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## **Proposals on the Agro-Industrial Sector Development Concept**

### **1. Reform Outcomes in the Agro-Industrial Sector**

Russia's agro-industrial sector is living through a crisis determined by: (1) sectoral problems accumulated during the Soviet period; (2) economic and social crisis in the country overall; (3) unavoidable implications of sectoral reforms; and (4) subjective errors in the development and implementation of the agricultural and food policy. Failure to realize that the problem of the crisis in the agro-industrial sector is a comprehensive one has led to one-sided decisions that could not be efficient.

The radical part of reforms in agriculture and related sectors has been implemented, what is needed now is strict compliance with the current legislation, some legislative improvements and legal framework development. Any attempts at revising the reform concept or outcomes would be counterproductive.

In agriculture, land reform has been carried out and agricultural enterprises have been restructured. Due to social and historical reasons, in Russia restitution in the agrarian sector could never be carried out in a manner similar to what took place in most Central and Eastern European (CEE) countries. The adopted concept of reform -- breaking up land and agricultural enterprises' property into individual titles made it possible to eliminate the state monopoly on land, transform agricultural enterprises into economic entities legally independent of the state; and created an enabling environment for entrepreneurial activity in rural areas.

As a result of reforms in agriculture, about 70% of arable land is now under various forms of private ownership. Large farms remain major agricultural producers, but their economic behavior is already considerably different from that of collective or state farms. An entirely new sector of private farmers has emerged that, although still marginal (about 5% of total output), provide an outlet for entrepreneurial activities of the most advanced groups of rural population. Agricultural production has started to respond adequately to market signals, with output being increased when demand grows and reduced when it declines. Agricultural producers are now used to diversifying channels through which to sell their produce and using factor markets; management mentality has started to change; financial accountability is emerging. In a situation of demand for land is constrained, trading in land titles has become relatively active, which creates a quasi market of land resources and, correspondingly, enables more efficient land distribution.

Emancipation of agricultural production by households (both urban and rural) has created favorable conditions for households supplying themselves with food during a critical period of societal transformation, high inflation, growing unemployment, and social instability.

The food and food-processing industries, wholesale and retail trade systems have been privatized, with few exceptions. A market infrastructure system has emerged instead of the socialist system of distribution, and is now developing. Alongside large trading companies operating in the agricultural and food production chain, there are thousands of small and medium-sized private intermediaries which facilitate flows of goods and market information.

Noticeable changes have taken place in approaches to agricultural sector regulation at both federal and regional levels. In their activities, government authorities are increasingly rejecting immediate intervention to market processes and management of producers' economic activities in favor of indirect ways of influencing economic entities. Agrarian policy instruments are becoming increasingly sophisticated and complemented with the methods used by market systems.

Russia's agrarian reforms are generally following the path as other transition economies<sup>1</sup>. Due to subjective and objective reasons, Russian agrarian reforms are slower and, consequently, their economic and social implications are more severe.

In light of the above, it would be wrong to say that no agrarian reforms have taken place in the country. Agrarian reforms cannot be expected to bring results fast when real incomes of the population are declining nation-wide which depresses the demand for food and other types of agricultural products. Besides, in rural areas the social environment is much more conservative and takes a long time to adapt to the new conditions. Russia's historical experience of the 20th century only makes the conservative attitudes stronger compared to CEE countries. If reform are assessed in terms of the path traveled rather than in terms of the results achieved, than the Russian agrarian sector can be said to have shown considerable results compared to other transition economies and to other sectors of the Russian economy.

On the other hand, it would be wrong to attribute the crisis in the agricultural sector solely to the reforms which have taken place, and, on that basis, call for a revision of reform results. As has been noted above, the sectoral crisis is a product of a large number of factors, including many externalities.

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<sup>1</sup> Here we mean industrial-type transition economies. Agrarian-type economies, such as Albania, Vietnam, China Rumania and some others feature a somewhat different type of reforms and, correspondingly, different reform implications.

