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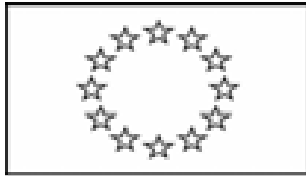


The Kosovo Dairy Sector

Study of Competitiveness with Imports

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Study of Competitiveness with Imports

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Foreword

This paper shows results of an investigation conducted by UNMIK Pillar IV in cooperation with the Ministry of Agriculture, Forestry and Rural Development (MAFRD). The initiative was prompted by complaints of the Kosovo Association of Milk Producers (KAMP) and the Kosovo Dairy Processors Association (KDPA) claiming under-invoicing of agricultural goods imports that compete with Kosovo products.

The analysis of under-valuation was completed in May 2006 and presented to the stakeholders. Since June 2006 Customs have been vigorously tackling under-invoicing with the result that declared values at the border have significantly increased.

This paper has been written to show a practical example of how to conduct an investigation and how to use the information obtained to make a sound policy analysis and recommendations for action.

The methodology followed to investigate border valuation is consistent with the obligations of the Central European Free Trade Agreement (CEFTA) and the related obligations of the World Trade Organization (WTO).

The authors would like to thank UNMIK Customs, the Dairy Associations, MAFRD staff, the Swiss Dairy Project and the USAID funded KCBS project for their valuable assistance in acquiring, presenting and interpreting data.

GLOSSARY

CAP	Common Agricultural Policy (EU)
CEFTA	Central Europe Free Trade Area (now including Western Balkans)
KAMP	Kosovo Association of Milk Producers (Dairy farmers)
KCBS	Kosovo cluster Business Project (USAID funded)
KDPA	Kosovo Dairy processors Association
MAFRD	Ministry of Agriculture, Forestry and Rural Development
PILLAR IV	EU funded part of UNMIK government
UHT	Ultra High Temperature or “long-life” milk
UNMIK	United Nations Mission in Kosovo
USAID	United States of Agency for International Development
VAT	Value Added Tax
WTO	World Trade Organisation

Executive Summary

In 2005, the dairy sector – farmers and processors – complained of the problem of competing with cheap imports. Their appeal led to this study, which seeks to understand:

- (i) why milk and dairy produce imported from some countries is able to enter Kosovo at very low prices, and
- (ii) how competitive the production of milk and dairy produce is in Kosovo and what potential there is to improve its position.

Structure of Dairy Market in Kosovo and Imports

Two thirds of dairy produce in Kosovo is produced inside the territory and either consumed on the farm or traded on local unregulated markets known as Green Markets. The other third of the market is supplied in the form of processed dairy goods, which is dominated by imports, especially for Cheese and UHT milk.

The main sources of imports are Hungary and Germany for Cheese (70% of all imports), and Slovenia and Hungary for UHT Milk (83% of all imports).

Comparison of Kosovo and Competitors' Production Costs

The price of milk at the farm-gate is actually lower than the main exporting countries – Hungary and Slovenia. After collection costs are added, Hungary has a small competitive edge. Except for UHT milk, processing costs are 30% lower in competing countries. compared to Kosovo. The domestic wholesale price of cheese was found to be 70% in Bulgaria, 75% in Turkey and 93% in Hungary 93% of the price for equivalent Kosovo product.

Subsidies Paid in Exporting Countries

Governments of most countries that export to Kosovo provide production subsidies to farmers, general subsidies to the industry, and for some products, export subsidies. The cumulative effect of these subsidies reduces the cost of cheese from 11 cts/kg up to as much as 65 cts/kg (Hungary); for milk by 2.5 cts/litre and Yoghurt by 4 cts (Slovenia).

Comparison of Export Prices with “Declared” Import Prices

Taking white Cheese and UHT milk, and comparing between the known wholesale price in the country of origin and the price declared at the Kosovo border, it is found that there is widespread under-declaration of 40% to 56% by key trading partners.

Analysis of Competitiveness

The analysis shows that Kosovo is price competitive in milk production, but not for cheese. This gives reason for hope in the longer term as subsidies are being removed in the trading system of competitors.

Looking at the problem of **under-invoicing**, rectification of the problem, if passed onto the consumer, would add 2 cts/litre to the price of imported milk and 16 cts/kg to imported cheese, as a result of increased tax levied at the border.

EU export **subsidies** are given for two products sold in Kosovo – Slovenian Yoghurt and Hungarian Trappista cheese. The latter provides very stiff competition with Kosovo producers.

Analysis of retail prices show that Kosovo products are at the low end of the market because of poor quality. Improving quality of product is therefore very important in capturing greater market share.

Finally, the Green Market is examined and it is apparent that Kosovo's **processed dairy products** are squeezed between cheap and convenient farm-to-market produce in Green Markets on the one hand and cheaper, quality imports on the other.

Conclusion

What initially seemed a simple issue of under-invoicing turned out to be a quite complex matter. The main factors influencing the marketability of local dairy produce are firstly quality, second cost of production, third subsidies and finally the effects of under-invoicing.

Rectifying the problem of under-invoicing will have some effect but other more important measures need to be taken to make the sector effectively competitive, in particular actions to improve quality. Other measures required to improve competitiveness include reducing milk collection costs, utilising manufacturing capacities better and ensuring contracts between farmer and Dairy are properly honoured.

