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Status quo of state support to investments in the agricultural sector of Ukraine

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About the Project "German-Ukrainian Agricultural Policy Dialogue" (APD)

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.

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EXECUTIVE SUMMARY

The amount of investment in Ukraine's agricultural sector increased substantially in recent years. Public financial support contributed to that growth. Direct subsidies were relatively small and decreasing, but tax reliefs generated benefits that were roughly equivalent to the amount of capital investments in the sector (USD 1.43 bn or 0.8% of GDP in 2012). However, a room for a further increase in investment exists as the capital stock in the sector remains to a large extent outdated.

Given the existing budget constraints, opportunities for further increase in public financing are limited. The government bodies and local authorities make promotion of private investment by providing investors with information services and facilitating their contacts with officials, but effectiveness of those measures is limited. The key conditions for an increase in investment are improvement of the business climate and cancellation of the moratorium on farmland sale and purchase.

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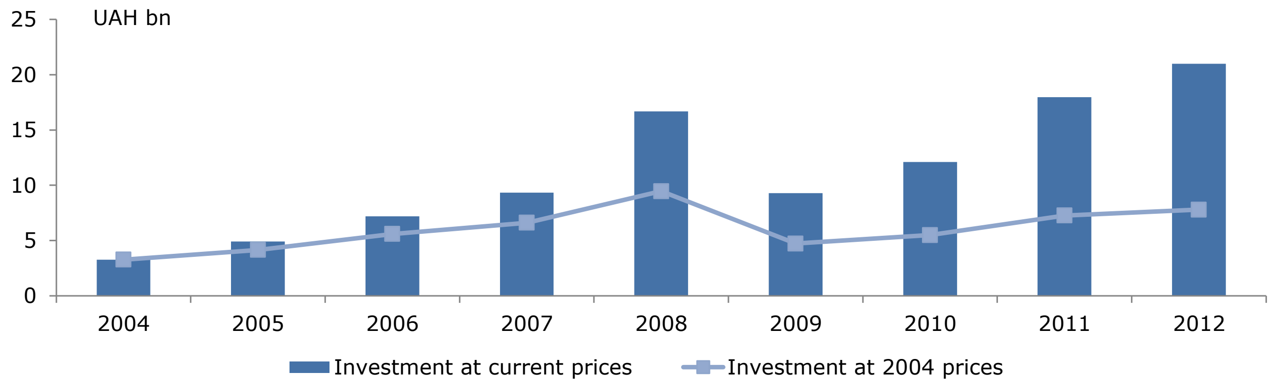
1. Investment in agriculture in Ukraine

