AGRICULTURE FOR DEVELOPMENT POLICY BRIEF

Getting Prices Right through Policy Reforms in Developing Countries

Much progress has been made since the 1980s in reducing policy biases against agriculture in developing countries, especially through macroeconomic reforms. Significant room exists, however, for further reforms to promote faster agricultural growth and poverty reduction. Complementary transitional programs are often needed to compensate losers, to address the political economy of reforms, and to facilitate adjustment to new markets.

Policies in developing countries have historically blunted incentives for agricultural producers. Macroeconomic policies have taxed agriculture more than agricultural policies have done, but both have been important in poorer countries. In a study of 16 developing countries from the 1960s to the mid-1980s, average direct taxation (such as output prices set below world prices) was estimated at 12 percent of agricultural producer prices, and indirect taxes (such as overvalued exchange rates) were estimated at 24 percent. High taxation of agriculture was associated with low growth in agriculture—and slower growth in the economy—especially in the poorest developing countries that taxed agriculture the most.

Reforms have significantly reduced taxation of agriculture.

Reforms in the 1980s and 1990s to restore macroeconomic balance, to improve resource allocation, and to regain growth in many of the poorest countries have improved price incentives for agricultural producers in developing countries. Those reforms have reduced but not eliminated historical policy biases against agriculture. Between 1980–84 and 2000–04, net taxation (both direct and indirect) of agriculture declined on average from 28 percent to 10 percent in agriculture-based countries (mostly in Sub-Saharan Africa). It also declined from 11 percent to 2 percent in transforming countries (mostly in Asia) and from marginally negative protection to net protection of 10 percent in urbanized countries (mostly in Latin America).

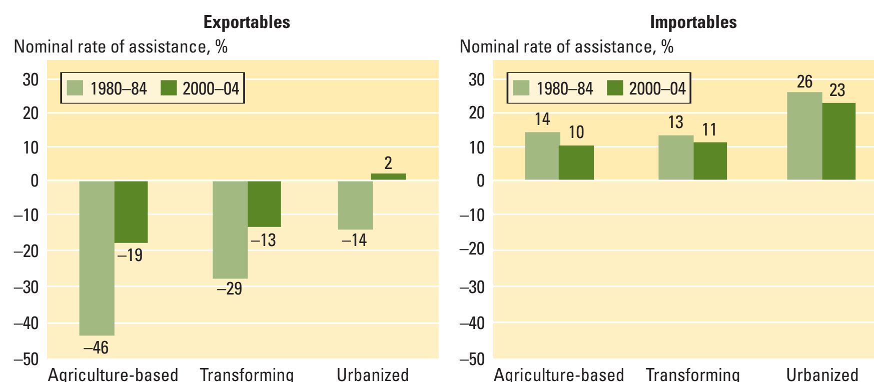
Much of this progress was through macroeconomic reforms. The reduced overvaluation of currencies, which taxed agricultural exports (usually exported at the official rate) and subsidized food imports, is reflected in the huge decrease in the parallel market premiums for foreign currency in developing countries. For 59 developing countries, the average premium in the parallel market fell from more than 140 percent in the 1960s, to approximately 80 percent in the 1970s and 1980s, and to just 9 percent in the early 1990s, with wide variation across countries.

Initially, macroeconomic and agricultural sector reforms in the 1980s had little effect on agricultural growth, because commodity prices in global markets were declining. The situation changed over the 1990s. More favorable world commodity prices and continued reforms led to larger increases in real domestic prices of agricultural exports. The stronger price incentives explain part of the higher agricultural growth in many Sub-Saharan countries since the 1990s.

Continuing reforms are still needed.

Although macro reforms have been broadly successful, considerable room for reform still exists within the agricultural sector. The relatively lower level of overall net taxation hides a combination of protection of imported products and taxation of exports, which can both be high (figure 1). Hence, significant room remains for further efficiency gains through developing countries' own trade policies.

Figure 1. Taxation of Exportables declined from 1980–84 to 2000–04



Source: Anderson, Kym. 2004. (eds.) Forthcoming. ***"Distortions to Agricultural Incentives: A Global Perspective."*** *London, U.K. and Washington, DC: Palgrave Macmillan and World Bank.*

Note: The nominal rate of assistance is a measure of domestic output prices relative to border prices, which also takes into account domestic input subsidies.

Meanwhile, member countries of the Organisation for Economic Co-operation and Development have made slow progress in policy reforms. Their protection and subsidies continue to distort world prices for many commodities, especially cotton and oilseeds (see brief on Agricultural Trade).

There are winners and losers in the reform process. A particular concern with trade liberalization policies is their potential effect on the welfare of the poor, especially with respect to food staples. Any change in price will produce winners and losers among the poor. The distribution of winners and losers varies from country to country. Trade liberalization that raises the price of food hurts net food buyers (the largest group of rural poor in countries such as Bolivia and Bangladesh) and benefits net sellers (the largest group of rural poor in Cambodia and Vietnam).

