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## IMPERFECT COMPETITION IN DAIRY INDUSTRY IN REPUBLIC OF SERBIA<sup>1</sup>

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### Abstract

*Serbia has natural, human and economic resources in the primary production and the dairy industry, but they are not used in the right way that would lead to economic satisfaction of all market participants, especially producers and consumers. The paper focuses on under-developed competition policy on the milk market in the Republic of Serbia. Particularly noteworthy is the need for state to participate actively in order to correct market failure and increase production, consumption and exports of milk and dairy products.*

**Key words:** *market, imperfect competition, competition policies, dairy industry.*

### Introduction

The noticeable facts in the domestic retail market of agricultural food products in the second half of 2010 are represented in the shortage of basic foodstuffs, especially milk, some dairy products (especially butter) and sunflower oil. The authors attempt to focus on the problem of professional community, and to present the main reasons for this situation and ways to overcome it. Emphasis is placed on the milk and dairy products market. It is evident that the domestic market is unable to allocate resources in the areas of primary milk production and processing ensuring maximum benefits for producers, consumers and the overall economy and society. At the same time, the role of government in correcting market failure is very small and mostly reduced to the

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role of mediator and negotiator between primary producers and processors, and dairy industry. This role of government is clearly not sufficient. Its responsibility should be much larger, and the role of active, constructive and consistent with practice in developed market economies.

### **Market failure based on the purchase of raw milk and production of industrial milk in R. of Serbia**

The following types of **market deviation from perfect competition** (situations where market fails to make an efficient resource allocation) are recognised in economic literature (these are also the main reasons or arguments for government intervention)<sup>3</sup>:

1. Market structures with varying degrees of imperfect competition (occurs when the actions of individual market participants, buyers or sellers can influence the price and the amount of certain goods). Two main causes of imperfect competition are: (1) effects of the economy of scope, i.e. decreasing average costs; and (2) barriers to market entry (high entrance fee can be determined by high technology or achieved standards)<sup>4</sup>.
2. Side effects or externalities.
3. Market participants that are insufficiently informed about goods and services they buy or sell.

In R. of Serbia non perfect competition in the agricultural and food products is characterized by oligopson market structure, underdeveloped competition policy, "grey" economy and "broken" ownership and contractual relationships, covering primary production and processing during the privatization of the processing sector.

Specifically, the domestic market purchase of raw milk has the following characteristics regarding market structures of oligopsony<sup>5</sup>:

- The high degree of concentration in the dairy-plant sector. For example, in the majority ownership of the company Danube Foods Group BV two dairies are presented, "IMLEK" and "Dairy, Subotica, where in 2006. and 2007. there merged a number of other dairies (Zemun, Zajecar, Novi Sad Dairy). All diary plants clusters within the Danube Foods Group were formed following the founding of the Commission for Protection of Competition. Logical analysis

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3 Samuelson and Nordhaus (2000:31-32, 272); Burda and Wyplosz (2004:414).

4 Market distortions on the supply side (small number of suppliers - producers or distributors of products) imply oligopoly, duopoly or monopoly structures. These result in reduction of supply levels and higher prices, and generally represent a threat to consumers. On the other side, market distortions on the demand side (small number of buyers as compared to large number of sellers) lead to oligopsony, duopsony or monopsony structures, which can result in reduced demand levels, reduced prices and production, and consequently producers, will suffer losses.

5 Decision by the Commission for Protection of Competition of the Republic of Serbia, dated 25 January 2008.

leads to conclusion that in small market economies and economies with undeveloped market mechanisms, such as is local Serbian economy, these collusions could easily have negative impact on local competition.