## 2. Agricultural and Food Sector: Main Problems

Main problems currently facing the agricultural and food sector lie outside the sphere of institutional change and mostly relate to the issue of increasing the demand for agricultural products. Growing sales by agricultural producers will make it possible to increase financial proceeds available to the sector<sup>2</sup>, and will make an important contribution to addressing the problem of insolvency and the debt burden. Only this can ensure that the sector obtains credit in a way that is normal for a market economy (i. e. not from the state). A profitable agricultural sector and a profitable food industry are extremely attractive for investors due to the following reasons: rapid turnover of capital and insignificant lump-sum investments are consistent with the current needs of domestic investors which have no access to large amounts of capital. The food industry is also attractive for foreign investors. Investment means technological restructuring of production facilities and continued growth on a fundamentally new basis. At the same time, investments generate demand for resources needed for agricultural production and, consequently, development of agricultural machine-building, microbiology industry, chemical fertilizers industry etc. A profitable agricultural sector also means additional revenues to local budgets in rural areas and job creation in non-agricultural sectors. In their turn, these measures will promote deeper restructuring of agricultural production, in particular, by shedding excessive labor, divesting social assets etc.

The agricultural and food sector is not isolated from the rest of the economy and, naturally, faces same problems as other sectors of the national economy do, such as financial instability; lack of legislative guarantees of property rights and contract enforcement; low management skills; weak economic governance etc. Nonetheless, some problems are sector-specific. Keeping in mind the above hierarchy of problems facing the agricultural and food sector, let us review the main problems of the sector in greater detail.

1. The main problem of the sector is *limited demand for agricultural products*. The 1992 price liberalization led to the abolition of state subsidies to agriculture which, for some products, had previously amounted to 80% of the retail prices. This resulted in a dramatic reduction of the purchasing power of the population. An underdeveloped market infrastructure severed normal links between food producers and consumers, which further limited marketing opportunities of domestic agricultural producers. The unsatisfied demand was covered by imports, which are easier to prevent from entering, than to drive away from, the market. This was what generated the fundamental problem of sales for the Russian agricultural and food sector. The steep decline of household incomes in real terms resulted in a continued reduction of demand for domestic agricultural and food products over the years of reform.

2. Another important problem currently faced by the Russian agro-industrial sector is *difficult financial condition of agriculture*. In the Soviet economy, the price

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<sup>2</sup> Post crisis development of the sector (after 1998) has proved that this premise is true: import substitution has made it possible to achieve a dramatic output increase in the food industry, the number of profit-making farms grew from 11% to 40%, and overall sector profitability increased from -22% to +14% in just one year.

proportion between agricultural products and factors of agricultural production was shifted in favor of agriculture; the share of agriculture in the end prices for food was also kept too high (compared to international levels). Naturally, price liberalization conducted at the outset of economic reforms in Russia resulted in resource and food prices growing faster compared to procurement prices in agriculture. These proportions stabilized after a couple of years and no significant changes in the proportions were observed thereafter. Nonetheless the objective nature and subsequent elimination of this process do not make the condition of agricultural producers any easier. Due to the above trends (normally referred to as price disparity), agricultural producers lost own working capital as early as the first year of reform. The lack of an adequate credit system in agriculture rendered the loss of working capital effectively irrecoverable, which perpetuated the problem of poor financial condition of agricultural producers.

The main elements of the financial problem in agriculture are as follows:

Limited financial receipts from sales of agricultural products due to demand constraints<sup>3</sup>.

Shortage of own resources required for seasonal financing of agricultural production and lack of access to bank credit. This results in a proliferation of non-cash credit (from the state and private sector), barter transactions and mutual offsets. Under all forms of in-kind exchange, the set proportions would normally be less advantageous for agriculture than under regular cash transactions. Correspondingly, this results in further deterioration of the financial condition of agriculture;

High indebtedness of the sector, especially as a result of soft government credits. Accounts of most agricultural enterprises are blocked (*kartoteka*), which perpetuates non-cash forms of credit, further proliferation of barter in the sector, and considerable profitability reduction.

High arrears to budgets and extra-budgetary funds. The bulk of arrears is composed of penalty interest on, and fines for, late payments. The existing system of taxation ignores the seasonal nature of agricultural production and seasonal flows of financial receipts. These arrears are also instrumental in the blocking of settlement accounts and barterization of transactions in the food supply chain with all the ensuing consequences.

