Do Prices Matter?-The Case Of Third World Agriculture

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THIS PAPER AIMS to answer two questions about prices in agricultural markets in the Third World:

- Is pricing important?
- Should governments intervene or leave pricing to the markets?

Such questions relate to any economy, in the developed or underdeveloped world, and reach deep into the foundations of many economic policy conflicts. The paper begins by discussing the importance of food prices in the economy, before examining the details of operational direct and indirect pricing policies, and then recommending, with some qualifications, a new orientation for policy, one that firstly makes markets workable and then, and only then, leaves pricing to the market.

Are Prices Important?

> *"Prices fulfil three functions: they are signals, incentives and instruments for the allocation of resources and incomes." (Streeten)*

Accepting this quotation, then surely pricing is important. Distorted prices give the wrong signals and incentives and do not contribute to the economic objectives of equity and efficiency. In any society food prices are key prices, having implications for the purchasing power of all as well as specifically for the level of income of the agricultural population; a particularly salient point in the Third World where in 1985 74% of the labour force were involved in agriculture. (World Development Report 1988)

National Policy Bias

An important influence on Third World agricultural policy has been the assumption that industrialisation provides a route, if not the only route, to development. This dual economy Lewis type model holds an industrial-agricultural inequality as a necessary driving force to achieve growth and development. The overemphasis on the factor role in Kutznet's outline of the three contributions[1] of agriculture to the process of development reflects this, in that agriculture becomes

viewed solely as a source of capital and extractable surplus, at the cost of its other two possible contributions. It is often suggested that this is reflected most clearly through an urban bias in policy. Food pricing policy in particular, and also the direction of investment reflect this with the net result of reducing incentives to agricultural production. This was demonstrated by 1986 World Bank data which focused on Columbia, Egypt and Nigeria.

Direct pricing policy tends to result in the depression of agricultural prices which is often justified on the grounds that the Third World farmer is a non-rational man who has a target income and thus does not respond to price increases by increasing output and that supplies of cheap food are necessary in order to feed the population and in particular the expanding urban population.

Evidence on the "non-rational" Third World farmer would seem to show that farmers are in fact rational and, depending on resources available, will increase production in response to price increases. Widely used direct policies include compulsory government purchase of food for domestic markets and the imposition of taxes which reduce producer prices(a convenient revenue raiser). Export taxation accounts for the contrasting experiences of Sri Lanka and Kenya in the tea market and China and Cote d'Ivoire in cocoa, in each case the former imposed export taxes and lost market share due to reduced exports.

Ironically policies with the goal of favouring farmers often have what Lipton calls a "price twist" so that those who benefit the most are those with the greatest resources originally. Subsidised inputs are often associated with administrative difficulties and corruption in bureaucracy so that most of the potential surplus is eliminated by bribery or that most of the value accrues to larger and richer farmers. For instance in Brazil in the 1970s, credit subsidies were diverted to non agricultural usage. Tax reliefs to favour agriculture in the same country favour large farmers and the accumulation of large land holdings - particularly as the poverty stricken do not pay tax anyway given that their incomes are so low.

Overall macroeconomic policy also often reflects a strong anti-agricultural bias with effects on agricultural prices. Primarily this occurs through import substitution measures with which over-valued exchange rates are associated. Protection of local industries may also force farmers to purchase domestic inputs at uncompetitive prices. Resources tend to move to the protected sector, and traded goods are less protected so that agricultural exports are heavily discriminated against. In the Philippines between 1950 and 1980 the prices of agricultural exports were artificially depressed by between 44% and 71%.

International Policies

The price problems in agriculture stem not only from national intervention, but also from effects of international policies. The prime example of this is the EC's Common Agricultural Policy which subsidises EC agricultural output. The excess production resulting from such massive subsidisation programmes lowers world food prices for these products. Liberalisation of agricultural markets through CAP reform would benefit producers through higher world prices whilst damaging consumers where food is imported (Matthews 1985). Freeing up these markets may thus bring its own problems. The World Development Report 1982 reports that in developed countries, producer prices are 50%-100% above world market prices, in contrast to less developed countries where prices are well below world levels, often due to the policies outlined above.

Tyers and Anderson simulated the effects of lower trade barriers, with results indicating the strong benefits of trade liberalization for selected sets of commodities. Higher import bills for LDCs could occur but the 1986 World Development Report suggests that this would be more than offset by the gains from exports of other commodities. Overall it seems that international intervention in markets is costly and inefficient and highly politically motivated especially where it involves giving favoured status to ex-colonies and political allies.

Another international aspect to agricultural pricing is the provision of food aid. It is often the case that food aid only displaces and does not add to the overall supply, especially as its provision tends to reduce prices, thus reducing the incentive to produce and perpetuating the domestic problem it seeks to alleviate, by creating long term dependence. The effectiveness of food aid depends on its targeting so that it will prove effective and yet have no negative effects on production.

Do Prices Matter? - A Role for Government

It follows then, without question that in the Third World agricultural prices are distorted by both national and international actions. The question begs answering — does this matter? Does the Third World farmer have an upward sloping supply curve or does he operate under the concept of a target income and is, consequently, unresponsive to price changes. Evidence suggests that increased prices may benefit only those who have land and technology available—production will only increase where opportunity as well as incentive exist. Thus prices matter but they are not all that matters.

What is the role for government policy in such a context? It is to this that Lipton addresses himself in an article discussing the standpoints of two World Bank Reports, the 1986 World Development Report and a report called Poverty and Hunger by the Agricultural Research unit of the Bank. He sees the World Development Report as promoting a "pricist" strategy, emphasising the price distortions

outlined in the previous parts of this essay. Lipton feels that this ignores the root of the problem, which is at least in part the social and political structure of the country - evidenced not only by bias in pricing but also witnessed in investment policies. He suggests that sole dependence on prices and free markets as a solution to problems may be damaging and that other considerations may also be important.

The argument suggests itself that perhaps getting prices right is the solution but only if markets are freely operating. If the ability to respond to price changes does not exist, then getting prices right may at best have no effect and at worst cause further distortions. As Lal espouses in his book "The Poverty of Development Economics", correcting one distortion with another is an ineffective and potentially damaging policy. It is unlikely that anyone knows what the "right" prices are or that any government knows how to attain them. The farmer faces a constrained maximisation problem: maximise income which is a function of price and output, subject to a technological constraint, availability of land and water, a capital constraint and human capital. The role for government should be to relax these constraints thus ensuring effective operation of markets - in this context increasing efficiency will have equity impacts for agriculture.

Conclusion

In conclusion the realisation is required that resources cannot be continually extracted from agriculture without expecting an effect on performance and a potentially problematic one. Land reform so that adequate access to land is provided, increased access to technology especially labour using technology such as high yield crops, are possible ways of increasing responsiveness and thus the agricultural sectors ability to take advantage of opportunities. The benefits of crop research contributed to Brazil's soya bean success in the late 1970s. Irrigation not only benefits agriculture but also rural employment in construction as was indicated by a World Bank study of a Malaysian irrigation project. Government insurance schemes could also perhaps respond to the risk aversion of farmers. However on the other hand evidence from Indonesia shows that the curtailment of government intervention in one case resulted in the setting up of profitable lending arrangements and the improvement of credit availability.

Prices then do matter, but only as one element of agricultural markets. The priority for any government must be to ensure that opportunities exist to take advantage of incentives before pricing policies favouring agriculture are used.

To summarise,

"Getting prices right is not the end of economic development but getting prices wrong frequently is."(Timer 1984)

NOTE

The others being defined as that of providing products (i.e. food and raw materials) and that of forming a market for the goods of other sectors.

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