- According to the Decision by the Commission for Protection of Competition of the R. of Serbia from 2008, dominant participation in purchase and processing of raw milk in the domestic market (47.4% in 2006) is held by one competitor (DANUBE FOODS GROUP B.V.), and the position was abused by imposing unfair business terms and conditions to achieve higher profits<sup>6</sup>. The Commission found series of irregularities, including the procedure for establishing raw milk quality, establishing milk purchase price, primary producers' obligations, dairy-plant rights, etc.
- A large number of small farmers on the supply side of raw milk, with low economic strength and as a result of disorganization, low negotiating positions on issues impact on the conditions of purchase and establishment of purchase prices of raw milk. Dairy industry includes over 280 thousand raw milk producers on the supply side, where around 80% of these producers have 1 to 3 heads of dairy cattle and at the same time sell their milk to a dairy plant<sup>7</sup>. At the same time, the data collected in dairies "Imlek" regarding the number and size of their suppliers in 2006. year indicate that most suppliers of dairy (up 99%) are small producers, who produce between 5,000 and 50,000 liters of milk per year<sup>8</sup>.

The negative consequences of underdeveloped competition in the market purchase of raw milk are numerous and clearly indicate the serious problems that come up if the dairy sector is solely left to market forces. Some of the consequences that are already present or are likely to be up to them in the future will include the following:

- **Decline in production of raw milk**, as a result of reduced demand or/and unattractive purchase prices.
- **High prices consumers pay for milk and milk products and low price achieved by direct agricultural producers at purchase.** Milk purchase price is the lowest in the region and Europe, while retail price is among the highest. This is particularly true for sterilized milk, where a single company has a market share of 87%<sup>9</sup>.
- **Lack of competitiveness in international market**, resulting in low foreign currency profits generated from export of milk and milk products. Exports of milk and dairy products predominantly aimed to the CEFTA countries, and exports to

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6 In 2006 there were registered 211 dairy on domestic market. Among these dairy, and apart from one dairy with 47.4% market share and three dairy with individual share of 3.9-5.8%, all other dairy had individual share of milk purchase of less than 2%.

7 The National Programme of Agriculture of Serbia 2009-2011, March 2009, Serbian Ministry of Agriculture, Forestry and Water Management, page 39.

8 Decision by the Commission for Protection of Competition of the Republic of Serbia, dated 25 January 2008.

9 The National Programme of Agriculture of Serbia 2009-2011, March 2009.

the EU has been disabled by inadequate quality (especially the significant problem of low quality raw milk) and cost non competitiveness;

- **High poverty rates among rural population;** sector of dairy industry includes over 280 thousand producers, thereby contributing significantly to the rural development of Serbia (80% of milk producers own 1 to 3 cows and at the same time sell their milk to a dairy plant).

This is especially necessary to emphasize the following. Although oligopoly/oligopsony can damage competition and enable large companies to create high profits at consumers' and producers' expense and expense of economic advance in general, such market structures are the rule in all countries and most industries. Also, these market structures are not always undesirable, nor are they easy to avoid. For example:

- Numerous, high and dynamic requirements of the environment, technology, and organization itself (introduction of standards, effects of economies of scale) – leading to concentration (partnerships/alliances) of capital and companies. This has made many industries stronger, and each economic branch ended with a few dominant giants<sup>10</sup>.
- Oligopoly/oligopsony enable organisations to offer better products at lower prices, due to better production organisation, better efficiency, effects of economies of scale. They also introduce technological standards and innovation by investing into research and development, marketing etc<sup>11</sup>;

Oligopson placed on the agricultural products market in R. Serbia also **can not be avoided**, regarding the fact that domestic market is small, aggravating features of placements, especially exports, high technological requirements of production standards in the system of food safety and quality, the EU requirements and the like. At the same time, it is indisputable that oligopsony to some extent is **extremely useful** in our market providing a contractual relationship between processors and agricultural producers (farmers, thereby reducing market risk), contributing to improvement of the quality and the introduction of standards in primary production and processing of milk and the like. For example, a company Danube Foods Group BV since the beginning of dairy privatization significantly invested in improving the quality of milk and the introduction of the required standards. Also, in a situation of constant dissatisfaction with the price of dairy farmers, Competition Commission observes the tendency of milk to bind to dairies within the Danube Foods Group BV (providing a long-term and continuous purchase), even under the condition that other dairies offer for 5-10%

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10 For example, the industry grain flakes for breakfast in the U.S. is oligopoly that controls several companies, although it seems that the diversity of cereal is infinite. Paul A. Samuelson, William D. Nordhaus: Economics, Fifteenth Edition, 2000. Mate, Zagreb str. 151.