In other countries governments have intervened to improve milk quality through use of subsidy for "A" grade milk. It is suggested such a scheme might be appropriate in Kosovo using the VAT system.

Finally there is a need for more market research on consumer preference in Kosovo so that processors can plan better product lines for the future and be better placed to take on the Green Market.

0. Introduction

This paper looks at (i) why milk and dairy produce imported from some countries enters Kosovo at very low prices, and (ii) how competitive the production of milk and dairy produce is in Kosovo and the potential to improve its position.

Table 1 shows the average price declared at the border, before taxes and duties, for the different dairy products imported into Kosovo. The major exporting countries are shown in bold. Prices in bold are those below the cost of production in Kosovo or below international prices.¹ The first three columns show milk, yoghurt and cheese, products that compete directly with Kosovo production, while the last three columns show items not produced in Kosovo. In fact Milk Powder (customs code 0402) is used in manufacture of some milk products in Kosovo.

Table 1: Average Declared Import Prices for Dairy Products by Country of Origin, before Duty and VAT (in cts/kg)

Customs code	Competing			Non-competing		
	0401 Milk	0403 Yoghurt	0406 Cheese	0402 Powder	0405 Butter	0404 Whey
Hungary	0.30		1.17	2.32	1.00	
Macedonia	0.34	0.47	1.55		1.89	0.41
Slovenia	0.37	0.45	2.96	0.55	1.28	
Bosnia	0.39	1.14	2.54		2.41	
Serbia/ Montenegro	0.40	0.35	1.08	0.77	1.43	0.04
Croatia	0.51	0.48	2.93	4.69	1.49	0.69
Austria	0.57	0.52	2.54	7.11	3.20	0.46
Germany	1.28	0.69	2.08	0.59	0.75	5.25
Bulgaria	1.60		1.09	0.60	0.56	
Czech Republic			1.08	0.58	0.57	
Poland				0.56	1.25	
Slovakia				0.56		
Turkey	0.55	0.55	1.97	2.02	4.21	
Kosovo	0.48	0.65	2.50			
<i>Minimum value Import¹</i>	0.40	0.55	1.80	1.70	1.50	

^{1/} *Minimum Value Import* is established in this paper as the lowest price that the cheapest producer is able to deliver to Kosovo based on their cost of production and transport to Kosovo. Annex Table I.

Source: UNMIK Customs 2005

Much of the milk and dairy produce that enters Kosovo arrives at prices considerably lower than the domestic cost of production. These low prices declared at the border have for a long time been of concern to the domestic milk industry – especially with regard to cheese. The Kosovo Association of Milk Producers (KAMP) and the Kosovo Dairy Processors Association (KDPA) intervened with the Ministry of Agriculture, Forestry and Rural Development (MAFRD) in April 2005 on this issue. The milk processors claimed they would need to reduce the buying price from 24 to 20 cts/litre in order to compete with imported dairy produce. KAMP estimate their direct costs are 21 cts/litre, giving a gross margin of 3 cts/litre at a farm-gate price of 24cts/litre.

¹ Indicative Dairy export prices for US quoted in FAO's Food Outlook, December 2005.

However, there are a number of possible reasons for the low prices of imports. It could genuinely reflect the fact that foreign milk products are produced more cheaply and Kosovo is a high cost producer. On the other hand, prices could be lower due to subsidies in the exporting countries and or under-invoicing at the border in order to avoid taxes. The latter has been the complaint brought forward by the dairy producers.

Therefore, after consultations with the MAFRD, UNMIK Pillar IV conducted an enquiry of major milk exporting countries, which provided data for an in-depth comparative analysis.² Official letters of enquiry were sent by UNMIK Pillar IV to the Governments and major milk processors in Hungary, Slovenia and Bulgaria in April 2006. The analysis was carried out with the assistance of KDPA and KAMP, who provided data on Kosovo costs (see Annex II for a Sample Letter of Enquiry).

The analysis proceeds in the following steps:

- Section 1 provides an overview of the Market for Dairy produce in Kosovo and the dominant position of imports in the “processed” segment of the market.
- Section 2 looks at the cost of production in Kosovo and in the main competing countries.
- Section 3 looks at subsidies paid in the main exporting countries.
- Section 4 compares the derived export price shown in section 2 with the **declared** import price into Kosovo.
- Section 5 analyses the competitiveness when subsidies are taken out of the equation; determines the amount of under-invoicing that is occurring and finally looks at the effect of export subsidies.
- Section 6 concludes on how the Kosovo dairy Industry can be made more competitive and what policies need to be followed to achieve this.

The full cost of production in the exporting countries has been pieced together from information supplied by their Ministries of Agriculture and their leading dairy companies. A comparison is made of subsidies paid in production and for export by the different exporting countries. The “derived price” is then set along side the declared value of the goods when they enter Kosovo. Finally an analysis is made to show exactly how much of the low price can be attributed to competitive cost structure, how much to subsidy and how much to under-invoicing.

² The sending of official letters of enquiry with a 30 day deadline was an effective method of getting information. Although the answers were not always fully exhaustive, they were sufficiently authoritative to support the comparative analysis.

1. Structure of Dairy Market in Kosovo and Imports

Two thirds of dairy produce in Kosovo is either consumed on the farm or traded on local unregulated markets known as Green Markets. The other third of the market is supplied by factory-processed dairy produce. This is dominated by imports.