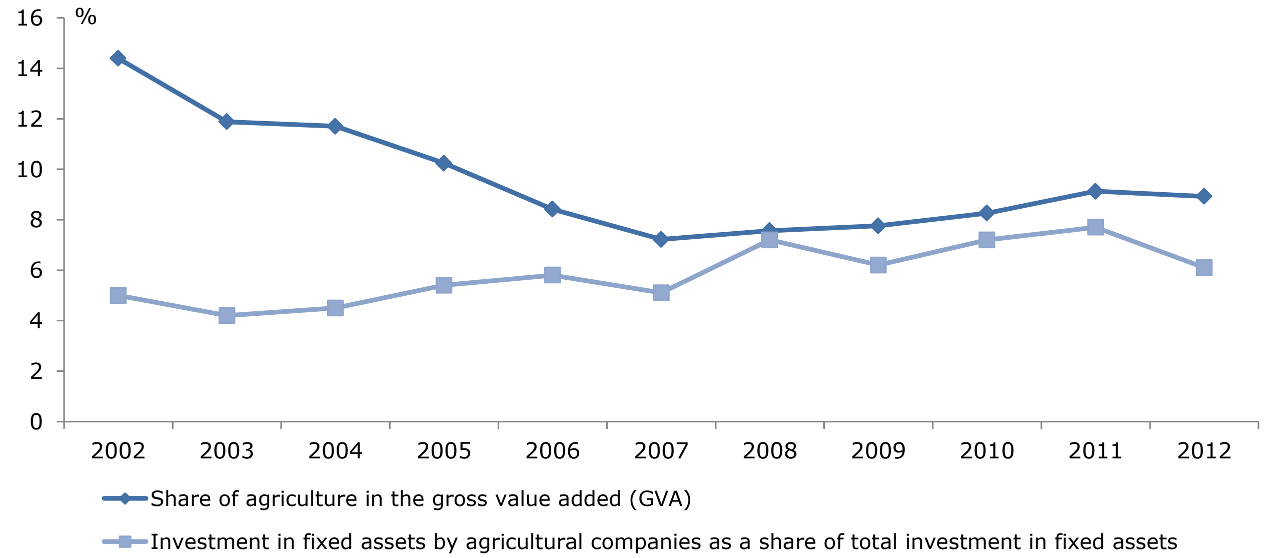
The last decade saw a surge of investment in Ukraine's agricultural sector. In 2004-2008, investment grew at an annual rate ranging from 18% to 43%[1]. The growth was interrupted in 2009 by the economic crisis, but resumed in 2010 (see Figure 1). The surge in investment contributed to a substantial capital stock improvement. In 2005, the sector's capital stock started to grow after a lengthy period of decline. As a result, the share of agriculture in the gross value added (GVA), which shrank from 26% in 1990 to 7.2% in 2007, expanded to 9.1% in the next three years[2] (see Figure 2).

Figure 1. Investment in Ukraine's agricultural sector, 2004-2012



Source: own calculations based on data from the State Statistics Service of Ukraine

Figure 2. The share of agriculture in the gross value added (GVA) in Ukraine, 2002-2012



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[1] Measured at constant prices. If not specified otherwise, the source of data in this section is the State Statistics Service of Ukraine.
[2] The State Statistics Service of Ukraine; Kozyuk, V. et al. History of Economy and Economic Thought: XX-beginning of XXI century. Kyiv. Znannia, 2011.

Source: own calculations based on data from the State Statistics Service of Ukraine

However, the amount of investment in agriculture remains relatively low in absolute terms. In 2012, total capital investment in the sector were UAH 15.8 bn (EUR 1.5 bn) or UAH 433 (EUR 42) per ha of the arable land. Investments were distributed relatively evenly among regions. In 2007-2011, the average amount of investment ranged from EUR 25 to EUR 55 per ha of arable land in 20 out of 25 regions of Ukraine. The amount of investment is significantly above the average level in two regions — Kyiv region and Cherkassy region (see Figure 3).