11 Vaknin (2006), [http://www.globalpolitician.com/21565-governanceThe Benefits of Oligopolies](http://www.globalpolitician.com/21565-governanceThe%20Benefits%20of%20Oligopolies).

higher price of raw milk<sup>12</sup>. However, the role of government (antitrust policy) must be strong and effective when it comes to abuse of monopoly position by one or more participants. For example, in developed economies there is an active state role in the field of competition, which is provided by primarily effective judicial system.

### **The role of government in correcting market failures on the purchase and production of milk**

It has been observed in the economic literature that one of the **main tasks of a state** in a market economy is to **correct errors, i.e. increase market efficiency**. The main economic policy measures aimed at the achievement of this goal are: (1) efficient protection of competition policies (anti-monopoly laws); (2) encouraging competition; (3) regulations (state supervision over private companies)<sup>13</sup>. However, it is obvious that states, or governments, do not demonstrate genuine interest (political will) in implementing anti-monopoly laws. This problem is especially prominent in developing and transition countries, which are characterised by undeveloped institutions, high corruption rates, high and inefficient public spending, etc. Therefore, it seems that adjusting production levels and purchase prices to interests of trading companies, distributors and retailers, has much more negative impact on income and profitability of primary agricultural producers in these countries than in the developed countries.

Although the R. Serbia adopted many laws and regulations governing the area of competition, competition policy is insufficient, and the efficiency of antitrust policy is a small. Competition policy in the R. of Serbia began to legally define the 2005th when it enacted the Law on Protection of Competition<sup>14</sup> and when it was established Commission for Protection of Competition, with the aim to improve economic efficiency and accomplish economic welfare for the society as a whole, particularly consumers' benefit. According to lawyers' and economists, main weaknesses of Competition Law from 2005 include insufficient material-legal norms and total absence of practical implementation of existing norms (primarily due to the small powers of the Commission and inefficient judicial system)<sup>15</sup>. The new Competition Law has been enacted by the Serbian Parliament in July 2009 (it will be applicable from November 2009.). New Law relating to the previous, first of all, differs in the fact that the Commission has received considerably more authority in the action (the ability to implement "fully fledged dawn raids", the right to order the Commission deconcentration and other structural measures, etc.), and provides the possibility that the Commission directly impose

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12 Decision by the Commission for Protection of Competition of the Republic of Serbia, dated 25 January 2008.

13 Samuelson and Nordhaus (2000:176).

14 Law on Protection of Competition (Official Gazette of the R. of Serbia", No. 79/05 and 51/09).

15 White book 2008, Foreign Investors Council.

fines on enterprises after the violation decision. From a material law perspective, the new Competition Law basically does not bring about major changes (e.g. in relation to restrictive agreements and abuse of a dominant position).

Although the new Law on Protection of Competition, problems in implementation are still present, primarily because of the inefficient judicial system, which suspends or slows down the process of proving the monopolistic behavior. In recent years there were no sanctions for violation of competition and any act of the Commission has been confirmed in court. The Commission does not have a good track record in terms of more complicated cases. Based on public knowledge, whenever its decision was challenged before the Supreme Court of Serbia, the court decided to take the claimant's view and annul the Commission's decision. In all fairness, grounds for annulment have mostly been of formal nature<sup>16</sup>. For example, two decisions of the Competition Commission, which indicate that the company Danube Foods Group BV largest processor of milk in Serbia and that has abused a dominant position in the purchase of raw milk have not yet received a certificate in court<sup>17</sup>: (1) The first decision of the Commission in January 2008. The Serbian Supreme Court after the company the Danube Foods Group in March 2009, appeal, has voided<sup>18</sup>; (2) Another solution encourages the Commission in 2009. though still in the process for the Administrative Court. However, as the Administrative Court during year 2010. is resolving disputes dating year 2007. , the court ruling will be more than overdue.

