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## **The Draft Law 'On Agriculture': Questionable Objectives and Inappropriate Instruments**

Oleg Nivievskyi

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The German-Ukrainian Agricultural Policy Dialogue provides policy advice to Ukrainian state authorities and business associations on reforming agricultural policy and legislation in accordance with principles of a market economy. In our advisory work, we take into account relevant German as well as international experience and practice (EU, WTO). The project is funded by the German Federal Ministry of Food, Agriculture and Consumer Protection under its Cooperation Program through GFA Consulting Group GmbH.

### **German-Ukrainian Agricultural Policy Dialogue (APD)**

Reytarska 8/5-A,  
01034 Kyiv, Ukraine  
Tel: +38 044 / 235 75 02  
Fax: +38 044 / 278 63 36  
agro@ier.kiev.ua  
www.apd-ukraine.de

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## The Draft Law 'On Agriculture': Questionable Objectives and Inappropriate Instruments

### Executive Summary

On January 27<sup>th</sup> 2012, the Ministry of Agricultural Policy and Food of Ukraine made public its Draft Law 'On Agriculture'. So after more than 20 years of transition Ukrainian agriculture is near to have its own framework law. In its current form, however, the Draft of the Law contains quite questionable objectives of the State agricultural policy (SAP) and the measures to reach them.

The **objectives** of the SAP in the Draft Law mainly remind modern agricultural policy objectives. Further detailed analysis of the Draft Law, however, reveals that food security is meant in a sense of food self-sufficiency. The widely accepted definition of food security, however, emphasizes physical availability of food, as well as its economic availability, i.e. at reasonable prices. Ensuring food self-sufficiency will exclude Ukraine from international trade and specialization benefits, thus making the country overall poorer.

Another deficiency is that achieving productivity increase is completely missing from the set of SAP's objectives. And this is despite the fact that productivity in Ukrainian agriculture has been below the corresponding worldwide averages over the last decade, although growing conditions in Ukraine are certainly above average. Economic research suggests that the only sustainable way to increase the competitiveness of agriculture is to ensure its productivity growth. Given the current productivity gap in Ukraine, this should be the key issue for the government; focusing on fostering technical and efficiency progress will ensure food security in the country and increase the contribution of agriculture to national economic growth and welfare. So with regard to the **objectives of the State Agricultural Policy**, we suggest the following:

1. streamline the objectives of the State Agricultural Policy according to the modern agricultural policy principles, i.e. to the EU principles,
2. ensure that food security is appropriately defined in the Draft Law,
3. ensure that increasing productivity to be the key objective of the State Agricultural Policy.

The key element of the Draft Law is the system of so-called **agricultural passports**. Individual agricultural passports are developed for five years and contain **agricultural production standards** as well as the five-year planned production and other targets. The system is structured in the following way: agricultural passports are developed for each agricultural enterprise and afterwards they are aggregated to administrative unit (rayon) level and further up to regional (oblast) and to the national level, i.e. to 'Agricultural Passport' of Ukraine. Local, regional and national agricultural development programs should be based on the agricultural passports and achieve the targets specified in these agricultural passports.

Agricultural production standards, among other things, set up the norms for crop structures and rotations, for densities of keeping animals, preserving specialization of the farm, as well as preserving soil fertility etc. Moreover, the Draft Law foresees administrative and even criminal responsibility for breaching of the agricultural production standards. The ultimate result of these will be the failure of 'invisible hand' of the market to restructure Ukrainian agriculture into a more competitive and productive sector. Freezing crop and animal structures for five years destroys one of the fundamental market mechanisms of adjusting production plans according to the international markets price signals; it will 'freeze' non-competitive farms in the sector. Essentially the system of agricultural passports is a return to the principles of **central planning of the Soviet era**. A further key instrument of the SAP is **price regulation**. The Draft suggests allowing price fluctuations within the price bands, i.e. within minimum and maximum prices, and apply market interventions, pledge purchases, export and import quotas and other trade barriers to keep the prices in the band. In case the difference between the market price and corresponding min-max limits exceeds 20%, administrative measures may be imposed. The economic literature is quite unanimous about the negative consequences of this instrument. Moreover, it is incompatible with WTO standards and it inflicts huge budget expenditures and huge social losses to the economy. With regards to the **instruments of the State Agricultural Policy** we suggest the following:

4. drop the concepts of agricultural passports and agricultural production standards; if the government wants to keep it, they should not be binding for producers and should not foresee any kind of responsibility for breaching of the agricultural production standards; the government should use them exclusively for purposes of monitoring, reporting and adjusting policy measures;
5. if the main purpose of agricultural production standards is preserving soil fertility, the government should tackle the problem directly, via enforcing the Law of Ukraine 'On Land Protection', but not intervening directly into the production process;
6. turn down the idea of price regulation; on the contrary, the government should declare its adherence to free market pricing by a binding commitment that it will not interfere on agricultural markets.

