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Institute for Economic Research and Policy Consulting**

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**Why agricultural producers lose huge market
opportunities with state monopolies –
International experience and Ukrainian
evidence**

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The Institute for Economic Research and Policy Consulting (IER) is the leading Ukrainian analytical think tank focusing on economic research and policy advice. The IER was founded in October 1999 by top-ranking Ukrainian politicians and the German Advisory Group on Economic Reforms.

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About the Project "German-Ukrainian Policy Dialogue in Agriculture"

The German-Ukrainian Policy Dialogue in Agriculture is advising Ukrainian state authorities and business associations on reforming agricultural policy and legislation, taking into account international experience of Germany and other countries as well as international practice (EU, WTO), in accordance with principles of market economy. The project is funded by the German Federal Ministry of Food, Agriculture and Consumer Protection under its Cooperation Program and by the German Centre for International Migration.

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Two draft laws came out to the public in February 2011 that might effectively turn into September 11 for the agriculture and food sectors of Ukraine in case at least one of the two comes into the force. A Draft Law #8053 as of February 2, 2011 "On amendments to the Law of Ukraine "On State Support to Agriculture" (as to the peculiarities of exports of products subject to state price regulation)" and a Draft Law #8163 as of February 25, 2011 "On amendments to the Law of Ukraine "On Grain and Grain Markets" (concerning the grain exports)" effectively aim at granting to the State a monopoly of the export of various agricultural products in the former and of the grain in the latter case. What does the global and Ukrainian experience say about state monopolies? In the following we briefly shed some light on this fundamental issue for developing the Ukrainian agrarian potential.

Global experience, in particular the Canadian Wheat Board (CWB) and the Australian Wheat Board (AWB) highlight several important factors that urge Ukrainian law makers to think twice about its current plans to monopolize agriculture and food exports.

The AWB and the CWB historically were seen almost as sister agencies. AWB engaged in wheat while CWB in wheat and barley (in more recent times) trade. Both used price pooling mechanisms¹ and enjoyed export monopolies as well as monopoly power on their respective domestic markets². Both also benefited from government underwriting and guarantees of their payments to producers and of export loans that they extend to customers/farmers.

The empirical evidence about the success of the CWB and AWB (the use of market power to extract price premiums) is, however, at best inconclusive. Most of empirical studies that do find evidence of a success were produced either by or for the CWB and AWB, were not subject to peer review, and are not replicable, as they are based on data which are not publicly available. Some of the independent studies, however, registered even losses of AWB operations in farmer's premiums of roughly -1.31 US\$/t. Also, many 'proofs' of the successful exercise of market power have been advanced by the Boards themselves, generally taking the form of assertions that cannot be confirmed independently³.

Both the AWB and the CWB have, however, relied on private grain traders, including large multinational ones (MNT), to execute significant proportions of their export transactions. This fact is an implicit admission that private enterprises, including (MNT), are capable of outpacing the state monopoly in terms of marketing efficiency. Some sources assert almost one-half of the CWB's wheat exports and well over one-half of its malt barley exports went via accredited exporters⁴. The fact that the MNTs have dominated international grain trade for so many decades in relatively stable composition underlines that attempting to develop an efficient grain exporting system without these firms would be unlikely to succeed. Direct comparisons in term of market efficiency shows that Australia and Canada both lagging behind the US. For example, grain producers in Australia were paying at least US\$ 5 per ton more for grain handling and transportation than their counterparts in the US⁵.

¹ The mechanism works as follows. Farmers deliver their wheat or barley to an elevator, receive an initial payment from the State agent (e.g. equivalent to 70-85% of the final price in case of the CWB). All proceeds from the sale of grain on domestic and export markets are pooled, minus operating costs and the costs of the initial payments. The net of the pool is allocated among farmers as a final payment to ensure that each gets the same return on his grain, minus cost of delivery and corrected for the quality of the grain.

² World Bank (2009): A State Trading Enterprise for Grains in Russia? Issues and Options. Report No.: 45925 - RU

³ See footnote 2

⁴ Informa Economics (2008): An Open Market for CWB Grain – A study to determine the implications of an open marketplace in western Canadian wheat, durum and barley for farmers. June 2008.

⁵ Booz, Allen and Hamilton (1995). Milling Wheat Project: Consultant's Report to the Australian Grains Council. Canberra.