The main imports dominating the market are UHT milk and Cheese.

Kosovo imports €21m worth of dairy produce or 24% of Kosovo's requirement by volume.³ Of this amount nearly 70% by value is coming in at prices below the cost of production achievable in Kosovo (see Annex 1).

The dairy market can be divided roughly into three segments. One third is consumed by producers on the farm itself. A further third is raw milk or home produced cheese sold on local "Green Markets" and the last third is consumed as processed dairy products (dominated by imports).

Overall, the market for processed dairy produce is dominated by imports (see Table 2). The main dairy products consumed in Kosovo are milk, yoghurt and cheese. The first line in the Table shows the quantities in tons of milk-equivalent, that is milk required to make the products. The rest of the total shows the production in actual weights of product.

Table 2: Consumption of Processed Dairy Produce in Kosovo, 2005 (in tons)

Product	Imported	Local	Total	% Local
Total (in tons of milk equivalent)¹	86,400	32,400	118,800	28%
Kos Yoghurt		5,000	5,000	100%
Yoghurt	9,000	9,000	18,000	50%
Fresh Milk	1,000	5,000	6,000	83%
UHT Milk	20,000	4,000 ²	34,000	41%
Cheese	5,000	1,300	6,300	21%
Milk Powder	1,000			0%
Other	1,200			0%

1/ Cheese is converted into milk equivalent at average of 8 litres milk for 1 kg cheese covering both Kashkaval and white cheese.

2/ Total Local UHT is 14,000 tons but only 4,000 tons is made from fresh milk and 10,000 tons from *imported* reconstituted milk.

Source: Customs data for imports, KDPA estimates for local production

More than 80% of dairy product imports are from European Union Member States, the main countries being Hungary, Slovenia and Germany (see Table 3):

- **Hungary** is the most important trading partner providing 37% by volume of imported dairy produce. It provides two thirds of the imported cheese and half of the imported milk.
- **Slovenia** is the next most important, providing milk and yoghurt.
- **Germany** is the main source of imported yoghurt but also provides a significant amount of cheese.

³ This is milk-equivalent volume.

Within the region Serbia is an important source of imports in all products, and Bosnia and Herzegovina has recently become a significant supplier of milk. Macedonian UHT milk is also beginning to appear on the market. Both Bosnia and Macedonia though are actually net importers of milk.

Table 3a: Imports of Dairy Produce into Kosovo, 2005 (in tons)

Country:	% of total	Total	Milk	Yoghurt & cream	Cheese	other
Hungary	37%	13,698	10,688	-	3,010	-
Slovenia	29%	10,924	6,937	3,974	13	-
Germany	13%	4,604	32	4,034	538	-
Serbia	8%	2,810	1,498	648	501	163
Bosnia Herzegovina	4%	1,399	1,295	78	4	22
Other	8%	4,249	738	450	1,023	2,038
Grand Total	100%	37,684	21,188	9,184	5,089	2,223

Source: UNMIK Customs

Cheese imports are considered particularly damaging to the Kosovo processing industry as cheese prices are the most competitive. Milk consumption is slightly higher in the winter months than in the summer months, yet milk production is high in the summer months. In most advanced countries, processors will produce milk powder in the summer month with surplus milk and *add it back* in the winter months when milk supply drops. In Kosovo, processors do not have the machinery to dry milk (into powder). They therefore depend on making more cheese in the summer months. The KDPA estimate there is an excess supply of nearly 10,000 tons of milk that could be purchased to be made into cheese in the summer months, but currently is not collected.⁴

Table 3b ranks the most important source of cheese imports. Kosovo's processors had complained in particular about Bulgarian and Turkish white cheese. This study reveals that neither country is a significant source of cheese.

Table 3b: Imports of Cheese into Kosovo, 2005 (in tons)

Country	%	Tons
Hungary	59%	3,010
Germany	11%	538
Serbia	10%	501
Bulgaria	7%	343
Turkey	5%	233
Czech Republic	4%	222
Austria	3%	139

Source: UNMIK Customs

⁴ KDPA, Unpublished analysis on Milk Consumption and Production, October 2005. It is alleged that much of this milk is thrown away by farmers.

2. Comparison of Kosovo and Competitors' Production Costs

The price of milk at the farm-gate is higher in Kosovo than Bulgaria and Turkey, but lower than the main exporting countries – Hungary and Slovenia. Looking at cheese, it can be seen that Kosovo is not price competitive.

The Price of milk in competing countries is shown in Table 4. It shows the farm-gate price (a), cost of collection and delivery to the processing factory (b) resulting in an “into factory” price (c). Farm-gate prices were obtained from the two major export countries – Hungary and Slovenia, and for comparison from Bulgaria and Turkey. The price of collection is an estimate and set at 1.5 cts/litre, considerably below that for Kosovo (4 cts/litre). Kosovo’s collection costs are high due to small scale and scattered nature of operation.

The farm-gate price of milk does not explain the strength of the main exporters. In Table 4, milk prices in Bulgaria and Turkey are shown to be considerably lower than in Kosovo, but their exports only cover a minor market share. In Hungary, milk is only slightly cheaper, whereas in Slovenia it is more expensive, and yet these two countries are the major source of imports to Kosovo. Consumer perception of quality is therefore an important element in determining demand.

