Does the financing of the European Union Funds and state aid facilitate the development of the dairy industry?

Audit report by the State Audit Office • Riga, May 2017
The State Audit Office conducted a performance audit and prepared audit report “Does the financing of facilitate the development of the dairy industry?”.

Milk production is a traditional occupation in the countryside of Latvia and dairy industry plays a significant economic and social role in ensuring population of the rural territories and work places, as well as milk and dairy products are an important export product group.

Latvia as a Member State of the European Union implements the Common Agriculture Policy of the European Union in the agriculture and dairy industry. Members of the dairy industry have access to the support of the European Union and the state, including emergency support for solving industry problems in certain market conditions.

From 2014 to 2016, the Latvian dairy industry the same as other dairy industries in the European Union were affected by the import ban imposed by the Russian Federation on the agriculture products, as well as the abolition of the dairy quota system. To eliminate the negative consequences caused by these factors, the industry received a significant support, financing granted to the dairy industry members from 2008 to 2015 amounted from 72 to 146 million euros per year, and majority of that was paid to the milk producers.

Although, the dairy industry is developing, during the audit, it was noted that the massive amount of the European Union financing and state aid granted has not contributed to solving problems of the industry, as the milk procurement price is still low, the industry remains fragmented and the milk processing companies are in a weak competitive position. Moreover, the Ministry of Agriculture has not applied a thought-out support provision scheme in all cases.

The European Union support available to the organic farmers covers the additional costs incurred during production of organic and ecological products and facilitates agricultural production in an environmentally friendly way, however, the further transportation, sales and processing logistics chain of the organic products shows that the end users do not benefit much from these investments.

We hope that the Ministry of Agriculture in cooperation with the non-governmental partners of the industry would create a viable and favourable conditions for the development of the dairy industry in line with our recommendations. Thereby the contribution of this significant agriculture industry in the Latvian economy would be increased, along with the welfare in the Latvian countryside, at the same time fostering the efficiency of use of financing granted for the development of the industry.

We would like to thank the Ministry of Agriculture, Rural Support Service, Agricultural Data Centre, and VSIA “Sertifikācijas un testēšanas centrs”, association “Vides kvalitāte” and social partners of the Ministry of Agriculture - industry non-governmental organisations - for the support provided to the auditors of the State Audit Office.

Yours sincerely,
Director of the Department
Ilonda Stepanova
**Motivation**

The dairy industry plays a significant role in the Latvian economy, as milk forms 17.7% of the end production of agricultural products, as well as the proportion of milk and dairy products in the total food and agriculture products forms 10% of the exports value. The dairy industry is important in facilitating population and employment in the rural regions.

Member of the dairy industry have access to the support measures financed by the European Union and state budget. From 2008 to 2015, at least 888 million euros have been provided to different support measures, including 333 million euros for special measures in the dairy industry.

The development of the dairy industry has been provided support in the European Union Funds programming period 2014–2020 that is incorporated in several Rural development programme measures and from 2017 to 2019, it is planned to provide support to the milk producers to ensure their further operations. (Image 1)

Regardless of the support provided to the industry, several issues are still topical: fragmentation of the industry, the comparatively low milk procurement price among the Member States of the European Union, and competitiveness of milk processing companies.

Considering that significant resources have been invested in solving short-term issues of the dairy industry in crisis situations and in the development thereof, and in future, it is planned to continue provision of support, a performance audit was conducted to make sure whether the support provided to the dairy industry facilitates its development.
**Key findings**

Although, in the recent years, the dairy industry was impacted by the import ban imposed by the Russian Federation, changes in the global market and abolition of the dairy quota system in the European Union, the audit has noted that the financing granted by the European Union and state aid has facilitated development towards the goals set for the dairy industry by the Ministry of Agriculture and industry non-governmental organisations.

At the same time, to ensure more efficient use of the resources available for the development of the dairy industry, the Ministry of Agriculture should improve the dairy industry policy planning and requirements for provision of support as:

- the system of support measures in breeding sector does not provide an opportunity to make sure that the amount of granted support complies with the actual costs of the breeding services and maximum permitted support intensity;

- support tools provided to milk processing and sales development have not been efficient enough to facilitate sales and processing of the produced organic milk;

- competition is not ensured in the selection of projects of processing companies and financing is provided to all projects that comply with the minimum selection criteria, regardless of the expected added value;

- in the provision of exceptional support, opportunities to support producers with long-term perspective have not been used enough.
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**NATIONAL DEVELOPMENT POLICY PLANNING SYSTEM**

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**AGRICULTURE INDUSTRY POLICY**

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*Image No. 2* National development policy planning system and agriculture industry policy.

