivate the huge number of rural households politically, as they produce 80% of all milk in Ukraine (see Figure 1).

Figure 1. Milk production in Ukraine, by type of producers, million tons



Source: State Statistics Service of Ukraine

Secondly, governmental bodies themselves criticized the Regulation as an instrument, which demotivates product quality improvements. Exclusive relation of minimum price to 2nd class raw milk has even caused market distortions in several regions, i.e. 1st class raw milk was sold cheaper than 2nd class raw milk.

Thirdly, state interventions are not the responsibility of CMU but Agrarian Fund, which intervenes in agricultural markets and collects commodity stocks. At the same time, raw milk should not be the object of state intervention in general as it is a product with a short life span and, therefore, its stocks cannot be physically collected.

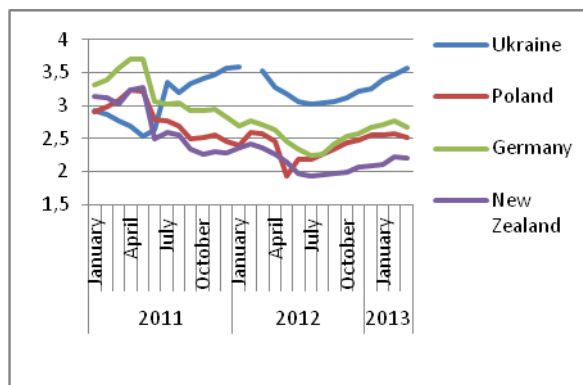
To eliminate this collision, the following two draft laws were introduced in February 2012:

- #2297 of February 14, 2013 "On Amendments to the Law of Ukraine on State Support of Agriculture with Regard to Establishment of Farm-gate Prices for Milk and Ordering of State Price Regulation of Agricultural Products (Commodities)"
- #2297-1 of February 27, 2013 "On Amendments to Article 15 of the Law of Ukraine on State Support of Agriculture with Regard to Regulation of Farm-gate Prices for Milk"¹

According to these draft laws, CMU would obtain the right to establish minimum prices for raw milk, whereas Agrarian Fund is not responsible anymore for collection of raw milk stocks. Thus, the motivation behind suggested legislative amendments is to enable milk price regulation by the government.

¹ In the course of drafting of this AFPR, the draft law #2297-1 has been taken back by its author.

Figure 2. Milk farm-gate prices, monthly averages calculated for Ukrainian basic indicators of fats (3.4%) and proteins (3.0%), UAH/kg



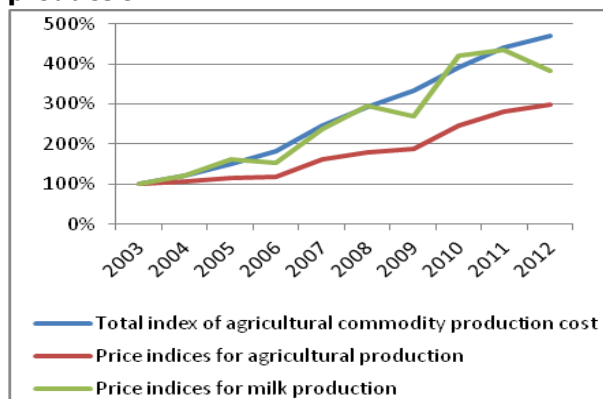
Source: *www.milkua.info*

Noteworthy, the draft laws are over more than three months under approval procedure at the parliamentary Committee for Agricultural Policy and Land Relations. One of the possible reasons for such protraction is the positive situation at the domestic market. Ukrainian farm-gate prices are currently high, even in comparison with those of the European Union (see Figure 2).

Furthermore, Ukraine is embedded in global markets as a net dairy exporter and seasonal decrease of milk prices is not expected due to favorable price developments at global markets in 2013. For example, the EU demonstrates considerable price increase (5-10%) from the beginning of 2013. The upward tendency is caused by increase of production cost due to low crop of feedstuffs in 2012.

Even in the context of negative price situation in 2012, long-term milk price indices remain high as compared to other agricultural commodities in Ukraine (see Figure 3).

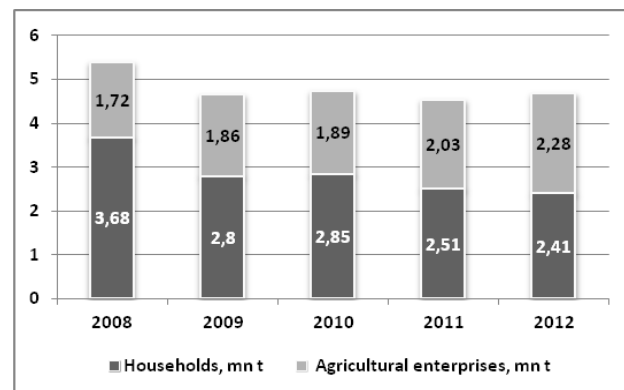
Figure 3. Dynamics of cost and price indices for total agricultural production and milk production



Source: *State Statistics Service of Ukraine*

Apart from market situation, there are preconditions which would allow criticizing the adoption of the draft laws from the dairy chain and consumer perspectives.

Figure 4. Milk supply to dairies, by category of suppliers



Source: *State Statistics Service of Ukraine*

First of all, minimum farm-gate prices established above the market level will give advantage to the aforementioned rural households. However, these small-scale producers will benefit only in the short-term perspective. In the midterm, agricultural enterprises will restore their market share because of a) better quality and b) lower transaction costs. As proof, agricultural enterprises gradually catch up with households in milk supplies to dairies (see Figure 4).

Second, establishment of minimum farm-gate prices will negatively affect the profitability of dairies. This will lead to monopolization of the local market. Small-scale dairies will have to exit the market due to inability to deal with squeezed margins. Eventually, prices for dairy products will grow leading to decrease of Ukrainian dairy products' competitiveness. Consumers will lose because of market monopolization and higher prices.

Thus, the mechanism of minimum prices practically subsidizes all milk producers. The most efficient of them (i.e. large farms) are able to enjoy supernormal profits while the least efficient (i.e. households and small farms) are profitable enough to stay at the market, but without incentives for improvement of efficiency and quality. This will hamper the process of restructuring in the dairy sector and increase costs along the whole supply chain. The latter will cause losses for end consumers.

In this context, numerous economic studies in the EU and USA are unanimous in their conclusions that state regulated minimum prices are the least

efficient mechanism to support producer incomes (see also [AFPR #5/2012](#) of APD). They lead to significant budgetary expenses, higher consumer and input prices and, as a result, poorer society. Therefore, the draft laws on minimum prices have to be rejected.

In the view of dualistic production structure and high seasonality of milk production, small producers could receive temporary state support with the objective to overcome their small scale management, as this is one of the main causes of inefficiency and low quality raw milk. Key obstacles lay

primary not in the area of agriculture policy, but in the general investment climate in Ukraine, which does not stimulate large scale investments with long return periods. Stable, welfare oriented legislation, without consideration of individual economic interests as well as efficient execution systems without corruption would improve the situation and set up the base for improvements, particularly for the development of large scale milk farms, thus leading eventually to high efficiency milk production and good milk quality.