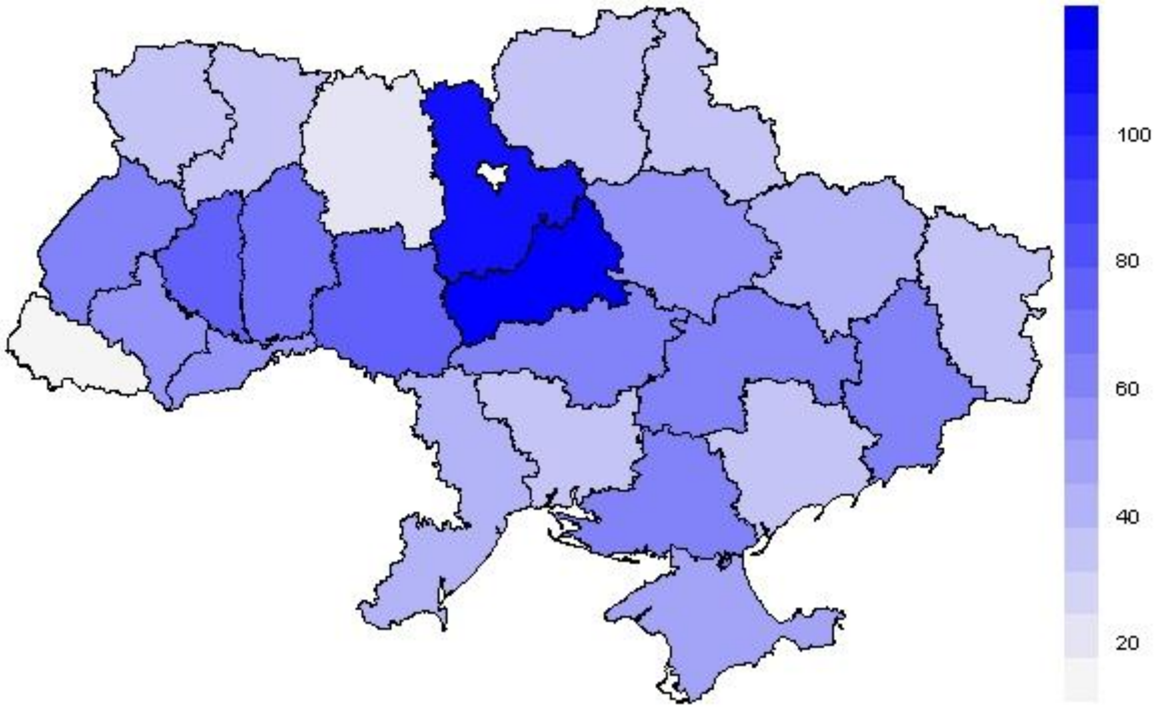
Access to finance is a serious and enduring problem for agricultural companies, as well as for other businesses in Ukraine. In 2007-2010, 60.4% of investments in Ukraine were financed from companies' retained earnings, 14.8% — from bank loans, and 9.7% — from funds of the government and local authorities. The rest of financing came from private individuals (investment in real estate), foreign investors, and other sources.

Inflow of FDI into Ukraine's agricultural sector was significant in 2004-2008. In that period the FDI stock increased from USD 206 m to USD 813.3 m. Later the trend to rapid growth stopped. As of January 1, 2013, the FDI stock in the sector totaled USD 800.7 m.

Since 2007, more than 20 agriculture and food companies have gone public on international stock markets in Warsaw, London, Frankfurt and Paris. The total amount of investment drawn from that source exceeds USD 1 bn[3].

[3] http://latifundist.com/novosti/40187-blagodarya-operatsiyam-na-ipo-agrosektor-privlek-1-mlrd-44-mln-dollarov; Agricultural Sector Report: Ukraine. Prepared by the Institute for Economic Research and Policy Consulting in 2012; Interfax Ukraine news agency.

Figure 3. Investment in Ukraine's agricultural sector by regions, in 2007-2011 on average per year, EUR per ha



Source: own calculations based on data from the State Statistics Service of Ukraine.

2. INVESTMENT REGIME IN UKRAINE

From a formal point of view, the regulation of investment in Ukraine is generally based on liberal principles. The country's laws give equal rights to all domestic investors, ban officials from interfering in business operations beyond their authority, and contain guarantees against uncompensated nationalization and requisition[4].

Ukraine is also open to inflow of foreign capital. National treatment is secured for companies with foreign investment, with only a few exceptions. The main exclusions are the following. First, companies with foreign capital are prohibited to own agricultural land in Ukraine (although at the moment a temporary moratorium on purchase and sale of farmland applies to all companies and individuals). Second, the right

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[4] The Law on Investment #1560-XII.

of companies with foreign capital to own non-agricultural land is limited[5]. Third, such companies have to pay an additional repatriation tax at a rate of 15% on the amount of dividends transferred to foreign shareholders[6]. Fourth, foreign investors are granted additional privileges. Specifically, they may benefit from (1) exemption from import duties on goods imported as a foreign investor's contribution to the capital of a Ukrainian company, (2) unconditional guarantees against nationalization, (3) the right for prompt restitution of losses from any incorrect decisions made by officials[7].