Overall, the Draft Law has a strong 'non-market' or central planning flavor with potentially significant negative economic consequences as well as it does not take into account the lessons that the EU learnt with its heavily regulated CAP. In its current form, the Draft Law should be heavily reconsidered.

**Author:**

Dr. Oleh Nivievskyi

nivievskyi@ier.kiev.ua

+ 38 044 278-63-42

**Lector:**

Dr. Ricardo Giucci

giucci@berlin-economics.com

+ 38 044 278-63-60

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## 1. INTRODUCTION

On January 27<sup>th</sup> 2012, the Ministry of Agricultural Policy and Food of Ukraine made public its Draft Law 'On Agriculture'. So after more than 20 years of transition Ukrainian agriculture is near to have its own framework law that would define its long-term objectives, mechanisms and instruments of the State agricultural policy (SAP) as well as the principles of agricultural markets organization in Ukraine.

To this day some elements of the proposed Draft Law have been already in place. For example, the main objectives of agricultural policy in Ukraine are formulated in the Law on "Basic Principles of the State Agrarian Policy up to 2015"<sup>1</sup>. They include: (1) food security; (2) efficiency and international competitiveness; and (3) integrated development of rural areas and improvement of social conditions of the rural population. The "State Targeted Program for the Development of the Ukrainian Countryside Until 2015"<sup>2</sup>, translated these policy objectives into specific tasks, identifying financing needs and sources. In reality, however, actual policy-making have been rarely agreeable with these formally established government objectives and publicized state programs. It has been largely ad hoc, lacking a cohesive and broadly-supported long-term strategic perspective based on basic economic principles. It often appears to be driven by vested interests and personal rent-seeking. Implementation of restrictions on grain exports four times in the last six years (2006/07, 2007/08, 2010/11 and 2011/12) strongly supports this observation (e.g. see Nivievskiy et al, 2011a and 2011b).

This circumstance, however, gives us an opportunity to analyze the Draft Law 'from the scratch', i.e. without references to the Law on 'On Basic Principles...'. On the other hand the Draft Law clearly defines the reference system, against which it can be assessed. §2 of the Article 2 declares:

*'The State agricultural policy is based on the national priorities and accounts for necessity of integration of Ukraine to the European Union and to the world economic space'.*

In other words, our reference system is the EU and WTO. In this paper we perform a political economy analysis of the main elements of the Draft Law. First we investigate whether the objectives of the SAP in the Draft Law correspond to the reference system as well as to the modern agricultural policy objectives. In particular we look at whether the objectives of the SAP in the Draft Law adequately address the problems that Ukrainian agriculture currently faces. Next we analyze whether the measures and principles of the market organization suggested in the Draft Law are adequate to reach the objectives of the SAP declared in the Draft Law or defined by the reference system. Each section we supplement with a set of recommendation.

## 2. OBJECTIVES OF THE DRAFT LAW

The Draft Law suggests the following **objectives** to be pursued by the SAP of Ukraine (see Article 4):

- i) food security and supply of high-quality food and raw materials for processing industry,
- ii) agricultural export development,
- iii) competitiveness of agricultural goods,
- iv) efficient agricultural and food markets that ensures profitable operation of farms
- v) rural population employment
- vi) contribution of agriculture to preserving nature and landscape.

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<sup>1</sup> The Law of Ukraine # 2982-IV on "Basic Principles of the State Agrarian Policy up to 2015" as of October 18<sup>th</sup>, 2005

<sup>2</sup> Regulation of the Cabinet of Ministers No. 1158 of September 19, 2007

From the first glance these policy objectives remind modern agricultural policy objectives, particularly the ones of the Common Agricultural Policy of the EU<sup>3</sup>:

- i) to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;
- ii) thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;
- iii) to stabilise markets;
- iv) to assure the availability of supplies;
- v) to ensure that supplies reach consumers at reasonable prices.

From comparisons of these two sets of objectives, one can figure out pretty similar 'mantra' of words, like 'food security', 'efficiency', 'agriculture employment', 'farmers' incomes' etc. Further detailed analysis of the Draft Law, however, reveals some surprising peculiarities.

