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National and international priorities in agriculture

The past several decades of development have demonstrated that growth in agricultural production and productivity in developing countries can match or surpass the growth in industrial countries. As discussed in Chapter 1, the record has shown that agriculture can be a dynamic sector in developing countries and contribute greatly to growth in real incomes, employment, and foreign exchange earnings and to the alleviation of poverty. Although there is still substantial room for improvement, the policies and investments increasingly being pursued by governments in many developing countries have given rise to guarded optimism about the long-term prospects of food production increasing faster than population. This optimism replaces the Malthusian pessimism that resurfaced in the wake of the unusual increases in food prices in the early 1970s. Given the sharp drop in commodity prices since then, there is now little basis for believing that a fundamental break has occurred in the long-term trend of declining real food prices.

Episodes of commodity booms and slumps are nothing new; nor are dearths and famines, which continue to occur periodically, albeit with much less frequency than in earlier times. Such episodes should not detract from the progress already made, nor should they prevent recognition of the fact that agricultural programs and policies in different parts of the world affect one another. The pricing and trade policies that industrial and developing countries follow will have a great effect on the pace of future growth in rural incomes and the alleviation of poverty and hunger. At stake is the well-being of the hundreds of millions of very poor people in the world who depend on agriculture for their livelihood.

This chapter begins with a review of the priorities for developing countries with respect to pricing and trade policies. The recommended changes will benefit developing countries individually and collectively. But these gains—as well as the gains for industrial countries—will be much larger if significant progress is made in liberalizing trade. The liberalization option is reviewed in the final section.

Priorities in developing countries

Many developing countries have begun to reform their agricultural and trade policies. In some cases, particular programs, crops, or public institutions have been affected. In others, sweeping changes have been made in conjunction with broader reforms of the whole economy. No generalizations are possible about the specifics of desirable reforms since their nature, design, and timing are largely determined by country circumstances. At best, it is possible to indicate those areas that merit careful consideration as candidates for reform.

Reforms of specific sectoral policies in agriculture should not be divorced from reforms of economy-wide policies and development strategies that induce strong biases against agricultural production and exports. As was discussed in Chapter 4, many developing countries have discriminated against agriculture through high industrial protection and through inappropriate macroeconomic and exchange rate policies. The taxation of domestic producers that results implicitly from overvaluations of the exchange rate can easily dominate the effects of sector-specific taxes and subsidies. The linkage between sectoral and macroeconomic policies is usually so strong that it is best to carry out agricultural reforms in conjunction with reforms of general economic policies.

The most important priority in agriculture is to ensure that the profitability of farming is not artificially depressed because of either macroeconomic or sectoral policies. Yet, as seen in Chapter 4, both types of policies often create a strong bias against agriculture.

Export taxes and quotas—whether they are used to exploit monopoly powers in trade, to subsidize agroprocessing, to raise revenue, or to promote domestic production of competing crops—are commonplace and often excessive. They can greatly reduce the benefits that developing countries can attain through trade. In the case of imports, one would expect the goal of self-sufficiency to lead countries to support domestic producers. But state trading in domestic and foreign markets and the high costs of financing urban food subsidies can lead to domestic procurement prices that are lower than import prices—an indirect subsidy to imports that has been very high in some cases.

Some taxation of agriculture is, of course, unavoidable, if only because of the need for revenue. But there are many different forms of taxation. Taxation of export and import-competing crops is perhaps the worst of the available options in developing countries. The costs of such taxation—in terms of real national income forgone—have been extremely high. Greater reliance is desirable on land and income taxes or on sales and value added taxes that bear on consumption.

Apart from moderating the taxation of farm outputs, it is also important to examine the principal public spending programs that affect farm profitability. Many governments have introduced subsidies on modern inputs and credit because they are thought to provide compensation for the taxation of farm outputs. But, as Chapter 5 made clear, the benefits of such subsidies are typically confined to small and relatively wealthy sections of the rural population. Excess demand at subsidized prices leads to rationing, and the actual costs of inputs to farmers often exceed officially sanctioned prices. The main concern of farmers throughout the developing world is not so much the prices of these inputs but their easy and timely availability. Input subsidies, as well as inefficiencies in public distribution agencies, tend to restrict availability. Moreover, input subsidies encourage the wrong mix of inputs and misdirect technological change. Credit and machinery subsidies, for example, lower the demand for rural labor. Public spending can be significantly reduced by eliminating or curtailing input subsidy programs—and the savings can be used to lower the taxation of farm outputs.