However, from a practical point of view, regulation of business in Ukraine is burdensome. The World Bank's Doing Business 2014 (DB) Index, which measures "the regulation and red tape relevant to the life cycle of a domestic small to medium-size firm", rates Ukraine 112th out of 189 countries[8]. According to the 2013 Index of Economic Freedom (IEF), Ukraine is a repressed economy, ranked 161st out of 177 countries[9]. The main problems that hinder investment are burdensome taxation, poor property rights protection, and corruption. According to the Doing Business 2014 Index, Ukraine is among the twenty countries that have the most complicated and costly procedures for getting electricity in the world (172nd position). Regulation of land use and construction activities is also cumbersome.

The regulation of business has improved slightly over the last three years. Ukraine streamlined procedures for starting a business, getting construction permits, and registering property. But further reforms are needed to make the business climate substantially better.

3. PUBLIC SUPPORT TO INVESTMENT IN AGRICULTURE

3.1. Subsidies and taxes

The government provides significant support to agriculture in the form of subsidies and tax exemptions. In recent years, subsidies were not large due to budget constraints (0.7% of GDP in 2012). The money was used mostly to finance implementation of growth-enhancing measures (educational programs, research and development programs). The main tool for public financial support to agricultural investment was sector-specific tax reliefs (0.8% of GDP in 2012).

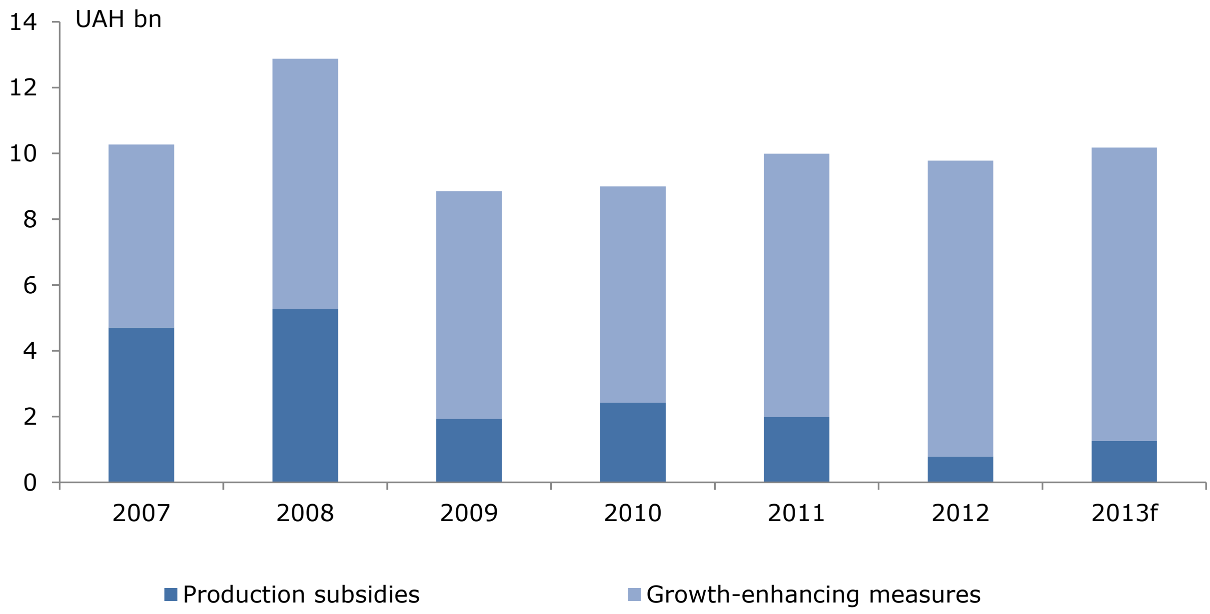
3.1.1. Subsidies

The amount of direct public subsidies to agriculture in Ukraine is not large comparing to other countries. In 2012, the transfers totaled UAH 9.8 bn (EUR 0.95 bn) or 0.7% of GDP[10]. Those figures were a result of a steady decrease in the relative amount of subsidies in recent years (in 2007 agricultural subsidies