3. Due to low profitability of the sector, agriculture is suffering from considerable *decapitalization and technological degradation*. The lack of adequate financial receipts has resulted in physical depreciation of the bulk of fixed assets of agricultural enterprises, and procurement of machines and equipment has decreased several times. Growing resource costs has, on the one hand, increased the efficiency of resource use in agriculture compared to the Soviet period. On the other hand, though, even with if demand on domestic agricultural and food products increases, a rapid response on the supply side will be constrained by the level of decapitalization of the sector.

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<sup>3</sup> We estimate that due to a vast proliferation of informal economy in agriculture, actual financial receipts of the sector are 20-25% higher than the reported numbers (up to 50% in grain production).

4. As a result of problems presented in paragraph 1 above, the agro-industrial sphere (production of means of production for agriculture) is suffering from depressed demand for its products. As a result, production of means of production for agriculture is poorly adapted to the current needs of Russian agriculture. Two categories can be identified amongst the factor-producing subsectors: those which are oriented at the domestic market only (e. g., machine-building); and those that have some export capacity (e.g., production of mineral fertilizers). Faced with a dramatic demand reduction, the first subsector group is now in a profound crisis. Delayed enterprise restructuring in these subsectors and the ruinous practice of channeling public resources to largest enterprises (Rostselmash, the Krasnoyarsk Combine Harvester Plant etc.) have resulted in a situation whereby enterprises have found themselves lagging critically behind the contemporary needs of the agriculture and food sector. In particular, first attempts to create modern dealership networks and leasing companies have been started only recently. In this environment, Russian enterprises may lose all ability to compete with Western agricultural equipment producers which provide much better maintenance and also have operational and financial leasing arrangements in place. A short price advantage period, fortunately prolonged by the 1998 ruble devaluation, is still available to Russian manufacturers which they must use for carrying out radical restructuring, establishing maintenance networks, and mastering leasing technologies.

Having found a niche on international markets, the export-oriented subsectors were less severely hit by the demand contraction on the domestic market. The longer-term problem faced by these subsectors is that growing demand for their products can be contained by their reluctance to reduce prices to below international levels or adapt to domestic consumers' needs.

5. Underdeveloped agricultural and food markets remain one of the agro-industrial sector's major problems, which, in turn, falls into several subproblems.

First of all, it is necessary to mention inter-regional trade barriers which are especially articulated in the agricultural and food sector. As a rule, regional authorities justify the creation of trade barriers by the need to ensure self-sufficiency of their respective territories in terms of food supplies to the population. However, the overall amount of grain flowing among regions does not decrease on an annual basis. This means that regional trade restrictions are introduced for only several months of the harvesting period when the majority of agricultural producers must sell their products. Restrictions on the exportation of agricultural and food products depress prices on the markets of regions that are net importers of food, and, correspondingly, drive prices up on the markets of regions that are net exporters. Introducing exportation restrictions makes it possible for regional administrations to accumulate inexpensive products in the so-called regional funds operated by "pocket corporations", and then export products at higher prices to food-deficient regions. Thus, the introduction of regional trade barriers is a classic manifestation of *rent-seeking* on the part of regional administrations. It also worsens dramatically the financial condition of agricultural producers (loss of profit), corresponding market operators (affording a preferential trade regime to the "pocket operator" to the detriment of other operators), and, in the

final analysis, end consumers because, with all other conditions being equal, the lack of competition results in prices growing in excess of the equilibrium level.

Besides, regional governments demonstrate a clear inclination to regulate retail prices for basic (“socially important”) foodstuffs. In an environment of fiscal constraints, containing prices is achieved through the administrative fixing of trade margins and those of food processing enterprises. Such containment of prices leads, first, to spasmodic price increases that are due to the fact that in contemporary conditions administrative control is no longer able to effectively keep prices within preset limits during a lengthy period of time. Second, spasmodic price increases result in periodic shortages and outbursts of consumer panic. All these factors distort market signals for market participants and, correspondingly, produces a negative effect on the development of the entire food supply chain.

As has been mentioned above, proliferation of barter and other in-kind transactions is a significant factor constraining the development of the agricultural and food products market.