### Dairy industry policy

The development of the agriculture industry is mainly implemented using the financing provided by the European Union Funds and on the basis of the Rural Development Programme approved by the European Commission.

The development of the dairy industry is planned on the basis of the initiative of non-governmental organisations, and the Ministry of Agriculture in cooperation with non-governmental organisations developed a document in 2012 “Development priorities of dairy industry until 2020”. The document by its contents and development procedure is not a policy planning document within the framework of the common development policy document system and it has not been approved by the Cabinet of Ministers. (Image 2)

The audit noted that “Development priorities of dairy industry until 2020” should be updated and improved, as the development priorities and performance indicators have not been defined qualitatively to ensure that the policy of the dairy industry would be clear enough and the achievement of the indicators could be interpreted unambiguously.

After assessing the progress of achievement of the goals prescribed in the document “Development priorities of dairy industry until 2020”, it has been concluded that in general the indicators describing the dairy industry are moving towards the planned, however, six out of 14 indicators show minimum progress and there is a risk that with the current development tempo and used tools, the indicators will not be reached until 2020.

At the same time it should be noted that the performance indicators prescribed in “Development priorities of dairy industry until 2020” are not a result of just the operations of the Ministry of Agriculture, as some performance indicators are not fully dependent upon the actions taken by the Ministry or purposeful support conditions have not been provided to achieve the performance indicator.

Auditors would like to draw attention that the Ministry has not
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fully complied with one of the basic principles of the policy planning – the principle of transparency, as in the website of the Ministry of Agriculture, the document “Development priorities of dairy industry until 2020” has published in the form of incomplete summary, the assessment of performance indicators of development priorities in 2015 has been conducted by the Ministry and non-governmental organisations and its results have not been published in the website, therefore not providing opportunity to all stakeholders to get familiarised with the interim assessment.

Moreover, the meetings of advisory council of the Latvian agriculture non-governmental organisations during which decisions are reviewed and made on the topical matters of the industry have not been recorded since 2014 and have not been published in the website of the Ministry, as opposed to other advisory councils and working groups of the Ministry of Agriculture. The general public does not have any opportunity to get familiarised with the justification of decisions taken in a written procedure, as well as suggestions and objections submitted by the Supervisory committee.

Regularly available support measures in the dairy industry

Support to breeding

State aid to breeding measures in the dairy industry 2014–2016 amounted to 72 million euros, including 67.3 million euros support to determine genetic quality of the milk-producing dairy cows and assess their efficiency.

The Commission Regulations that is binding to all the subjects and is directly applicable prescribes that such a support to the cattle breeders (owners of livestock) is provided in kind without providing direct payments and emphasising that control measures taken by the owner of livestock and regular inspections of milk quality shall not be covered by the state aid.

According to the State Audit Office, the system for provision, payment and monitoring of support to determine genetic quality and assess efficiency is not “completely transparent”.

It was not possible to conclude that the financing paid to the owners of livestock has been used only to determine the genetic quality of livestock and assess the efficiency. (Image 3)

Although determining of genetic quality and efficiency is a complex and large set of measures, neither the national laws and regulations, nor annotations, contracts between the Animal Breeders Organisation and

Image No. 3 Provision of services necessary to monitor livestock
owner of livestock do not provide clearly for the performance of which work and whether use of services provided by third parties ensures support to the owners of livestock.

The Ministry of Agriculture developed the list of services necessary to determine genetic quality and efficiency that would justify payment of the support in the amount of 67 million euros only during the audit upon request of the auditors of the State Audit Office.

After assessment of the list and conducting analysis of additional data, it can be concluded that not all the services indicated by the Ministry of Agriculture have been necessary for all livestock every year. For example, according to the information available in the database of the Agricultural Data Centre, the number of DNA analysis conducted to determine the origin of an animal is significantly lower than the number of analyses paid for. Moreover, during the audit, the State Audit Office could not satisfy itself with the attributability of costs of artificial insemination services.

According to the Commission Regulation, only 70% of costs shall be attributable when paying the above support, therefore it is important to determine not only the services necessary to the owner of livestock but also their regularity and costs.

However, the amount of support for one dairy cow depends only on the milk yield and is not related to the scope of services necessary for the respective livestock and their costs, therefore, according to the estimate of the State Audit Office, the maximum permissible amount of support might have been exceeded by 4.04 million euros.

Support to breeding has been paid for such milk-producing dairy cows over which no monitoring is conducted.

Additional support provided from 2014 to 2015 to assess the efficiency data, 21.5 million euros at least 2.5 million euros have been paid for such milk-producing dairy cows that are not monitored at all and no costs related to assessment of efficiency can be incurred.