[5] Investors from abroad may avoid the above mentioned land ownership restrictions by using a string of Ukrainian subsidiaries.
[6] The Tax Code of Ukraine, article 160.
[7] The Law on Foreign Investment #93/96-VR.
[8] http://www.doingbusiness.org/data/exploreeconomies/ukraine
[9] The Index of Economic Freedom by The Wall Street Journal and The Heritage Foundation (http://www.heritage.org)
[10] Source: calculations by IER based on data published by the State Treasury of Ukraine. The figures include administration costs (salaries and other administrative expenses paid by the Ministry of Agrarian Policy, the State Veterinary and Phytosanitary Service of Ukraine, the State Agency for Land Resources of Ukraine, the State Forest Resources Agency, and other government bodies, responsible for policy-making in the agriculture sector).

added up to 1.43% of GDP). The biggest drop in the amount was in 2009, after Ukraine joined the World Trade Organization (WTO).

Figure 4. Public subsidies to the agricultural sector of Ukraine's, in 2007-2013



Source: own calculations based on data from the State Treasury Service of Ukraine, the State Budget Law for 2013.

According to WTO rules, public transfers to the sector may be grouped into two categories: production subsidies (market distorting transfers, referenced to also as "amber box measures") and growth-enhancing measures (not-distorting, "green box measures"). In Ukraine, the largest subsidies were of the latter kind. In 2012 they amounted to UAH 9.0 bn (EUR 0.9 bn) or 0.64% of GDP (in 2007, those subsidies were 0.77% of GDP)[11]. The main categories of programs financed by growth-enhancing subsidies were the following[12]:

- educational programs (financing of educational institutions, tuition fees, and other expenses on education; in 2009-2012, the average amount of financing was UAH 2,619.8 m or EUR 245.6 m per year),
- research and development programs (in 2009-2012, the average amount of financing was UAH 806.6 m or EUR 75.8 m per year),
- land market development programs (in 2009-2012, the average amount of financing was UAH 368.2 m or EUR 35.1 m per year).

The production subsidies were focused on supporting investment. A smaller portion of transfers were used also to encourage production and trade. In recent years the amount of production subsidies decreased significantly. In 2007-2012, it dropped from UAH 4.7 bn to UAH 0.8 bn or from 0.65% to 0.06%

[11] If not specified otherwise, the source of data in this section is calculations by IER based on data published by the State Treasury of Ukraine.
[12] Not including administration costs (in 2012, they were UAH 3,080.0 m or EUR 299.9 m).

of GDP. It was much smaller than the amount that Ukraine could grant under its commitments to the WTO (UAH 3.04 bn). In 2012, the subsidies were used to finance mainly the following programs:

- support for establishment of orchards, vineyards, and berry plantations (in 2009-2012, the average amount of financing was UAH 353.4 m or EUR 33.1 m per year)[13],
- investment in the capital of the company Ukragrolisyng, which specializes in leasing equipment for agricultural companies (in 2010-2012, the average amount of financing was UAH 243.4 m or EUR 22.8 m per year),
- support for construction of local wholesale markets (in 2010-2012, the average amount of financing was UAH 93.4 m or EUR 8.6 m per year).