A market is competitive when new operators are free to enter it. the high entry barriers existing in Russia today are determined by both formal factors (licenses, permits and other administrative restrictions) and informal ones (open corruption, bribe solicitation by government officials, extortion by criminal circles etc.)<sup>4</sup>. This reduces the level of competition on the markets; leads to inflated food prices (and, correspondingly, depressed demand); reduces the share of agriculture in the end price (and, correspondingly, financial receipts of agricultural producers).

6. Today. the problem of *rural development* is not only a social problem, but also an economic problem of agricultural production. First, the social infrastructure in rural areas, to a large extent, remains financed by agricultural enterprises thus inflating their non-productive costs and depressing profitability. The regulatory framework needed for addressing this problem is already in place, but, this fact notwithstanding, enterprises are reluctant to divest engineering facilities to municipalities. First of all, this is related to the lack of budgetary financing needed to maintain these facilities. The traditional way to finance rural infrastructure is by local taxes (taxes on property and land), when all producers in a given locale participate in financing. However, in Russia agricultural enterprises remain village-forming entities, and may easily be the only producers existing in a given territory. That is why they prefer to provide direct financing to systems that are of vital importance for their employees and family members, rather than to pay corresponding taxes.

The other dimension of the problem is that agriculture is easily the only source of income in rural areas. This makes managers of agricultural enterprises to keep an excessive number of employees (today excessive workforce accounts to up to three fourths of the total agricultural employment) in order to preserve local social stability. However, this leads to decreasing labor productivity and overall profitability of the sector. Besides, as has been noted above, with the exception of agricultural enterprises

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<sup>4</sup> According to our observations, market entry costs may be as high as 50 percent of operators’ current costs.

in rural areas there are no economic entities that would be interested in maintaining the social infrastructure.

### **3. What Should Not Be Done in the Agro-Industrial Sector**

#### ***3.1 Export Duties on Agricultural Goods and Food***

In January 1999, export duties were introduced on sunflower seeds - the most profitable crop in the current conditions. Currently, the introduction of export duties on wheat is under discussion. Today there are two main reasons for introducing restrictions on agricultural exports. The first reason, which primarily relates to oil-bearing crops, is that the state seeks to restrict export of raw materials so that to support the domestic processing industry. It is expected that having found it unprofitable to export their produce, producers of sunflower seeds will start supplying it to domestic processing plants. This expectation is an illusion: faced with declining profitability of their produce (and sales on the domestic market are less profitable by definition), they will simply reduce output volumes. Besides, the main problem facing processing plants is not a shortage of raw materials, but their products' being unable to compete on the domestic market. If the vegetable oil-producing industry is able to increase volumes of sales on the domestic market, it will be perfectly able to expand access to domestically-grown raw materials, phasing out exporters by using the price factor rather than export restrictions.

The second objective pursued when export duties are introduced is a purely fiscal one. In both cases, however, export restrictions constrain opportunities for selling agricultural goods, reduce the amount of potential financial receipts available to the sector, and therefore erode the sector's efficiency. In addition, Russia is losing an excellent opportunity to win back a share of the international agricultural and food markets, which would be a long-term loss.

#### ***3.2 Agreements on Food Aid to Russia***

The lack of reliable market information disorients both market operators and the state itself: incomplete information on output volumes and carryover stocks, and on prices on agricultural and food markets has resulted in requests for food aid (both on a grant basis and on concessional lending terms) from the USA and the European Union in 1999, similar food deliveries from the United States are negotiated in 2000. Food aid does not only produce a depressive influence on the corresponding agricultural and food markets, but also destroys the market infrastructure created thus far. Food aid is a reincarnation of the system of centralized food imports whereby authorized agents were hand-picked to distribute imported food. Thus, authorized agents obtained access to interest-free lending for working capital purposes and advantageous market positions compared to those of other market operators. In other words, the state creates unequal competitive conditions on agricultural and food markets.