Reforms of pricing and trade policies that affect farmers cannot be separated from institutional issues since, in practice, many of the problems arise from the widespread use of public sector marketing agencies, which charge excessive margins, implement their policies inefficiently, and often require large subsidies from the government. The objective of price stabilization that many agencies pursue typically leads to high costs, erratic policies, and the displacement of private operations in stabilization and risk management. This, again, is an area that requires a great deal of emphasis in policy reforms.

Maintaining low food prices for urban consumers is an important motivation for having pricing policies that discriminate against farmers. The benefits of urban food subsidy programs are generally distributed widely across income classes; they are usually inefficient instruments for helping the poorest people. Since they are often very costly and since the costs can suddenly increase because of world price movements, they almost always lead to suppression of producer prices, which reduces incomes in rural areas where most of the extreme poverty is often to be found.

Small and well-targeted food distribution programs are more effective in promoting specific nutritional objectives in especially disadvantaged groups. To mitigate the effects of higher food prices in general, it is clear that governments should pursue other policies that aim at increasing incomes and employment; only if incomes rise can chronic malnutrition be eliminated.

Governments provide many essential services and facilities that private markets cannot, such as irrigation, research, extension, rural roads, and education. These types of activities should account for the bulk of public spending on agriculture. At the same time, it must be emphasized that the rationalization of pricing and marketing policies along the lines described above is required if the full benefits of public spending are to be realized.

Balanced agricultural strategies in developing countries require not only public spending on essential agricultural services, but also a sound policy environment within which private markets can efficiently function. Providing both is the basic challenge that governments in developing countries face. Many of them have taken measures to improve the policy environment; others need to review their macroeconomic and sectoral policies to avoid intersectoral biases and expensive consumer and producer subsidy programs that serve neither growth nor other objectives. They should

also examine their taxation systems in order to lower the economic cost of raising revenues. It is critically important for governments to reduce their role in marketing agricultural outputs and inputs and to eliminate monopoly privileges for marketing parastatals. This will allow a much greater role for the private sector and improve the efficiency of domestic and international marketing.

Trade liberalization

This Report has argued that the barriers to trade that complement domestic programs—especially in industrial countries—constitute a fundamental policy problem for the international community. This is not only because trade liberalization will help developing countries attain faster rates of economic growth, but also because the benefits to the industrial countries will be high as well.

No firm estimates are possible of the total gains in world income that would occur if trade in agricultural and agro-industrial products were liberalized. The estimates cited in Chapter 6 refer to selected sets of commodities only. They do not take into consideration the long-term gains for both industrial and developing countries that could be achieved by allocating investment funds and research activity in directions consistent with each country's comparative advantage; nor do they reflect the gains in manufacturing and agricultural trade that would result from faster growth of world income if trade were liberalized. The estimates are nonetheless significant because they suggest that the potential gains can be very large indeed and would, in the first instance, accrue mostly to countries with the highest levels of protection. While some developing countries may lose as a result of higher import bills for some commodities, the losses are likely to be more than offset by gains in exports of other commodities—especially if they and the industrial countries reform their domestic policies simultaneously.

Even though the estimates of the potential gains from free trade presented in Chapter 6 are conservative, the gains to industrial countries would be nearly double their official development assistance. The adage "Trade is better than aid" is clearly of great relevance to agriculture.