Support to production and sales of organic milk

In the recent years, the amount of products produced by the organic agriculture sector, including the amount of organic milk, has increased.

Within the framework of the Rural Development Programme “Organic agriculture”, support of 109.1 million euros in the form of area payments was paid to organic farmers from 2007 to 2013, it is planned that from 2014 to 2020 the support will amount to 151.9 million euros, including support in the amount of 36.6 million euros provided from 2012 to 2015 also to the organic farms.

According to the audit findings, the European Union support available to the organic farmers, including co-financing ensured by Latvia in the amount of 30%, covers the additional costs incurred during production of organic and ecological products, however, the further transportation, sales and processing chain does not ensure that the organic products reach the consumer.

In 2015, only 23% of all produced organic milk was sold as organic milk.

As opposed to the previous programming period of the European Union Funds, in programming period 2014–2020, the expenditures of organic farming are not related to efficiency and sales of products, considering that the European Commission has defined the environmental goals as the priority. According to the State
Audit Office, there is a risk that part of organic farmers are not motivated to increase the efficiency of organic product sales and providing access to these products to consumers.

This particularly relates to the sales of organic milk. After analysis of the data and calculations provided by the Ministry of Agriculture, auditors estimated that in 2015, only 23% of the produced organic milk was sold as organic milk, as opposed to the calculation made by the Ministry of Agriculture, 35% (Image 4). Moreover, large part of farms, have sold at least half or majority or all the produced organic milk as conventional products or used it in the farm, which is especially characteristic of Latgale region.

In 2016, the Ministry of Agriculture, changed the requirements applicable to organic farmers and processing companies to receive support, reducing the number of points provided in the project selection. No application has been submitted with regard to establishment of organic cooperatives, and no information is stored and analysed about the received support for the short food chain development.

### Support to investment projects

Several years exports of raw milk is presented as a significant problem in the dairy industry, therefore there is a clear necessity to facilitate processing of milk in Latvia. All in all, during programming periods 2007–2013 and 2014–2020 of the European Union Funds, support of at least 24.4 million euros has been provided to milk processing companies to facilitate investments.

Although the Ministry of Agriculture has prescribed criteria for selection of investment projects, it was concluded in the audit that the financing provided to the processing companies during programming period 2007–2013 (except for the final stage) and 2014–2010 in the first three stages was sufficient for all support candidates, therefore there was no competition between the submitted projects and financing is provided to all projects that comply with the minimum selection requirements, regardless of the expected added value.

The wish of the Ministry of Agriculture to ensure acquisition of the European Union Fund for agriculture in full is understandable, however, it should be noted that out of the total European Union financing available for the investment projects for 2014–2020, financing of 75.6 million euros, large part (almost one third) is made up of the Latvian co-financing, therefore, according to the assessment of the State Audit Office, a thought-out and purposeful utilisation of taxpayers’ money should be ensured.

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**Image No. 4** Development of raw milk produced organically and sold as organic milk (data of the Ministry of Agriculture)

Although, the Ministry of Agriculture in the planning documents has prescribed to facilitate sales and processing of organic agricultural products, including organic milk, according to the State Audit Office, the support measures prescribed in the document “Development priorities of dairy industry until 2020” do not facilitate achievement of the performance indicators enough.
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Considering that the project selection criteria might be important in the end of programming period 2014–2020 of the European Union, according to the State Audit Office, the selection criteria should be improved for the next stages to support such projects that facilitate implementation of innovations and create a higher added value and provide a significant contribution in the agriculture industry. Especially considering that, according to the Ministry of Agriculture, dairy products with high added value are almost all dairy products and those currently make up 90% of the total amount of dairy products.

Support measures in crisis situations

Exceptional support to milk producers

Considering the milk procurement price and decrease of revenues of milk producers, from 2014 to 2016, exceptional support was provided to milk producers in the amount of 30.8 million euros. (Image 5)

Considering that decrease of milk procurement prices and revenues of milk producers is period, it is important to ensure that milk producers are informed about the state position with regard to the possible support measures and their conditions in crisis situations. However, the Ministry of Agriculture has not prescribed such basic principles. Although, according to the laws of the European Union, exceptional support was provided to reduce the impact of market disruptions, the Ministry of Agriculture did not plan any other significant additional goals for the development of the industry.

According to the European Commission, with the first exceptional support granted, Member States should have considered the impact of import ban imposed by Russia on specific producers, and further exceptional support should have been provided to those farmers.

who suffer the most from the market disruptions. According to the analysis of data of 2014, the Ministry of Agriculture concluded that the embargo imposed by Russia impacted all Latvian milk producers equally.