The state budget does not make provision for all public subsidies that are allowed by Ukraine's laws. Since 2010 the government has not financed the program for partial compensation of price of agricultural equipment that was manufactured in Ukraine. In 2012, the government discontinued another three programs:

- Subsidized interest rates on loans and leases. In 2009-2011, on average UAH 538.4 m (EUR 49.8 m) per year were disbursed for that program. The program covered loans of up to 7 years to finance both investment projects (purchase of equipment[14], construction of production and storage facilities, and wholesale markets) and current operations. The subsidy was allocated on competitive basis by the Ministry of Agrarian Policy and Food of Ukraine.
- Reimbursement of investment in construction and reconstruction of livestock farms and fodder factories. In 2010-2011, on average UAH 360.3 m (EUR 33.4 m) per year were spent on the program. The subsidy was used to finance construction and reconstruction of relatively large farms (with capacity of at least 500 heads of cattle or 1200 sows or 1 m heads of poultry). The subsidy could cover up to 50% of construction cost (excluding VAT). The subsidy was allocated on competitive basis, the priority was given to companies that already operated livestock farms and planned to invest in dairy production.
- Support to livestock and crop production (in 2009-2011, the average amount of financing was UAH 233.4 m or EUR 21.8 m per year).

3.1.2. Taxation of agriculture

Producers of agricultural products in Ukraine benefit from a number of tax exemptions. Two main of them are a special VAT regime and the fixed agriculture tax (FAT), which is paid instead of four other kinds of taxes including the corporate tax. The amount of benefits from those two exemptions is estimated at up to USD 1.43 bn per year (0.8% of GDP in 2012). Those benefits are an important source of funds for investment, which, as mentioned above, are financed mostly from companies' own funds.

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[13] The program for 2012 includes also support to hop growing.
[14] Only equipment manufactured in Ukraine or equipment that could not be manufactured in Ukraine.

The special VAT regime is the most advantageous for agricultural producers. They may not pay the VAT on their value added (if they choose). Companies have only to collect the amount of the tax on their own special bank accounts. After that they can use it at their own discretion. Every company that generated at least 75% of its revenue from sales of self-produced agricultural products in the latest 12 months is eligible for that VAT exemption[15]. That regime creates benefits to agricultural companies in the amount of USD 1.25 bn per year[16].

The companies that are eligible under a similar criterion may also choose to pay the fixed agriculture tax instead of four other kinds of taxes (the corporate tax, the land tax, the water usage fee, and certain fees on retailing operations). The FAT is based on the "normative value" of land that was determined in 1995. The tax rate is from 0.03% to 1% of the "normative value" of land depending on the type and location of the farmland[17]. The average effective rate of the FAT is low — UAH 6 per ha (EUR 0.55 per ha as of October 2013). The FAT generates UAH 131 m (EUR 12 m) of budget revenue each year[18]. Benefits from the tax for agricultural companies are estimated at USD 0.08-0.18 bn per year[19]. However, the tax can be increased in the near future. In November 2013, a Member of Parliament from the ruling party (the Party of Regions) submitted to the Parliament a draft bill that was intended to increase the amount of the FAT paid by companies to UAH 679 m (EUR 62.3 m) per year by updating the "normative value" of land[20].

3.1.3. Specific tax exemptions to support agricultural investment

Agricultural producers and manufacturers of agricultural equipment also benefit from a set of specific tax exemptions aimed at supporting investment in the sector. The main such reliefs are the following:

- companies that plant gardens of fruit trees are exempted from paying the land tax before the trees start bearing fruit[21],
- companies do not have to pay VAT on imports of equipment for production of biofuel (until the end of 2018, if the like equipment is not manufactured in Ukraine)[22],
- biofuel producers are exempted from paying the corporate tax on profits from sales of biofuel (until the end of 2019)[23],
- manufacturers of agricultural equipment are exempted from paying the corporate tax (until the end of 2020)[24].