Beyond the first-order effect on food prices, trade liberalization affects the poor through the creation and loss of employment and wages. Broad-ranging trade reform in Vietnam in the early 1990s induced a large supply response and welfare gain among poor farmers. In Bangladesh, the average landless poor household lose from an increase in rice prices in the short run but may gain in the long run as wages rise over time. Decompositions of incomes in Vietnam, Bangladesh, and Uganda reveal that labor market effects are indeed important channels for trade reforms to affect welfare. The effects, however, are quite country specific.

Political economy matters. Because there are winners and losers, reforms are usually politically sensitive, with strong vested interests. Hence, they are often difficult to achieve. Membership in the World Trade Organization can help induce reform. Local media can expose taxpayer costs and unequal incidence of gains. In some cases, bargained compromises and compensation schemes for the losers can be effective—as in Mexico's 1990s reforms for food staples. Linking domestic agricultural reforms to a broader set of economywide reforms can increase the likelihood of success, as in many developing countries in the 1980s and 1990s. Those reforms, however, remain incomplete for agriculture.

In recognition of the political sensitivity of reforms and country specificity of the effects of those reforms, providing countries with flexibility within trade rules makes sense if it is done in ways that encourage the shift to market liberalization. Programs tailored to country-specific circumstances will be needed to ease the transition to new market realities, especially for small-scale farmers and other vulnerable groups.

Effective reforms require complementary policies and programs.

Complementary policies and programs (including aid-for-trade) are needed to compensate losers (transfer programs) and to facilitate rapid and equitable adjustments by smallholders to emerging comparative advantages (investments in public goods and institutional reforms). A challenge is to ensure an adequate balance between transfer payments to ease the transition and investment in core public goods to spur long-term agricultural growth and poverty reduction. The risks of falling into protection and subsidy traps induced by a dominant focus on transitional support at the expense of long-term growth are high.

Transitional programs. Transitional programs to help farmers adjust to new market signals and to compensate losers are often needed for successful reforms. Those programs must recognize the heterogeneity in the groups adversely affected, examine their distinguishing demographic and geographic characteristics, and analyze the magnitude of the losses and potential gains. Transitional support may include the following:

- ***Grants to facilitate production shifts.*** An example is the Turkey program to reduce agricultural subsidies. Per hectare grants were paid to farmers to facilitate their transition out of tobacco and hazelnut production and into more efficient alternatives, such as maize, soybeans, sunflowers, and vegetables. Complementary support was provided to improve the efficiency of cooperative marketing channels.
- ***Cash transfers and social safety nets.*** To sustain the extremely poor and to support needed adjustments, the government may have to make cash payments and provide social safety nets, as Mexico did through its PROCAMPO program.

Governance problems may limit the country's capacity to implement transitional programs, and this situation must also be addressed.

Public investment for long-term development. Cash transfers and grants may not be sufficient to induce long-term supply response that depends on rural infrastructure (irrigation, roads, transport, power, and telecommunications), as well as on markets, rural finance, and research. Complementary investments in those public goods and services will be necessary to take advantage of trade reforms and to respond to better incentives. In many countries, particularly in Sub-Saharan Africa, significant investment is needed, particularly in market infrastructure, institutional development, agricultural research and extension, and natural resource management.

Transitioning to alternative forms of taxation. Further reducing the protection of imports and the taxation of agricultural commodity exports can pose a fiscal dilemma for many agriculture-based countries that depend on those revenues for public investment. In Sub-Saharan Africa, taxes on border trade account for about a quarter of all government revenues. In the developing countries of Asia, they account for about 15 percent. Agriculture remains the dominant sector in most Sub-Saharan countries and so will have to continue to contribute to national and local government revenues. Four key principles that can guide agricultural taxation are that it should (a) be nondiscriminatory across sectors, (b) minimize distortions to market prices, (c) take into consideration their effectiveness in capturing fiscal revenues, and (d) be feasible to implement.

Recent evidence shows a mixed picture in shifting to alternative sources of revenue. But it also provides some lessons on how to deal with trade revenue losses. Efforts to broaden tax bases by reducing exemptions, simplifying rate structures, and improving revenue administration can help, as can excise and broad-based value added taxes on consumption.

This policy brief has been extracted from the World Bank's 2008 World Development Report, *Agriculture for Development*. Further information and detailed sources are available in the Report. The Report uses a simple typology of countries based on the contribution of agriculture to overall growth, 1990-2005 and the share of rural poor in the total number of poor (2002 US$2-a-day level). In agriculture-based countries (mostly Africa), agriculture contributes a significant (>20%) share of overall growth. In transforming countries (mostly in Asia), nonagricultural sectors dominate growth but a great majority of the poor are in rural areas. In urbanized countries (mostly in Latin America and Europe and Central Asia), the largest number of poor people are in urban areas, although poverty rates are often highest in rural areas.