Table 4: Price of Milk in Competing Countries (in €cts/litre)

	Turkey	Bulgaria	Hungary	Slovenia	Kosovo
<i>a</i> Price of milk at farm	20.0	20.0	25.0	27.0	24.0
<i>b</i> Collection and transport	1.5	1.5	1.5	1.5	4.0
<i>c</i> Into factory (a+b)	21.5	21.5	26.5	28.5	28.0
<i>as % of Kosovo price</i>	77%	77%	95%	102%	100%

Source: Letters of Exchange, Turkey: Ministry of Agriculture website, Kosovo data: KDPA

For all processed dairy produce, the main component cost is milk. In order to find out the domestic cost of cheese in the exporting countries, we take the example of White Feta type Cheese. White cheese requires approximately 7 litres of milk to make 1 kg of cheese. The manufacturing cost in exporting countries is assumed to be 75% of that in Kosovo, as the competitors are enjoying economies of scale.⁵

The cost of production of white cheese in four countries is derived in Table 5. Note that Slovenia is not included as they do not export cheese to Kosovo. The cost of white cheese is derived by adding the cost of milk required (d) to the manufacturing overhead costs (e). The derived wholesale price (f) is expressed as a percentage of the Kosovo cost of production. The wholesale price of the product (g) is given as reported by the exporters in their own country.

⁵ The estimate of foreign processing costs are based on the known milk price and the known wholesale price in their domestic markets. This approximates to about 75% of cost report by KDPA for Kosovo.

Table 5: Derived Cost of Production for White Cheese (in €cts/kg)

	Turkey	Bulgaria	Hungary	Kosovo
<i>d</i> Milk to Cheese convert (litres)	7.0	7.0	7.0	7.0
<i>e</i> Cost of milk for cheese (<i>c x d</i>)	151	151	186	196
<i>f</i> Manufacturing overhead ¹	41	41	41	54
<i>g</i> Derived wholesale price (<i>e+f</i>)	191	191	225	
<i>h</i> Actual Wholesale price ²	188	176	233	250
as % of Kosovo price	75%	70%	93%	100%

1/ 75% of Kosovo cost - as explained in text.

2/ Notified wholesale prices as reported through letters from Ministries of Agriculture.

In Bulgaria and Turkey, the actual reported wholesale price is lower than the calculated one (8% and 1% respectively of the derived price), **whereas for Hungary it is the opposite** (3% more than the derived price). The difference in Bulgaria is bigger and may reflect lower manufacturing costs, lower milk collection cost or perhaps less milk used in the cheese.

On the evidence so far, it appears that critical costs in Kosovo are for collection and the manufacturing. This is revealed in the final line which shows domestic price of the cheese in the country of origin in relation (h) to the Kosovo price. Turkey and Bulgaria, with much cheaper milk, are able to produce white cheese for 75% of the Kosovo price, and Hungary for 93%. The lower price of foreign competing products may also reflect subsidies paid in the system, which is reviewed in the next section.

3. Subsidies Paid in Exporting Countries

Most countries exporting to Kosovo provide production subsidies to farmers, general subsidies to the industry, and for some products, export subsidies. The cumulative effect of these subsidies reduces the cost of cheese by 11 cts up to 65 cts/kg, milk by 2.5 cts/kg and Yoghurt by 4 cts/kg.

There are three areas where subsidies are given:

1. *Production subsidies* which support the price of milk to the farmer.⁶
2. *Indirect subsidies* in the form of support measures such as capital grants, subsidized interest, 'special' pension schemes for farmers, and reduced excise duty on fuel which all can be counted as a subsidy to the sector. Some of the countries have given an overall estimate of this. The total sum spent can be divided by the total amount of milk produced to express it in cts/litre.
3. *Export subsidies* enable countries to export surplus milk or milk products. In the words of the European Union's Common Agriculture Policy (CAP) this is "to protect the competitiveness of European agricultural products abroad".⁷ Regarding exports to Kosovo, Slovenia receives subsidies on yoghurt and Hungary on cheese from CAP funds. Bulgaria subsidizes some its cheese exports, but not for exports to Kosovo.

Production subsidies paid to farmers by Bulgaria, Hungary and Slovenia are shown in Table 6. Subsidies paid on raw milk (i) range from 1.5 to 1.75 cts/litre. Bulgaria and Slovenia admit to other indirect subsidies that average out at 1 ct/litre. Adding the direct and indirect subsidy gives a total subsidy on milk. Hungary is lowest with 1.65 cts/litre, followed by Slovenia with 2.5 cts/litre and Bulgaria with 2.75 cts/litre.

Bulgaria and Slovenia professed indirect subsidies and grants to the dairy industry that average about 1 cent/litre produced (ii). Added to the raw milk subsidy a total subsidy on milk can be calculated. To determine the total production subsidy for a product it is necessary to multiply it by the amount of milk required to make one kg of product (milk to cheese convert ratio).

⁶ Subsidies are usually paid on grade A milk, to encourage farmers to produce quality milk. MAFRD proposed milk subsidies of 5c per litre in December 2004.

⁷ Visit the official CAP website at <http://www.eur-export.com/anglais/apptheo/logistique/douane/PrincipesPolDouA.htm>.