First, food security objective is meant in the Draft Law in a sense of food self-sufficiency (Article 13). §2 of the Article 13 declares:

*'State, sectoral and regional agricultural development programs foresee... implementation of measures to ensure food independence of the state (region) and of rational agricultural activity'.*

The EU objectives, on the contrary, emphasize not just the physical 'availability of supplies', but also their economic availability, i.e. 'supplies reach consumers at reasonable prices'. Economic literature clearly shows that while self-sufficiency does indeed provide consumers with physical availability of food, but it does not ensure its economic availability. Why should Ukraine grow its own bananas when it can get them cheaper on a world market? The widely accepted World Food Summit (1996) definition of food security emphasizes its multidimensional nature and includes food access, availability, food use and stability. See the Box 1 for description of the dimensions of the food security concept. Moreover, basic international economics textbooks clearly show that ensuring food self-sufficiency (reaching autarky situation on some markets) will exclude Ukraine from international trade and specialization benefits, thus making the country overall poorer.

**Box 1: Dimensions of food security (FAO, 2006)**

**Food availability:** The availability of sufficient quantities of food of appropriate quality, supplied through domestic production or imports (including food aid).

**Food access:** Access by individuals to adequate resources (entitlements) for acquiring appropriate foods for a nutritious diet. Entitlements are defined as the set of all commodity bundles over which a person can establish command given the legal, political, economic and social arrangements of the community in which they live (including traditional rights such as access to common resources).

**Utilization:** Utilization of food through adequate diet, clean water, sanitation and health care to reach a state of nutritional well-being where all physiological needs are met. This brings out the importance of non-food inputs in food security.

**Stability:** To be food secure, a population, household or individual must have access to adequate food at all times. They should not risk losing access to food as a consequence of sudden shocks (e.g. an economic or climatic crisis) or cyclical events (e.g. seasonal food insecurity). The concept of stability can therefore refer to both the availability and access dimensions of food security.

Second surprise is that that achieving productivity increase is completely missing from the set of SAP's objectives, although this has been one of the key problems of the sector. Despite the fact that growing conditions in Ukraine are certainly above average, productivity in Ukrainian agriculture has been below the corresponding worldwide averages over the last decade (see Figure 1), although it has been slowly growing. For exam-

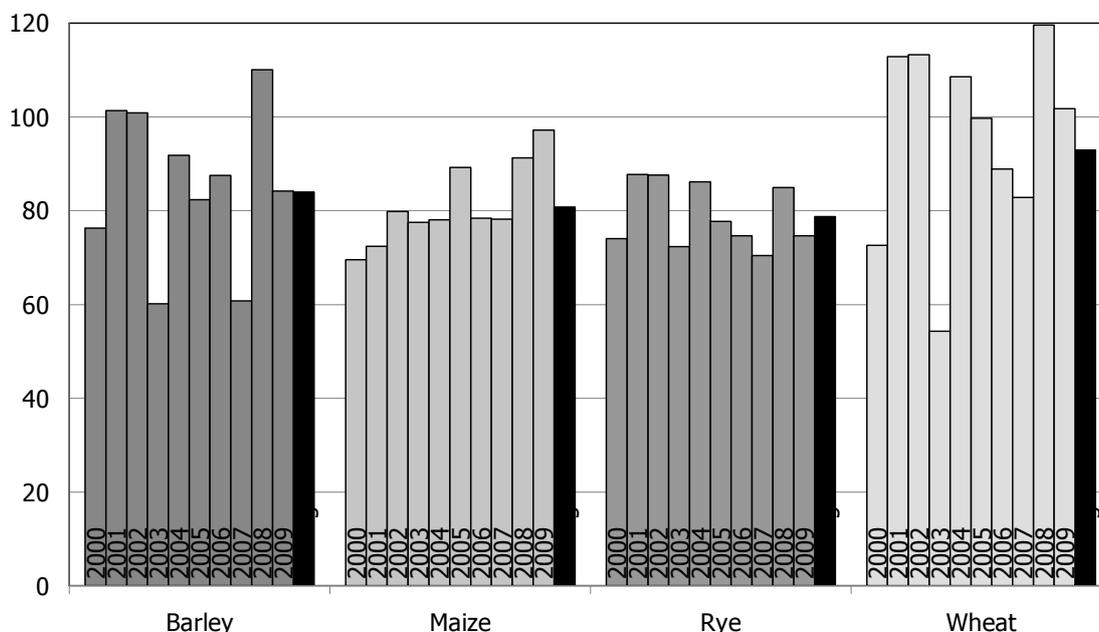
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<sup>3</sup> See Article 33 of the Treaty of Nice, Official Journal of the European Union C 321 E/10, as of December 12, 2006

ple, in the 2010/2011 season yields for barley were 2 t/ha vs. 4.3 t/ha average for the EU-27; for corn, 4.42 t/ha vs. 6.83 t/ha; for wheat, 2.64 t/ha vs. 5.29 t/ha.