[15] The Tax Code of Ukraine, article 209.
[16] Agricultural Sector Report: Ukraine. Prepared by the Institute for Economic Research and Policy Consulting in 2012.
[17] The Tax Code of Ukraine, articles 301-309.
[18] The explanatory note to the bill #3537 http://w1.c1.rada.gov.ua/pls/zweb2/webproc34?id=&pf3511=48925&pf35401=281582
[19] Agricultural Sector Report: Ukraine. Prepared by the Institute for Economic Research and Policy Consulting in 2012.
[20] The draft bill #3537. http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=48925
[21] The Tax Code of Ukraine, article 283, clause 1.5.
[22] The Tax Code of Ukraine, section XX, clause 2.2.
[23] The Tax Code of Ukraine, section XX, clause 4.15.
[24] The Tax Code of Ukraine, section XX, clause 4.17

Agricultural companies are also potentially eligible for corporate tax exemptions according to the law that is aimed at supporting job creating investment projects. Profits from the projects that are approved by the government will not be taxed in 2013-2017, and will be taxed at a rate of 8% in 2018-2022[25].

3.2 Institutional support for investment

A number of government bodies are responsible for development of investment policy and facilitation of investment in Ukraine. The Ministry of Economic Development and Trade is the main government body that develops investment policy. The Ministry of Agrarian Policy and Food coordinates implementation of investment projects in the agricultural sector. A special government body, the State Agency for Investment and National Projects (SAINP), is responsible for investment promotion and facilitation in all sectors of the economy.

The main tasks of SAINP, which was established in 2010, are development and implementation of national projects, and improvement of the investment image of Ukraine. The agency tries to attract private investment both from foreign and domestic sources to finance the projects. As of November 2013, the agency has three projects in the agricultural sector. In fact, each of those projects is more likely a broad framework for implementation of a number of particular investment projects in a sub-sector of agriculture. The brief description of the three national projects is below.

- The "Grain of Ukraine" project is aimed at increasing grain production in Ukraine by contributing to implementation of modern production technologies. The project is supposed to be implemented in 2011-2015, the amount of investment is not specified. In the framework of the "Grain of Ukraine" project the Kherson Machine-Building Plant launched production of a new line of harvesters in cooperation with the Claas company of Germany (august 2013). Negotiations about other particular projects are ongoing[26].
- The "Revived Cattle Breeding" project is intended to contribute to increase in meat and dairy production in Ukraine. The project is expected to be implemented in 2013-2022, its cost is UAH 12.7 bn. Negotiations about particular projects are in progress[27].
- The "Green Markets" project is meant to create a network of local wholesale food markets. The project is supposed to be implemented in 2012-2015, the amount of investment is UAH 4 bn. In August 2013, the second stage of the project preliminary feasibility study was completed[28].

The SAINP also organizes road shows, conferences and other events to attract foreign investment into Ukraine and to improve the investment image of the country. The special unit of the agency that works in

[25] The Tax Code of Ukraine, section XX, clause 4.10, The Law on Investment in the Priority Sectors to Create New Jobs #5205-VI, Order of the Cabinet of Ministers of Ukraine #843 as of August 14, 2013
[26] http://www.ukrproject.gov.ua/en/project/grain-ukraine
[27] http://www.ukrproject.gov.ua/en/project/revived-cattle-breeding
[28] http://www.ukrproject.gov.ua/en/project/green-markets

Ukraine under the brand "InvestUkraine" provides investors with information services and facilitates their contacts with government and local officials[29].

Regional centers for investment and development, which are also divisions of the SAINP, provide such services at the local level in each of the 27 regions of Ukraine. The stuff of the regional centers, however, is small in number. In 2012, the largest center had 15 employees (in the city of Kyiv). 12 centers had 7 workers each, and the remaining 14 centers had between 8 and 14 employees[30].

The organizational structure of local state administrations includes units responsible for implementation of state investment policy. In addition, those units conduct investment promotion activities (for instance, they organize conferences, exhibitions).

Ukraine also has a network of boards of investors. Those boards were established by authorities both at national and regional level in order to facilitate communication with investors. The main body of that kind is the Board of Domestic and Foreign Investors that is chaired by the President of Ukraine. Such boards are also established by the Ministry of Incomes and Fees, the Ministry of Foreign Affairs, the Ministry of Infrastructure, regional state administrations, and other bodies.