Table 6: Subsidies on Main Export Products to Kosovo (in €cts/kg)

<i>Product:</i>	<i>White Cheese</i>	<i>Semi-hard cheese</i>	<i>UHT Milk 3.2% fat</i>	<i>Yoghurt</i>	
Country:	Bulgaria	Hungary	Slovenia	Slovenia	
i. Subsidy on milk (cts/litre)	1.75	1.65	1.65	1.5	1.5
ii. Indirect subsidy (cts/litre)	1			1	1
Total subsidy on milk	2.75	1.65	1.65	2.5	2.5
<i>Milk to Cheese convert ratio</i>	<i>7:1</i>	<i>7:1</i>	<i>9:1</i>	<i>n.a.</i>	<i>0.6:1</i>
Production subsidy /kg of product (i + ii x ratio)	19.25	11.55	14.85	2.5	1.5
iii. Export subsidy on product		50			2.75
Total Subsidy (cts per kg)	19.25	11.55	64.85	2.5	4.25

Source: Official replies to letters of enquiry

Finally export subsidies (iii) are paid on Hungarian semi-hard cheese and on Slovenian Yoghurt exported to Kosovo.

Total subsidies on produce sent to Kosovo show Bulgarian white cheese with 19cts/kg, Hungarian White cheese with 11.5 cts/kg, Hungarian semi-hard (Trappista) with 65 cts/kg, Slovenian *Alpsko* milk with 2.5 cts/litre and Slovenian Yoghurt with 4.25 cts/litre.

4. Comparison of Export Prices with Declared Import Prices

Taking white Cheese and UHT milk, comparison is made between the known wholesale price in the country of origin and the price declared at the Kosovo border to establish a 'Real Border Price'. This reveals under-declaration by 40% to 56%.

After rectifying under-invoicing, Kosovo shows itself to be price competitive in UHT milk, but not in White Cheese.

It is possible now to determine what the real value of imported dairy produce is into Kosovo, given that we know the wholesale price, any export subsidy paid⁸ and the transport cost to Kosovo. Table 7.A shows the import price for cheese from Turkey, Bulgaria and Hungary, and Table 7.B for UHT milk from Hungary and Slovenia. This is then compared with the average **declared price** (d). The difference is the amount of under invoicing (e).

Interestingly, price is not the only factor determining market share. Although Turkey and Bulgaria are shown to be significantly cheaper, Hungarian cheese actually accounts for 60% of imports of white cheese.

Table 7: Calculation of Kosovo Border Price (in €cts/kg)

A. WHITE CHEESE					
	Country	Turkey	Bulgaria	Hungary	Kosovo
a	Actual Wholesale price ¹	188	176	233	250
b	Transport cost ²	15	10	10	
c	Real Border Price (a+b)	203	186	243	250
d	Declared price/kg³	203	109	107	
e	Under-invoiced	0%	-41%	-56%	

B. UHT MILK				
	Country	Hungary	Slovenia	Kosovo
a	Actual Wholesale price ¹	46	48	48 ⁴
b	Transport cost ²	10	10	
c	Real Border Price (a+b)	56	58	48
d	Declared price/kg³	30	37	
e	Under-invoiced	-46%	-38%	

1/ Price notified in reply to letters of enquiry.

2/ Transport costs for Slovenia given by Ljubljanske mlekarne. Assume Turkey 50% more.

3/ UNMIK Customs average prices for 2005 by country and product.

4/ Wholesale price for Kosovo UHT same as Slovenia as technology in processing is same.

While Turkish imports are not undervalued, others are. Bulgarian and Hungarian white cheese are under-valued by 41% and 51% respectively; Hungarian semi-hard cheese by 46% and Slovenian milk by 25%. For UHT milk, 75% is imported from Hungary and Slovenia. Both countries are severely undervalued compared with their domestic wholesale price.

However, even without under-invoicing problems, Kosovo's white cheese remains largely uncompetitive at €2.50/kg.

⁸ In the example shown in Table 7 for white cheese and UHT milk, no export subsidies are paid.

5. Analysis of Competitiveness

For milk, Kosovo is competitive, but for cheese not. This gives a prospect for the longer term as subsidies are being removed in the trading system of competitors.

Where serious undervaluation is currently practised, 2 cts/litre might be added to the price of imported milk and 16 cts/kg to imported cheese, from increased tax levied. There is a possibility of trade diversion from Slovenia and Hungary to Serbia, Bosnia and Herzegovina, and Macedonia to take advantage of their duty free access to Kosovo.

EU export subsidies are given for two products which make them cheap in Kosovo – Slovenian Yoghurt and Hungarian Trappista cheese. The latter provides very stiff competition with Kosovo producers.

Analysis of retail prices show that Kosovo products are at the low end of the market because of poor quality perception. Improving quality of product is therefore very important.

5.1 Comparison of Production Costs

In order to compare the true competitiveness with Kosovo, it is necessary to add back subsidies paid to farmers and processors in competing countries onto the price of milk. No information is available about Turkey, so we look only at Hungary, Slovenia and Bulgaria.

As noted in page 1, the cost of production for 1 litre of milk is relatively high at 21 cts/litre,⁹ giving a margin of only 3cts/litre to the farmer. This is because feed costs are relatively high in Kosovo and make up 70% of total cost. Average milk yields of cows are low, although commercial herd yields have shown a significant improvement due to improved breeds and technical assistance. In addition Kosovo farm management is poor and small herds result in higher overheads.