Given that competitiveness and export development are among the objectives of the SAP, economic research suggests that the only sustainable way to increase the competitiveness of agriculture is to ensure its productivity growth. Generally speaking, international competitiveness is driven by two main groups of factors: i) technology/efficiency/productivity and ii) prices (Nivievskyi et al, 2010). According to agricultural outlooks (see e.g. OECD, 2011), agricultural output prices are projected to remain strong in the foreseeable future. At the same time some of the agricultural outputs are used in other agricultural productions. Moreover, bullish agricultural prices will likely further boost the prices for fuel and fertilizers. So the net impact of high agricultural output and input prices on agricultural competitiveness is not clear and to a great extent depends on how efficiently the inputs are converted into the output, i.e. on efficiency and productivity growth. Closing current productivity gap in Ukraine should be the key issue for the government; focusing on fostering technical and efficiency progress will ensure food security in the country and increase the contribution of agriculture to national economic growth and welfare.

**Figure 1** Yields of major grains in Ukraine compared with the world average (2000-2009)



Source: BE Berlin Economics (2011)

**Recommendation 1:** Streamline the objectives of the SAP to the modern agricultural policy principles, i.e. to the EU principles.

**Recommendation 2:** Ensure that 'food security' is appropriately defined in the Draft Law and make the amendments accordingly.

**Recommendation 3:** Ensure 'increasing productivity' to be the key objective of the SAP.

### 3. MEASURES OF THE DRAFT LAW

#### **3.1 ELEMENTS OF CENTRAL PLANNING - AGRICULTURAL PASSPORTS AND PRODUCTION STANDARDS**

In the previous section we figured out that the SAP objectives (declared in the Draft Law) do not reflect appropriately the modern and widely accepted agricultural policy objectives. Against this background, we further analyze whether the measures and principles of the market organization suggested in the Draft Law are adequate to reach the objectives defined by the reference system.

The key element of the Draft Law is the system of so-called **agricultural passports** (Article 12). Individual agricultural passports are developed for five years and contain **agricultural production standards** (Article 11) as well as the five-year planned production and other targets. The system is structured in the following way: agricultural passports are developed for each agricultural enterprise and afterwards they are aggregated to administrative unit (rayon) level and further up to regional (oblast) and to the national level, i.e. to 'Agricultural Passport' of Ukraine. Local, regional and national agricultural development programs should be based on the agricultural passports and achieve the targets specified in these agricultural passports.

The main concern about the agricultural production standards is that, among other things, they set up the norms for crop structures and rotations, for densities of keeping animals, preserving specialization of the farm, as well as soil fertility etc. Moreover, the Draft Law foresees administrative and even criminal responsibility (Article 17) for breaching of the agricultural production standards in the agricultural passports.

The ultimate result of these new elements will be the failure of 'invisible hand' of the market to restructure Ukrainian agriculture into a more competitive and productive sector. Freezing crop and animal structures for five years destroys one of the fundamental market mechanisms of adjusting production plans according to the international markets price signals; it will 'freeze' non-competitive farms in the sector. It is important to remember that the social losses generated by non-competitive farms must be borne somewhere else in the economy. Essentially the system of agricultural passports is a return to the principles of **central planning of the Soviet era**.

The overwhelming mass of economists in the world accepts that for efficient allocation of resources in the economy the market principles are much more efficient than central planning (von Cramon-Taubadel, 1999). Even the most talented team of planners is not able to solve the problem of efficient allocation of resources as this task requires tons of information. The planners need to know how much resources is available, what are production costs and how enterprises value their outputs. Moreover, this information should be collected rather precisely and quickly and of course it requires significant financing. Maximum the planners can do is to collect average enterprise-level figures, which has a little practical value in these settings. Furthermore, the task is extremely complicated as private enterprises have different objectives. In a market economy, on the contrary, there is no need to collect these tons of information as it is accessible to market players via prices. They adapt their production plans to the prices and this facilitates efficient allocation of resources (von Cramon-Taubadel, 1999).