4. DISCUSSION AND POLICY RECOMMENDATIONS

Investment in Ukraine's agricultural sector grew substantially in recent years. But a room for a further increase exists as the capital stock in the sector (equipment, on-farm production and storage facilities) remains to a large extent outdated.

Public financial support to investment was important. Although direct subsidies were relatively small and decreasing, the sector-specific tax reliefs generated benefits that were roughly equivalent to the amount of capital investments in the sector. The tax exemptions also contributed to high returns on capital in the agricultural sector, which exceeded 25% annually in 2004-2007[31] and attracted investors. However, given the existing budget constraints, the opportunities for further increase in public financing are limited.

The government's promotion of private investment into the agricultural sector may be seen as largely ineffective. The national projects initiated by the State Agency for Investment and National Projects of Ukraine have not almost attracted any investment. Institutional capacity of the bodies responsible for investment support and promotion is limited. Institutional support (boards of investors, regional centers for investment and development) is focused on large investors giving little attention to medium and small companies.

It should be taken into account that the main reason for low investment in Ukraine is unfavorable business climate. The conventional wisdom is that domestic investors often transfer their assets abroad in order to preserve them. A part of the transferred capital returns to Ukraine under the guise of foreign

[29] http://investukraine.com/
[30] http://ukrproject.gov.ua/sites/default/files/upload/visnikberezen_2013_final_0.pdf
[31] The World Bank. Country Economic Memorandum: Ukraine. Strategic Choices to Accelerate and Sustain Growth. 2010.

investment, which helps to ensure enhanced protection of property rights. Some business owners attract third party foreign capital rather than invest their own funds in Ukraine.

Indirect evidence may be used to support the above stated theses. The outflow of capital from Ukraine was large, despite high returns to capital. According to the estimates of the National Bank of Ukraine (NBU), as of the end of 2012, Ukraine's outward foreign investment (FDI) stock was USD 9.4 bn, and the outflow of capital through non-official channels[32] amounted to USD 27.4 bn. In total it was about a half of the inward FDI stock (USD 72.8 bn). Cyprus companies, which are the biggest investors into Ukraine, transferred most of their investments to Ukraine not from Cyprus, but from other countries. according to Ukrainian official data, USD 12.7 bn came from Cyprus companies to Ukraine by the end of 2011[33]. But according to the Central Bank of Cyprus, the country's outward FDI stock to Ukraine was only USD 218 m for the moment[34]. Given that Cyprus companies were often used by business owners from Ukraine (as well as from other CIS countries) as a tool to improve property rights protection, it can be argued that a substantial part of investment from Cyprus is money originated from Ukraine.

The government and local authorities can undertake some measures to increase investment in the agricultural sector. At the national level, the government can improve the business climate by:

- improving protection of property rights,
- streamlining business regulation (restricting the scope of regulation, and simplifying procedures),
- enhancing public oversight of natural monopolies.

Better effectiveness of investment support and promotion activities will also contribute to an increase in investment.

At the sector level, the government should:

- cancel the temporary moratorium on farmland sale and purchase, which will allow using land as collateral for bank loans,
- pass the law on land market in order to ensure predictable regulation.

At the local level, authorities can facilitate investment by implementing the following measures:

- provide investors with personal guarantees from the governor of the region,
- establish clear procedures for interaction between investors and officials,
- improve skills and motivation of officials who interact with investors,
- ensure transparent selection of investment projects,
- elaborate a plan for infrastructure development, and disclose it to investors[35].

[32] Those channels include concealment of proceedings from export sales, payments for not received import goods and services, and fictitious operations with securities.
[33] http://www.ukrstat.gov.ua/
[34] http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11128
[35] Those ideas were drawn from the Action model for ensuring a favorable investment climate in Russia's regions http://asi.ru/asi_in_regions/Standart.pdf