Both AWB and CWB owe their long existence to strong producer support. Moreover, contrary to the initiative in Ukraine, creation of the wheat boards (at least in Canada) followed a bottom-up approach, under the farmers' pressure. Both operated with the express purpose of increasing/maximizing grower returns, and both were controlled or at least strongly influenced by grain producers over much of their history. Pressure for increased accountability to farmers led to the implementation of a new corporate structure for the CWB in 1998; a perceived lack of accountability led to the elimination of the AWB's monopoly exporter status following the oil-for-food scandal in 2007.

Centralized bureaucracy like CWB and AWB tend to grow, adding personnel and other expenses that increase costs and reduce competitiveness of the whole value chain over time. For example, the CWB administrative expenses increased from 1.83 to 3.47 CAN\$/t between 1995-1997 and 2005-2007⁶.

Apart from AWB and CWB, the global trend is to eliminate State monopolies on trade in agricultural products, and frequently to eliminate State participation in such trade altogether in countries where this has been the case. For example, state agricultural trade monopolies were removed in El Salvador in 1990, in Colombia and in Jordan in 1990s, in Honduras in 1991 and not long afterward in Peru.

In economic terms, if look only at the supply side of the problem, a state monopoly is a form of a non-tariff trade barrier that restricts/controls trade, for it makes the decisions on how much of each agricultural product is to be exported each year and its timing of delivery. Additionally State Agents are not as experienced and quick in trade as private traders that increases transaction costs in the sector and might, for example, exacerbate a downward seasonal trend in producer prices.

The net economic effect of this policy step is evident and harming the food security in the country. There is an international consensus that export restrictions discourage production of that product by downward pressure on the farm gate prices and thus providing disincentives for finance and investment into the sector. Decades of applied research on this issue demonstrate that the future production will rise or fall approximately in proportion to price changes⁷. Applying this result to Ukraine, a conservative estimate, for example, of the domestic price drop after introduction of the export grain quota in the fall 2010 is about 16%⁸. Other things being equal, it will reduce the future grain crops in Ukraine approximately in the same proportion. This in turn will have markedly negative effects on the sector's finance, investment and growth prospects in the long run thus exacerbating shortages and price hikes in the future. The burden of this measure will be especially felt in the export oriented sectors (which is definitely the case for Ukraine) and will seriously stall/backward the development of the sector.

The drafts, in particular #8163, in an old-fashioned Soviet manner explicitly blame middlemen and foreign [grain] traders for robbing Ukrainian farmers. This argument is populist and not based on facts. On the contrary, there is a unanimous global consensus that middlemen and private traders perform a very important role in the market economy, and the development of the grain and oilseed sector in Ukraine only corroborate it. [Foreign] traders do not only trade but make international capital available to help farms

⁶ See footnote 2 mechanisms

⁷ Norton R. (2004) Agricultural Development Concepts: concepts and experiences. FAO, (p 81)

⁸ Getreideexportquoten: Zum Umgang mit Chancen und Verantwortung. Ausgabe 28, Dezember 2010. Newsletter, Deutsche Beratergruppe

with liquidity constraints during harvesting and seeding campaigns. International companies in most of the cases are very reputable and creditworthy, and have access to the cheap credits. Independent experts estimate that Ukrainian farmers receive from traders about USD5-10 bln in cash for their grain during the harvest campaign to pre-finance their seeding or pay back the loans; farmers urgently need this liquidity in the post-harvesting period and grain traders provide it to them. Moreover the traders basically pay for the farmers the storage costs that they would otherwise incur. Will the State be able to mobilize these funds (several times more than the current agricultural budget) to farmers? Given the current problems with the budget deficit, this looks very unlikely. Many farmers remember the time when the State order was in place and how much they received for their produce? Very often the farm-gate price was as low as USD30/t, or about 30% of the corresponding fob or world market price. At the moment, farmers receive at least a half of the world market prices. Farmers could get even more unless the lion share of the difference between farm-gate price and world market price is lost through inefficient infrastructure, stock losses and [political] risks (due to, e.g. abrupt grain quotas etc). Empirical evidence shows that because of the fierce competition among traders, the actual trade margin in grain markets make up only USD1-2/t.

In this short note we have not covered other not less important economic consequences that would, for example, increase inflation pressure in the country and threatening the food security or indirectly lead to the reduction of the State budget revenues. But we think that the supply side effects as well as the global experience with state monopolies are evidence enough to get these two drafts down. Otherwise this would seriously stall/backward the development of the Ukrainian potential to produce more and profitably agriculture and food products.