Less government intervention, especially by industrial countries, will also help to stabilize international prices and will assist both industrial and developing countries in attaining their common objective of stability in farm incomes and prices. International commodity agreements—discussed in Chapter 7—are often costly and inefficient international responses to the problems caused by the variability of world prices. They frequently degenerate into efforts by producer groups to raise, rather than stabilize, prices. Compensatory arrangements such as the IMF's Compensatory Financing Facility are superior instruments for promoting stability in earnings or outlays. Chapter 7 also showed that protection in agriculture has not been mitigated by the Generalized System of Preferences or by regional schemes such as the EC's Lomé Convention and the U.S. Caribbean Basin Initiative. Examination of the expansion of trade that has resulted from such schemes indicates that the effects have been very limited, especially for the poorest countries. The preference schemes appear also to erode the interest of their beneficiaries in promoting general trade liberalization. A reduction in protection generally reduces the special benefits from preferences.

While full liberalization is unlikely, there is justification for moving forward now with partial and gradual liberalization. One approach to partial liberalization for agricultural products would be for each country to review how it could reduce protection of the most heavily protected products. A large part of the net losses caused by agricultural protection, as well as a large share of taxpayer and consumer costs, is concentrated upon a small number of products with substantially higher than average rates of protection. In the United States the farm products whose prices deviate most strikingly from what they ought to be are sugar, cotton, rice, wheat, and peanuts; in the EC the products are milk, beef, sugar, and cereals. Particular efforts should be made to lower the rates of protection for these products, and alternative means of providing income support to farmers should be used to ease the transition to lower levels of protection.

As is the case in developing countries, many governments in industrial countries are considering policy reforms. This is particularly so in Canada, the EC, Japan, and the United States, where farm programs currently involve very large costs for their citizens, both as consumers and as taxpayers. The United States has cut its milk support prices, and Japan has been gradually reducing its rice price support relative to its avowed objective, namely that of covering the full cost of production. Still, the U.S. Food Security Act of 1985, which keeps most producer price guarantees roughly at current levels through 1990, suggests that the necessary reforms have barely begun.

Without policy changes that reduce protection,

domestic costs will continue to rise in the years ahead, whatever means are chosen for handling growing excess supplies. There are three main problems:

- Adding to stocks, as the EC and the United States have done for cereals and dairy products, will become increasingly costly and eventually unsustainable as stocks grow larger in relation to annual domestic use or exhaust the available storage capacity.
- Restricting output through direct interventions, such as the milk quotas in the EC or acreage restriction programs in the United States, is unattractive, economically and politically. Compulsory measures are unpopular with producers. If the measures are voluntary, U.S. experience indicates that the budgetary and economic costs of obtaining even a modest reduction in output are great.
- Encouraging consumption domestically or abroad via subsidies will require even more budgetary outlays.

The main justification for agricultural protection is to improve the incomes of farm families, especially those under financial stress. But the benefits of protection go primarily to better-off farmers, while the burden of higher food prices is borne disproportionately by poorer consumers. Moreover, most of the benefits of the programs become capitalized into the price of the land at the time the programs are inaugurated. Farmers who buy land once the programs are in effect benefit little, if at all, from their continuation but, unfortunately, face substantial losses when agricultural protection is reduced or abandoned.

The GATT negotiations

Preparations are under way for negotiations on agricultural protection in a new round of GATT negotiations. There seems to be increasing recognition in Western Europe and North America that a continuation of recent trends in the growth of productive capacity and the very slow growth of domestic and international demand will inevitably lead to higher and higher costs of protection. Most OECD members will soon find it necessary to modify their domestic farm programs to reduce the costs that are incurred.

The analytical studies reviewed in this Report provide solid evidence about the costs of existing policies and the benefits that would be realized if the market interventions were reduced. The fact that the various studies come to similar conclusions should make it easier for governments to accept these results as an important component of the information base from which negotiations could start.

The forthcoming negotiations have to deal with extremely complex assessments of the effects of modifying domestic farm programs. Previous methods of estimating the reciprocal increases in exports and imports resulting from reductions in tariffs are quite inadequate to reflect the combined effects of modifications of domestic policies upon both imports into and exports from a given country. With the increased use of deficiency payments, direct export subsidies, and variable levies and other nontariff barriers, what becomes important is the effect of a change in programs on the net balance of trade. This can be difficult to gauge in light of the complexity and variety of interventions present. The participants in the GATT negotiations on agricultural products must be willing to negotiate about the various features of their domestic programs. This does not mean that any particular set of price and income support programs—such as the variable levies and export subsidies of the EC or the target prices and deficiency payment programs of the United States—have to be abandoned. What governments must be willing to negotiate about are the degrees of protection provided by their price and income support programs and the effects that the programs have upon production, consumption, exports and imports, and international market prices. In other words, there must be a willingness to negotiate about the effects particular domestic measures have upon the markets available to others.