If production subsidies are added back to the farm-gate price of competitors, Kosovo milk appears much more competitive. Table 8 clearly shows that when subsidies are added back-in, the gap between Bulgaria and Kosovo of 4 cts/litre narrows to 1.25 cts.

Table 8: Comparison of Real Price of Milk (in €cts/litre)

	Bulgaria	Hungary	Slovenia	Kosovo
<i>a</i> Milk Price (farmgate) ¹	20.00	25.00	27.00	24
<i>b</i> Total Milk Subsidy ²	2.75	1.65	2.50	
<i>c</i> Real Price (farmgate) (a+ b)	22.75	26.65	29.5	24
<i>d</i> Collection cost ¹	1.50	1.50	1.50	4
<i>e</i> Real into-factory price (c+ d)	24.25	28.15	31.00	28
<i>f</i> % of Kosovo price	87%	101%	111%	100%

1/ See Table 3.

2/ See Table 5, row showing total production subsidy.

Price competitiveness is eroded though by high collection costs. Collection costs can be brought down by more careful selection of farmers and collection points. Less accessible farms would lose out.

⁹ This cost of production includes direct costs only and does not include depreciation or profit.

Processing costs in Kosovo are high. This study deduced that competitors' costs were 75% to that of Kosovo (see Table 5). Capacity utilisation is a major problem with many working to only 30 to 40% of capacity, resulting from not being able to expand their market sufficiently. There is competition between firms as well as with imports. Kosovo dairy products are not generally recognised as high quality.

However, the real competition is probably in quality. Kosovo dairy products are at the low end of the market. Table 9 compares retail prices in Kosovo for UHT milk and White cheese by brand. The Slovenian brand *Alpsko* commands a price 10 to 15% above other brands, yet it has 18% Kosovo's market for UHT milk. *Sole* and *Sharri* brands are at the lowest end, with *Vita* brand carving a middle place.

Kosovo cheese is 15 to 20% more expensive than most imported cheese, and the quality is not usually as consistent.

Table 9: Comparison of Retail Prices (in €)

Country of Origin	Brands	UHT milk per litre	White Cheese per kg
Kosovo	Abi		2.75
	Sharri	0.54	
	Vita	0.58	
Slovenia	Alpkso	0.62	
Hungary	Sole	0.55	2.13
Turkey	Pinar	0.73	2.88
Bulgaria	n.a.		2.50
Serbia	Jersey		2.18

Source: Ben Af supermarket, Prizren June 2005.

5.2 Importance of Under-invoicing

A significant amount of under-invoicing was noted in Section 4, comparing the export price and declared price on import to Kosovo. If this is rectified, most importers will pay more tax. Will this make Kosovo products sufficiently competitive in the local market place? Assuming all price increases are passed on to the consumer, prices increases would average 2 cts/litre for UHT milk, 3 cts for yoghurt and 14 to 16 cts/kg for cheese (see Table 10). It will certainly make Kosovo products more competitive, but imported white cheese will still be 14% cheaper than local cheese.

Powder milk is used in the manufacture of some dairy products in Kosovo. Application of a minimum value would result in an extra 28 cts being levied, which, at approximately 1:8 ratio to reconstitute into milk, would raise the final price of reconstituted milk by 28/8 or about 3 cts/litre.

Table 10: Change in Valuation for Taxation and Increase in Price (in cts/litre)

	a	b	c	d
	Avg declared value of cheap importers	Minimum value	Difference cts/kg (b-a)	Price increase cts/kg ¹
Milk (UHT)	0.33	0.40	0.07	0.02
Powder Milk	0.59	1.70	1.11	0.28
Yoghurt	0.44	0.55	0.11	0.03
Butter	0.93	1.50	0.57	0.14
Cheese	1.15	1.80	0.65	0.16

1/ Basis for price increase given in Annex 1 – Effect on Amount of Tax Paid by Importers

The total amount of tax collected on Dairy produce from the countries currently under invoicing would increase from €3.7m to €5.3m, an increase of about 41%.

5.3 Export Subsidies

Kosovo cannot challenge EU export subsidies as they are accepted by WTO and in-line with various commitments that Kosovo has made. These subsidies affect two products – Yoghurt from Slovenia (2.25 cts/litre) with total value of €9,000 and Kashkaval cheese from Hungary (50 cts/kg) with total value of €450,000. It is possible that subsidies were paid on German exports, but investigations were not made there. Yoghurt is seen as profitable by local producers, so the subsidy cannot be seen to be damaging to the sector.

The subsidies on Hungarian Kashkaval cheese damage Kosovo’s cheese industry, and undercuts Kosovo prices.

Table 11: Effect of Export Subsidy on Kashkaval Cheese (in cts/kg)

Price breakdown	Kosovo	Hungary
Milk	252	239
Processing	138	104
Total Value	390	342
Export subsidy		- 50
Transport		10
Landed price (incl. transport)		302
Duty		30
Wholesale price	390	332
<i>difference</i>		- 58

Source: KDPA, Hungary Ministry of Agriculture

5.4 Competitiveness with the Green Market

The Green market (unpasteurised milk and milk products) consumes three times as much milk as the local dairy-processing industry. This sector is supplied by mainly semi-substance farmers who provide unpasteurised milk and cheese to local markets, or some deliver to local shops. Milk is usually sold in new and reused coca cola bottles and cheese is dispensed from plastic buckets to the consumer.