**Recommendation 4:** *Drop the concepts of agricultural passports and agricultural production standards. If the government wants to keep it, they should not be binding for producers and should not foresee any kind of responsibility for breaching of the agricultural production standards. The government should use them exclusively for monitoring, reporting and adjusting policy measures purposes.*

**Recommendation 5:** *If the main purpose of agricultural production standards was preserving soil fertility, the government should tackle the problem directly, via enforcing the Law of Ukraine 'On Land Protection', but not intervening directly into the production process. Pigouvian tax<sup>4</sup> would be another alternative to tax externalities of agricultural production.*

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<sup>4</sup> Pigouvian tax is a tax levied on companies that generate negative externalities, e.g. soil or environmental pollution

### **3.2 PRICE REGULATION**

A further key instrument of the SAP is price regulation. The Draft suggests allowing price fluctuations within the price bands, i.e. within minimum and maximum prices (Article 38). To keep the prices in the price band, the government can apply market interventions, pledge purchases, export and import quotas and other trade barriers. In case the difference between the market price and corresponding min-max limits exceeds 20%, administrative measures may be imposed.

The economic literature is quite unanimous about the negative consequences of such a price band regime moreover using the tools suggested in the Draft Law. For example, Summer et al (2010) reviewed economic literature over the last 100 years on the economic understanding of the courses and consequences of agricultural policy drew important for our case lessons to drift away from price and supply control programs:

**Lesson 1:** *Supply control programs and price discrimination policies have benefited producers and quota owners mainly at the expense of consumers. Detailed impacts depend significantly on details of policies... Common program features such as quota ownership restrictions and policy risk have affected the magnitude and distribution of benefits from quotas, and incomplete barriers to entry have undermined price discrimination and pooling programs.*

**Lesson 2:** *Governments have very limited potential to use carryover stocks programs to stabilize markets in ways relevant to producers or consumers without causing other problems that are even more severe.*

In addition, price control/support policy is incompatible with WTO standards and it inflicts huge budget expenditures and huge social losses to the economy. Minimum prices allow very efficient farms to generate 'above normal' profits, while inefficient farms generate some profits but remain in the sector rather than being forced to improve their production or exit. This prevents the sector from restructuring, adds costs to the entire value chain, reduces its international competitiveness and passes the burden of this regulation onto consumers. Maximum prices, on the contrary, decrease the incomes of farmers, reduce their investment activities and decelerate productivity growth in the sector. The deficiencies of this price regime became one of the key reasons why the EU initiated the reform of its Common Agricultural Policy (CAP) back in 1992.

**Recommendation 6:** *Turn down the idea of price regulation using minimum-maximum band system and administrative control. On the contrary, the government should declare its adherence to free market pricing by a binding commitment that it will not interfere on agricultural markets.*

### **4. OTHER CONCERNS ABOUT THE DRAFT LAW**

Despite the key problems that we described above, the Draft Law contains some other minor but nonetheless important contradicting and problematic points. Below we list and comment on them accordingly.

- 1) §2 of the Article 5 of the Draft Law declares that the SAP is to ensure profitability at least at the average level in the entire economy. As this is not the same as support of farmer's incomes, in principle this corresponds to the price support mechanism that we have covered above already and discussed the negative consequences. Given the current significant gap in agricultural productivity, ensuring profitability via certain government interventions, as price supports, for example, will only entrench inefficient farms in the sector and hamper the development of the entire sector.

**Recommendation 7:** *Drop this paragraph from the Draft Law.*

- 2) Article 8 lays down main principles of work and involvement of agricultural NGOs in the process of agricultural policy making in Ukraine. The main idea is that NGOs should influence policy making via a new institution, so called 'Agri-Food Council'. It is generally accepted that agricultural NGOs are weak in Ukraine and their role in agricultural policy making has also been generally weak. From this perspective it is a positive sigh that the law-makers turned their attention to agricultural NGOs. On the other hand, in April the President has signed already the Law 'On Non-Governmental Organizations' and agricultural NGOs should comply with the norms of this Law. So from this point of view, the article 8 looks redundant in the Draft Law.

The idea with the Agri-Food Council looks also redundant as Ukraine has already such an institution, i.e. Agricultura Chamber of Ukraine. The Agricultural Chamber has not been very active over the last couple of years, so probably reviving its activity would more efficient than creating new institution.

**Recommendation 8:** *Drop the Article 8 and revive the activities of the Agricultural Chamber of Ukraine as the place where different participants of agricultural policy process could discuss problematic areas.*

- 3) Chapter V covers the land relations in agriculture. This chapter is redundant as there will be a Law 'On Land Market' – precondition of lifting the moratorium on farmland trade.

**Recommendation 9:** *Drop the Chapter V from the Draft Law.*

- 4) Chapter VI covers the issues on environmentally friendly agriculture, land protection and food safety. Significant parts of this chapter are redundant as there are already the laws 'On land protection' and 'On food safety and quality'.

**Recommendation 10:** *Drop the parts of the Chapter VI that cover land protection and food safety issues.*

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