The role of the World Bank

The development of food and agriculture has been an important objective of the World Bank since its inception. In the past decade, roughly 25 to 30 percent of the Bank's lending has been for agricultural and rural development. Irrigation, drainage, and water control projects have been the major focus, followed by area and rural development and credit (see Table 8.1). Because the Bank finances only a part of total project costs, the $33 billion lent by the Bank for agriculture since 1975 has helped finance total investments of about $87 billion.

The Bank's experience with agricultural lending has demonstrated that economic rates of return in the agricultural sector are comparable with those in other sectors. Agricultural credit, irrigation, research and extension, rural development, and many other projects have proved to be successful

Table 8.1 World Bank lending for agricultural and rural development, by purpose and period

Major purpose	1975–79		1980–85	
	Amount (billions of dollars)	*Percent*	*Amount (billions of dollars)*	*Percent*
Agricultural credit	1.64	14.2	3.71	17.5
Agricultural sector loan	0.17	1.4	1.32	6.2
Area development	2.92	25.2	4.34	20.4
Irrigation	3.72	32.1	6.49	30.6
Research and extension	0.59	5.1	0.92	4.3
Other (forestry)	2.54	21.9	4.44	20.9
Total agriculture	11.58	100.0	21.22	100.0
Total lending	38.02	—	81.17	—

means of raising agricultural productivity and the incomes of the rural poor. However, there also have been failures. Agricultural projects are vulnerable to many factors, one of the most important being the policy environment.

Traditionally, Bank-supported projects, besides financing investments, have addressed a range of policy issues that are specific to the performance of the project and the sector. These have included cost recovery, interest rates, reforms of institutions, and counterpart funding. It has become increasingly apparent, however, that broad issues of reform involving pricing and trade policies to facilitate structural change cannot be addressed or financed through project lending.

Since 1980 the Bank has been involved in developing and supporting programs of structural and sectoral adjustment. With structural adjustment loans (SALs), funds are disbursed in support of a program of broad policy reforms rather than for a specific investment. Agreement is reached between the borrowing government and the Bank on specific measures of reform, and progress is monitored to form the basis for the release of funds. Generally, SALs have supported changes in pricing, trade, and public sector policies, as well as changes in the extent of government controls on various productive activities. Because economic restructuring normally takes several years, SALs are designed to span five or more years and may involve up to five separate loans. Since 1980 the Bank has approved thirty-two SALs in eighteen countries, for a total of more than $4.6 billion.

Many of these SALs address agricultural issues through changes in macroeconomic policies and through agricultural trade, pricing, and institutional adjustments. In some countries, however, the Bank's support of government reforms has been sector-specific. Since 1979 there have been seventeen agricultural sector adjustment loans. The majority (thirteen) were approved after 1983. The size of the loans has ranged from $5 million for Malawi to $303 million for Brazil. Most of these sector adjustment loans have focused on prices paid and received by farmers, controls on financial markets, performance of parastatals, trade barriers, and the size and composition of public expenditures. In some instances—for example, in Ecuador, Turkey, and Yugoslavia—the agricultural sector adjustment loans have been coordinated with SALs or with adjustment loans in other sectors. Coordination is also maintained with other agricultural lending, since the success of such lending often depends on the existence of an appropriate policy framework.

SALs and sector adjustment lending have proved to be important instruments for supporting reform programs of an economy-wide and sectoral nature. Improving agricultural policies can be a prolonged process; typically, a sequence of loans is required, and in some cases both SALs and sector adjustment loans are involved. In countries where the adjustment process is well established, Bank assistance generally takes the form of sector adjustment loans that support in-depth restructuring of policies and programs.