#### ***3.3 Establishment of a State-Owned Russian Agricultural Bank***

The country does not need a single state-owned bank to extend credit to agriculture. International experience - and, most importantly, several years of operating experience of such a bank in Russia - demonstrates that having a state-owned agricultural bank is counterproductive. First, it is impossible to have a bank that would extend credit to one sector only. Non-diversified banking activities will inevitably lead to bankruptcy. A specialized bank providing universal services cannot exist. Second, such a bank would be completely dependent on external financial sources (budgetary resources, funds provided by international financial organizations etc.); would not be able to provide normal intermediation between savings and investments, which is the basis for any bank's operations. In addition to other problems, such a bank would become an impossible burden on the national budget. Third, such a narrowly specialized agricultural bank would find itself isolated from the national credit system; it would not be able to attract urban investments to finance agriculture; and it would be isolated from the processes going on in the general banking system (for example, from the setting of market interest rates etc.). Fourth, a state-owned bank extending concessional credit to agriculture would completely block any opportunities for creation of market structures lending to agriculture, thus perpetuating the extraordinary nature of agricultural credit. On the one hand, the state bank would inevitably become a mechanism of non-market bureaucratic distribution of loans with all the ensuing negative consequences; on the other hand, borrowers would not perceive it as a normal bank and, consequently, be reluctant to pay back the loans. This would further aggravate the above problems.

### ***3.4 Introduction of a Single Agricultural Tax***

International practice does not know any examples of the use of a single tax levied on large corporate enterprises. The only exceptions are the Belgorod and Ukrainian experiments, the results of which are not obvious yet. In Polish agriculture, there exists an arrangement similar to a single tax, but in Poland agricultural production is based on small farms that have no sophisticated accounting systems with households deriving income singularly from agricultural activities etc.

In Russia, agricultural production is still based on large agricultural enterprises which, generally speaking, should be in a position to keep the full set of accounts enabling calculation of all tax liabilities. The existence of considerable tax exemptions for agriculture has resulted in a situation whereby the VAT and taxes to the social funds are the main types of payments flowing from agricultural enterprises to state coffers. By its very nature, the VAT cannot be incorporated in a single agricultural tax<sup>5</sup>. As regards payments to social funds, the structure of Social Insurance Fund payments does not make it possible to incorporate them in a single tax either. Excise taxes are likely to be difficult to incorporate in a single tax for the same reasons as the VAT. Thus, complete consolidation of all taxes and charges remains impossible.

A single land tax levied on gross proceeds would result in a growth of informal sales and serve as an incentive for concealing income from sales and lowering prices

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<sup>5</sup> In 1998, this was convincingly demonstrated by the failure of the Ukrainian experiment.



artificially. Besides, in a barter environment the concept of proceeds is extremely obscure.

A single tax levied on arable land results in a considerable redistribution of the tax burden onto the most fertile regions as well as farms specializing in extensive agriculture.

One more disadvantage of a single tax is that it cannot be used as an instrument of regulation of individual processes in the productive sector. It is impossible to encourage investment in the productive sector by, for example, applying accelerated depreciation rates. While considerably simplifying accounting procedures, a single tax does not have the flexibility of a multi-tax system.

#### **4. What is to Be Done in the Agro-Industrial Sector**

Russia's current agricultural and food policy could make some steps to support the emerging growth in this sector of the national economy. The main avenues of this policy can be grouped as follows:

##### ***4.1 Expanding Agricultural and Food Markets***

- supporting Russian exports of agricultural products and food (supporting export pools and their representative offices abroad; providing exporters with information on the situation on international markets; issuing export guarantees for credits etc.);
- ensuring that agricultural goods and food are procured for state needs on domestic markets only; expanded procurement of domestic products by companies with state capital;
- comprehensive linkage of targeted social assistance programs with programs aimed at supporting domestic agricultural producers (e. g., redirecting regional subsidies for animal husbandry to free meals programs at schools, hospitals and other social facilities);
- initiating and supporting Associations of Agricultural Producers; creating a system of certification of high-quality domestically-produced goods; carrying out a state-sponsored campaign to promote domestically produced goods.