Many consumers buy from the Green Market as they want ‘fresh’ produce from a trusted source. Health risks are minimal as consumers traditionally boil their milk. In Pristina Green market milk retails for about 50 cts/litre (compared with 45 cts for fresh pasteurised milk in plastic bag) and white cheese for €2.50/kg (on a par with imported white cheese).

The Green Market is only lightly regulated, but has a large clientele. Selling is time-consuming but where opportunity costs are low may make economic sense to small farms. For the commercial farmers the Green Market can be too time consuming to sell in and cannot absorb increased supplies.

Processors could capture market share from the Green Market if it could match the ‘fresh quality’ perception. However, focusing on the Green Market would have social implications for semi-subsistence farmers. Many would be squeezed out of business reducing household incomes unless other opportunities can be taken up. Therefore, it should be combined with strong Rural Diversification measures that can mitigate the reduction of subsistence farmers’ incomes.

6. Conclusion

What seemed a simple problem of competitiveness – undervaluation – is in fact more complex. The main factors influencing the marketability of local dairy produce are firstly quality, second cost of production, third subsidies and finally the effects of under-invoicing.

Rectifying the problem of under-invoicing will have some effect but other more important measures need to be taken to make the sector effectively competitive, in particular improving quality. Other measures required to improve competitiveness include reducing milk collection costs, utilising manufacturing capacities better and ensuring contracts between farmer and Dairy are properly honoured.

In other countries government's have intervened to improve milk quality through use of subsidy for A grade milk. Such a scheme might be appropriate in Kosovo using the VAT system.

Finally, more market research on consumer preference in Kosovo might help processors plan product lines better for the future and be better placed to take on the Green Market.

The study has shown that competitiveness analysis is complex and cannot be reduced to undervaluation. Although low import prices are mainly due to under-invoicing, rectifying this will not be sufficient for Kosovo to be competitive in selling cheese.

The most important elements affecting Kosovo's competitiveness, in order of importance, are:

1. Quality of product;
2. Cost of milk collection and manufacturing costs;
3. Subsidies paid to overseas competitors (mainly to farmers in supporting their farmgate prices) ; and finally
4. under-invoicing resulting in lower taxes being paid in Kosovo.

The analysis has shown that low declared value of dairy products is mainly due to under-invoicing and that proper customs control to prevent under-invoicing will therefore improve the price competitiveness of Kosovo produce. It will also have a detrimental effect on those processors who use a lot of imported milk powder, raising the price of reconstituted milk by 3cts/litre. This in turn will encourage processors to substitute imported powdered milk for fresh milk

At 24 cts/litre, Kosovo milk is competitive, notwithstanding production subsidises in competing countries. But, the cost of collection is high (4 cts/litre) and the cost of processing is about 20 to 30% higher than competitors. However, price is not the main determinant of market share.

Looking at the retail prices, Kosovo UHT milk has been at the lower end of the market, only under-cut by Hungarian milk and more recently milk from Macedonia, which consistently sell at 95% and 90% of Kosovo product. For yoghurt and Kos (semi-hard yoghurt) Kosovo prices are competitive. For cheese though, much imported cheese retails at 85% to 90% of the price of the equivalent Kosovo product. Measures to curb under-invoicing will do much to “level the playing field”.

Nevertheless, increasing prices slightly on imports may not allow the Kosovo Dairy Processors to increase market share greatly. This is because imported produce is often

seen as better quality and therefore can command a higher price. At the other end of the scale, Kosovo's green market provides fresh milk and cheese at a low price. The processors are therefore squeezed on freshness and price by local direct marketing in the green market and on price and quality by imported produce.

Quality factors

Kosovo milk and dairy produce is generally of poorer quality than imported items. Consumers are willing to pay higher prices for better quality, as is demonstrated in the large market share of Slovenian *Alpsko* milk and the successful penetration of the market by Turkish *Pinar* products selling at 15 to 20% above Kosovo prices.

The quality of milk has a big impact on the final product and shelf-life of the processed dairy produce and on its competitiveness. Most processors operate a system to pay a higher price for good quality milk, but enough good quality milk is still not coming through the system. Two technical assistance projects (the USAID-KBCS project and Swiss Contact) are presently working to improve the quality of milk at the farm level and the ability of processors to test for quality when buying.

Kosovo milk tends to be very 'dirty', i.e. it has a high bacterial count. In other countries, government introduced subsidies for "A" quality milk in order to improve standards in the industry. The MAFRD had proposed introducing a quality subsidy, but failed to secure funding. Improvement in the processing plants is also required, to ensure consistent hygiene and standards.

How to improve competitiveness

There are two areas where Kosovo needs to focus – firstly on improving price competitiveness, and secondly on improving quality at all stages of production. Experience from other countries show this is a slow process but is achievable by:

1. Cost reduction

- Concentration of dairy farms to reduce collection costs and be able to impose quality standards more effectively
- Concentration of processors so their capacities are properly utilised
- Ensuring contracts by farmer and processor are honoured

2. Quality Improvement

- Improved collection system with rigorous testing
- Increase price differential between "A" quality milk and lower qualities to stimulate farmers to develop proper hygiene and quality standards.
- Plan and schedule the introduction of staged regulation to the Green Market.