The criteria prescribed by the Ministry of Agriculture ensured that almost all milk producers who had provided milk for processing in a specific period of time were eligible to receive exceptional support of all four stages, including
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According to the State Audit Office, the data amount used by the Ministry of Agriculture and analytical methods applied do not provide an opportunity to make sure that the market disruptions impacted all milk producers equally. At the same time, the State Audit Office would like to draw attention to the insufficiency of the statistical information in the industry that would allow to assess the impact of crisis on specific milk producers or their groups objectively, therefore, an alternative solution should be assessed for similar situations, for example, storage of additional data, analysis, research, etc.

According to the auditors, the Ministry of Agriculture has not used all opportunities to use the provided financing to support such milk producers who have long-term perspectives in the market, as:

- according to the data analysis, out of all 9,186 milk producers entitled to receive the first exceptional support, almost 20% have stopped supplies of milk from September 2014 to September 2016, including 11% of producers do not have dairy cows registered in their livestock. At the same time, the Ministry of Agriculture has publicly declared that only 1% of farms have suspended operations in the dairy industry and 1.2% of farms have changed their line of operations;

- although the exceptional support had to reach the producers who still continue production and still are the part of the Latvian dairy industry, the criteria prescribed by the Ministry to measure the activity of producers, allowed that exceptional support was provided also to such producers who, before payment of support or shortly after, stopped supplies of milk and reduced the number of dairy cows significantly or completely, therefore actually stopped operating actively in the dairy industry.

For example, exceptional support in the amount of more than 4,000 euros was paid to a producer who, even before payment of support, reduced the number of dairy cows from 94 cows in the livestock and stopped supplying milk in general.

Support to restructuring of the dairy industry

To react to the global financial crisis and stimulate economy, the European Commission, in the beginning of 2009, developed the European Economic Recovery Plan, according to which the financing to agriculture and rural development available to Latvia was used to restructure the dairy industry. (Image 6)

According to the State Audit Office, the Ministry of Agriculture has not used all opportunities to provide a significant contribution to solving industry problems using the additional financing for restructuring of the dairy industry.
Regardless of the necessity to solve the issued present in the dairy industry and stimulate the economy in crisis situation, the Ministry of Agriculture in cooperation with the industry non-governmental organisations reached agreement on the conditions for receipt of support to a new milk processing company and other projects in the dairy industry only after a year.

Although, support to a new milk production company owned by milk producers was expressed in different documents, however, during the audit, the State Audit Office was not able to satisfy itself that alternatives have been assessed sufficiently and that the most useful solution has been selected.

During the audit it was concluded that support financing of 4.2 million euros to the project of a new milk processing company did not reach the goals, as:

- after attraction of foreign investor, the milk processing company is not considered a company that fully belongs to the Latvian milk producers that was the key argument for provision of support in the beginning;

- four years after implementation of the project, it has not been possible to achieve the processing amount indicated in the Regulations of the Cabinet of Ministers, as well as the project has not provided a significant contribution to solving issues of the dairy industry, for example, facilitating milk processing, reduction of exports of raw milk and reducing the negative effect of price fluctuations.

The remaining financing of 10.5 million euros available to restructuring of the dairy industry was used to co-finance 377 dairy industry projects providing those with 5 to 10% of support. Selection of the said projects did not provide any additional conditions to receive support, as well as, unlike in the project of the new milk processing company, no specific performance indicators were prescribed, therefore all the projects in the dairy industry were financed, regardless of their efficiency, contribution to solving issues of the industry and increasing competition.
Key recommendations

According to the conclusions of the performance audit, the Ministry of Agriculture has been provided recommendations, after implementation of which the planning and implementation of support measures available to the dairy industry would be improved, ensuring a more rational use of the provided financial support.

To facilitate the development of the dairy industry and ensuring transparent, justified and rational use of the available financial resources, the State Audit Office hereby asks the Ministry of Agriculture to take the following actions:

• to update and improve the performance indicators provided in the “Development priorities of dairy industry until 2020” and support measures to facilitate efficiency of the use of available support;

• to ensure that support to breeding measures is provided in kind or in the form of subsidised service and its amount does not exceed the maximum intensity of support;

• to improve the conditions for provision of support in cases when the industry has financing for specific goals or in extraordinary situations;

• to review the criteria for project selection and support intensity for the further project rounds to increase the efficiency of the use of support;

• to prescribe additional support measures that would facilitate sales and processing of organic milk.

Recommendations have been provided to the Ministry of Agriculture, after implementation of which the planning and implementation of support measures available to the dairy industry would be improved, ensuring a more rational use of the provided financial support.
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