##### ***4.2 Improving Competitive Environment on Agricultural and Food Markets***

- reducing the share of direct and indirect public procurement (commodity credits etc.); eliminating inter-regional trade barriers; reducing measures used to influence prices in the food supply chain (especially those used by regional administrations);
- curtailing state commodity credit programs, mutual offsets and other surrogate forms linking market participants;

- supporting market competition, including by the creation of an efficient market information system; eliminating all kinds of preferences granted to state trading intermediaries (or intermediaries acting on behalf of the state).

#### ***4.3 Strengthening Legal Guarantees of Operations of Agricultural and Food Market Participants***

- providing state guarantees of property rights to main productive assets to all participants of the food supply chain (primarily, legislating agricultural producers' right to land, including both lease-holding and property rights; extending lease periods and expanding the practice of transfers of wholesale and retail food trading premises; reducing the state's participation in food processing enterprises etc.);
- creating a system of contract performance guarantees (applying to product delivery contracts, credit agreements etc.).

#### ***4.4 Supporting and Encouraging Investment Activity in the Agro-Industrial Sector***

- affording a preferential import regime for food and processing industry technologies during 1-2 years;
- creating a new mechanism of concessional agricultural credit by using proceeds of the Agro-Industrial Sector Concessional Lending Facility for partial (within the limits of the funds available) subsidization of interest rates charged by commercial banks on loans extended to agricultural producers;
- supporting commercial leasing operations in agriculture by subsidizing them using proceeds of the Leasing Facility;
- providing legal and institutional support to the establishment of machine pools and firms providing technological services in agriculture.

#### ***4.5 Reforming Taxation in Agriculture***

- temporary introduction of an integrated tax. We define the integrated tax as the entirety of current tax and other payments effected by agriculture to budgets of all levels of government and extra-budgetary funds, integrated in a single payment. This approach stipulates preservation of all rates and taxable bases, as well as fundamental principles of tax liability calculation. However, the integrated tax would be paid as a lump-sum amount at the end of the year to the Treasury which would then redistribute the proceeds across the corresponding line items. The integrated tax would be payable in cash only.
- ruling out double taxation of farmers' (consumers') cooperatives. Cooperative profit distributed in the form of cooperative dividend paid to all cooperative members should be excluded from cooperative taxation. At the same time, farmers

- members of such a cooperative would be obligated to pay personal income tax on the cooperative profit received.

- vertically-integrated associations in the agro-industrial sector (holding companies, corporations and other associations) should be entitled to same exemptions as afforded to agriculture as a whole; however, such exemptions should apply only to those assets that are used for production and processing of agricultural goods (processing of self-produced agricultural goods only).
- the land tax should be delegated to the local level. The Tax Code of the Russian Federation should be confined to the determination of general principles of land taxation and maximum allowed rates. The responsibility to determine tax rates *per se*, the time frame and procedure of land tax payments should be delegated to the level of local (rayon) governments. Land tax proceeds must become the main revenue source for local budgets.

#### **4.6 *Agro-Industrial Sector Concessional Lending Facility***

The concept of the Agro-Industrial Sector Concessional Lending Facility must be revised. Today the Facility's sole responsibility is to distribute concessional state credit amongst the borrowers. As experience of other transition economies suggests, this Facility should be used to subsidize interest rates on seasonal loans extended to agricultural producers by any commercial bank at the point of loan repayment. Besides, the Facility could offer commercial banks guarantees on loans to small agricultural producers or on investment loans (i. e., the Facility would thus leverage the lending risk in a proportion determined by the Facility's financial capacity).

Concessional interest rates as well as leverage of risks would expand the borrowing capacity of the agricultural sector, with lending activities remaining strictly commercial. Banks attracted to agriculture would create corresponding entities and accumulate experience of operating in this very special sector. Later, they will find it quite difficult to pull out of the sector. Thus, a banking system partially oriented at the agro-industrial sector will be created. On the other hand, agriculture will get access to concessional lending during the transition. This lending arrangement also rules out bureaucratic approaches and negative consequences thereof.

Facility resources would be replenished using budgetary funds.

#### **4.7 *Social Development Programs in Rural Areas***

- non-agricultural job creation programs for rural areas.

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In conclusion, it is necessary to stress that macroeconomic stability in the country as a whole is an indispensable prerequisite of creating an efficient agricultural and food sector.

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