Moreover, a VAT Flat Rate Farming Scheme might be an option to provide a subsidy to support quality milk production. Most other countries have used a subsidy system to increase the differential for grade "A" quality milk.

FLAT RATE VAT SCHEME

This scheme compensates small farmers for the VAT paid for production inputs, which they normally cannot reclaim as they are not registered for VAT. Registration of thousands of small farmers would be a burden on the tax system.

For milk, the Flat rate scheme would allow the MAFRD and Tax Administration to agree an average amount of VAT paid for various inputs in the production of milk at x %/litre. This is termed “notional” VAT.

Farmers then add this “notional” VAT on their sale of milk when selling to VAT registered buyers of raw milk.

The farmer is able to keep the VAT he charges the Processor to compensate tax he has already paid in inputs, and the Processor can reclaim the Flat Rate he pays as an input tax.

Finally, as growth should be market led, a study of consumer preferences would be a good instrument for the processors to develop better products.

Annex 1: Effect on Amount of Tax Paid by Importers

By taking the Customs data for 2005, and analysing the imports by category and country, it was possible to list those countries that showed average values below the cost of production in Kosovo. A set of *minimum values* were established as follows:

Table A.1: Lowest Possible Values at Border (in €/kg)

<u>Minimum values</u>		<u>Basis</u>
UHT Milk	0.40	Hungarian milk price
Yoghurt	0.55	Average of all import prices
Milk Powder	1.70	World Price (OECD)
Butter	1.50	World Price (OECD)
Cheese	1.80	Bulgarian derived import price

For each category, countries showing average values below this were grouped together and the total *declared value* of the imports were calculated. These are labelled the *cheap product exporters*. Taking the same quantity imported a new total value was calculated using the minimum value.

All imported dairy produce is subject to duty at 10% and VAT at 15%. Under free trade arrangements, Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia are exempt from duty, but subject to VAT. In order to analyse the losses from possible under-invoicing, the *Cheap product exporting countries* were divided into 2 groups:

- Dutiable: Bulgaria, Croatia, Czech Republic, Hungary, Slovakia, Slovenia¹⁰
- Non-dutiable: Bosnia and Herzegovina, Macedonia, Serbia Montenegro

Table A.2: Dairy Imports and Tax Paid for Low Value Dairy Imports (in 000 €)

Value of imports from <i>cheap product exporters</i>	Declared value	Adjusted to minimum value
Dutiable	€ 13,525	€ 18,955
Non-dutiable	€ 995	€ 1,560
Total import value	€ 14,520	€ 20,515
Tax paid at border:		
Dutiable (26.5%)	€ 3,584	€ 5,023
Non-dutiable (15%)	€ 149	€ 234
Total Tax paid	€ 3,733	€ 5,257
Difference = tax avoided		€ 1,524

Source: EPO analysis based on UNMIK Customs 2005 data

A total of €3.7m was raised in revenue from those countries with low values, or 80% of total volume of dairy imports. If the real values are applied as calculated in this paper, value for customs purpose increases by 40% and the net increase in taxes collected is €1.5m.

¹⁰ For butter, Poland and Germany are added to this list.

**Annex 2:
Sample Enquiry Letter (Hungary)**

Dear [...]

The Ministry of Agriculture, Forestry and Rural Development of Kosovo has approached us with the request to enquire into the reasons why dairy products imported into Kosovo from Hungary are entering the territory at very low prices.

The main dairy product Kosovo imports from Hungary are UHT Milk, White cheese and Semi-hard cheese. We have undertaken research and would like confirmation, or correction, regarding some of the figures we have received.

Information	HS Customs code	Value/kg (2004)	Source
Price of milk at farm		€0.25	PIAC, Research Institute for Agricultural Economics, Market Information Service, Budapest 14 January 2005 EU Eurostat shows milk price of €0.27 per litre January 2005
Wholesale Price in Hungary of:			
Milk (UHT 2.8% fat)	040120	€0.46	
White cheese	040610	€2.21	
Semi-hard cheese	040690	€1.57	

Based on the Declarations presented to UNMIK Customs by the importers, it appears that these products are entering Kosovo at a declared value below these wholesale prices in Hungary. Therefore, could you please advise us

1. if the price of milk and average wholesale prices quoted here reflect the wholesale prices in Hungary in 2005;
2. if these goods are subject to export refund, and how much export refund was paid in 2005 for dairy produce destined for Kosovo;
3. how much subsidy, if any, is paid per litre of milk to farmers;
4. how much subsidy, if any, is paid to milk processors;
5. how much VAT, if any, is applied to milk and dairy products sold in Hungary.

We would kindly ask you to reply to us within 30 days of receipt of this letter, preferably by e-mail to [*****@un.org], followed up with a formal letter. We are writing similar letters to each of the trading parties involved in order to get a full picture of the subject matter.

After the period of 30 days, the Government of Kosovo will evaluate the evidence presented by all parties and take any further action that it considers necessary, with due regard to the normal protocols of trade.

Please be informed that pursuant to United Nations Security Council resolution 1244 (1999) Kosovo is under United Nations Interim Administration, and as such not member of the World Trade Organization.

I appreciate your kind cooperation in this matter.

[signed]

The background of the image is a blurred version of the European Union flag, featuring a blue field with twelve yellow five-pointed stars arranged in a circle. The stars are out of focus, creating a soft, bokeh effect.

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