### **Suggestions for improving the efficiency of market milk and dairy products**

Concerning the specific market trends of primary agricultural products in R. Serbia fundamental role of government in correcting market errors should focus on the following:

- Strengthening the institutional capacity of the state, and ensure effective legislative, judicial and executive authorities, to ensure the detection and sanctioning of those companies that distort competition. For example, without an efficient judiciary system, it will not be possible to ensure efficiency and credibility of activities of the Commission for Protection of Competition, it will be difficult to investigate and demonstrate even the most obvious abuses of a dominant market position, particularly more complex ones, such as: various blackmails or influencing suppliers, transferring profits on other business entities, etc.

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16 White book 2009, Foreign Investors Council, page 45-46.

17 Politika, 20.09.2010. Slowness of the courts postpone proving monopoly. <http://www.politika.rs/rubrike/Ekonomija/Bajalovic-Sporost-sudova-odlaze-dokazivanje-monopola.lt.html>

18 At issue was the question of the total amount of milk in relation to the estimated contribution of dominant companies.

- Consistent application of the Law on Protection of Competition.
- Encourage competition, i.e. create conditions for free market game in a regulated market (encouraging small companies, efficient ownership rights protection, easy and fast procedure for registering businesses, stronger competition by reducing customs duties and taxes, etc.).
- Establishment of the Agency for intervening in the market (reform of the Directorate for Commodity Reserves by model agencies for emergency purchase of the EU), which would be under clear rules and transparent manner carried out intervention in case of errors occurred in the functioning of markets.
- Integration of goods supply by developing agricultural clusters, stronger farmers' associations and established farmers' cooperatives. Only by joining forces, farmers will become able to increase their sources and their negotiating power will be considerably stronger, both in relation to the state, and in relation to the food industry, food trade, exporters. It is important to stress that cooperatives will only be able to fulfill their role when the new Law on Cooperatives is adopted, especially its consistent implementation in the area of efficient cooperative audit<sup>19</sup>.

### Concluding Remarks

The main problems that exist in the supply of the domestic market with milk and some dairy products (especially butter) are mostly the result of: (a) lack of strong competition on the purchase of raw milk (market structure oligopsony), (2) broken property relations between the primary and processing dairy sector through the privatization process, (3) ineffective role of government in correcting the mistakes of the market, or in the application of antitrust policy.

The existence of oligopsony (imperfectly competitive) in the market of agricultural food products - represents the market situation which is typical for almost all countries and most industries and can be justified by a number of economic reasons. However, what separates the market structure in oligopsony in Serbia and other underdeveloped countries as countries in transition from these structures in the developed economies is the following. In developed economies there is an active state role in the field of competition, which is provided by primarily effective judicial system. At the same time, support from the agricultural budget is a significant to primary producers, and the links between the primary and manufacturing sector are strong and based on long-term contractual relationship or equity relationship (usually the primary producers of raw milk are simultaneously a dairy specialist members of cooperatives and also dairy shareholders). On the other hand, in R. Serbia, during the privatization, the correlation between the ownership and of primary and manufacturing sector has missed, followed by under-developed state of law and policy of competition (an inefficient judiciary limits the full implementation of the Competition Law), and

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19 For more, refer to Paraušić, V., Cvijanović, D., Subić, J. (2007: 49-97).

support from the agricultural budget to farmers is much lower comparing to the EU.

Generally, increasing the efficiency of the competition policy and improvement of legislative, judicial and executive authorities (building the rule of law and consistent application of the Competition Law) – represents one of the main routes that the state should follow improving milk and dairy products market. Whether and how state will be determined independently and in collaboration with the private sector to ensure the development of this market in the future is under a big question mark. But it is quite certain that Serbia, like other transition economies, inevitably, is "waiting for" the improvement and strengthening of competition policy, especially given the ongoing processes of liberalization of tariff and non-competitiveness of dairy farming sector in the EU market.

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