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Regional Rural Development: The Need for Deregulation

by Karl Fasbender, Hamburg*

Government intervention in developing countries has often been biased towards the support of urban industries and the urban population. The resulting distortions in exchange rates and in the prices of the factors of production have had serious detrimental effects on rural areas. A gradual deregulation of prices is necessary if the problems of the rural areas are to be overcome.

Despite considerable economic success, the development strategies which are primarily oriented towards growth – and often directed towards the industrial sector – have not managed to prevent increased poverty in the Third World. Since the preconditions for the desired social and economic spread effects, forward and backward linkages, etc. do not exist or are inadequate, especially in the disadvantaged rural regions, poverty is concentrated upon those regions. Some 80 % of the 800 million or so people surviving at or below the minimum level of subsistence live in rural areas.

Owing to the complexity of the development problems, multisectoral and regional measures for specific social groups or target groups must be combined to form a general package in order to reduce poverty and to achieve the desired growth rates of the gross domestic product and other development policy objectives. As a strategic approach, integrated regional rural development should generally satisfy the maximum possible number of requirements in this respect.¹ That approach – or at least its main features – is therefore being taken notice of in an increasing number of developing countries.

When social, sectoral and regional programmes are being formulated for rural areas, however, no account is often taken of the general macro-economic conditions which may be conducive to the operations but generally impede and in extreme cases entirely prevent them.

These conditions include above all government interventions which have been designed to benefit the mostly urban industries and urban population but, by

distorting prices, frequently have a one-sided detrimental effect upon the production earnings of the agricultural sector which characterizes the rural areas. Empirical studies of agricultural products – including food which is used primarily for home consumption – also prove that the price elasticity of production is significantly positive. So a low-price policy results in reduced production.² Although the detrimental effects upon the agricultural sector in general and food production in particular have mostly been accepted, for financial reasons, with open eyes, their extent and the harmful impact upon the development of the rural areas and the economy as a whole have been equally underestimated.

Distorted Exchange Rates

In many developing countries price distortions are caused by tolerating or deliberately creating a foreign exchange value for the currency which does not accord with the scarcity situation: according to HWWA's investigations of 38 countries between 1970 and 1983, 29 of them have over-valued their currencies and 21 of

¹ Cf. inter alia Federal Ministry for Economic Cooperation and German Agency for Technical Cooperation: *Regional Rural Development*, Eschborn 1984; K. Fasbender: *Integrierte Entwicklung im ländlichen Raum*, in: *Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik*, Vol. 28, Hamburg 1983, pp. 267 ff.

² Cf. inter alia D. Keeschull, K. Fertig et al.: *Auswirkungen von Eigenanstrengungen auf den Entwicklungsprozeß* (now in preparation); T. W. Schulz: *Distortions of Agricultural Incentives*, Bloemington, London 1980.

³ Marked disparities are defined as average rates of change of more than 0.75 % p.a. in the real effective exchange rate index. Particularly pronounced disparities can be observed in Bolivia, El Salvador, Yemen, Nicaragua, Nigeria and Paraguay. Cf. inter alia: M. Holthus, K. Stanzel: *Die "Bonität" von Entwicklungsländern*, in: U. E. Simonis (ed.): *Externe Verschuldung – interne Anpassung*, Schriften des Vereins für Socialpolitik, NF 144, Berlin 1984, pp. 257ff.; *ibid*: Working Papers.

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those showed marked disparities.³ Four of the eight countries with under-valued currencies revealed a marked disparity.⁴

Over-valuation reduces the cost of foreign exchange and foreign indebtedness when measured against the domestic currency. (The converse applies in the case of under-valuation.) Although, macro-economically, this is only an apparent reduction⁵, it does have pronounced consequences through its influence on exports and imports, consequences which also affect the rural areas.

Over-valued Exchange Rates

Over-valued currencies – usually combined with low import duties – (deliberately) encourage imports of capital goods. Apart from the danger that artificially induced price reductions for imports of capital goods may favour the development of a production structure which is not aligned with the comparative advantages, those imports encourage primarily capital-intensive investment. This reduces the possibilities of industry to take on the manpower released for reasons of productivity from the agricultural sector. Moreover, because most of the favoured industries are located in urban areas, the rural areas acquire only a small share of the capital-intensive investment, particularly since hardly any of the supplier industries have been established in those areas.

The rural areas are, however, directly harmed by a disproportionate increase in food imports as a result of the over-valuation. Since the price elasticity of domestic production is also positive for those goods, the resultant distorted competition and the falling market and producer's prices are also instrumental in reducing indigenous food production and the earning potential of the farming population.

For political and/or social reasons many governments believe that they cannot forego the relatively low food prices which benefit the urban population and so, in many cases, none or only some of these price distortions are offset by means of high import duties. The harmful effects upon agriculture may be intensified if the supplier country keeps the price of its agricultural exports below the world market price by means of subsidies, or furnishes them in the form of low-price, long-term food aid (not short-term aid for natural

disasters). This also reduces the need for the governments of the importing nations to promote their own national food production. Moreover, if the imports change eating habits in favour of foreign foods which cannot be produced locally, there is a danger of irreversible damage to the agricultural sector.⁶

The consequent disadvantages are therefore particularly damaging for the rural areas because, at the same time, it becomes difficult to switch to products for export: over-valued currencies also cause an artificial increase in the price of exports. Since a large proportion of the developing countries' exports consist of agricultural products, this is particularly damaging to the international competitiveness of the rural producers. The existing trade restrictions resulting from parity distortions are often intensified by export duties in order to acquire earnings, which are then often employed to develop urban industries. According to information supplied by the World Bank⁷, as a result of price distortions of this kind several African countries are already faced with the problem "that producers of traditional export crops cannot be paid enough to cover their costs of production, even though these are the crops for which they have a strong comparative advantage".

Under-valued Currencies

Conversely, seriously under-valued currencies, which are comparatively rare, increase the export potential. From the producers' point of view they also have the advantage of artificially raising the price of imports – including agricultural products – and thus favouring an import substitution policy. Unless these effects are cancelled out by means of foreign trade levies, which occurs quite often in relation to agricultural products, under-valuation encourages the nation's agricultural production. In any case, it is not conducive to low prices which hamper production.

On the other hand, under-valuation of the currency increases the import prices of farm machinery, inputs and fertilizers. It is hard to say whether this has a general restrictive effect upon production and innovation but experience shows that – just like over-valuation – it does cause incorrect allocation of resources. Despite the fact that the impact upon agricultural production and the use of labour-intensive technologies (in industry too) is

³ Brazil, Costa Rica, Tunisia, Mexico. Under-valuation has increased in the 1980s in all 4 countries.

⁵ In the final analysis payments and debt servicing have to be remitted in scarce foreign exchange. This entails a real transfer from the purchasing or customer country. Cf. M. H o l t h u s , K. S t a n z e l , op. cit., p. 261.

⁶ Cf. S. B e t h k e : Gedanken zu allgemeinen Rahmenbedingungen für die Einführung stimulierender Preis- und Marktpolitiken in LLDC (DSE publication in course of preparation).

⁷ Cf. World Bank: World Development Report 1983, Washington D.C. 1983, p. 58.

largely positive in the medium term, under-valued exchange rates can therefore be ruled out as a suitable long-term means of promoting rural areas.

Apart from this, an under-valuation policy has detrimental effects upon other nations. Pronounced long-term disparities are thus bound to encourage running-matches in protective countermeasures.

Distortions in the Cost of Capital

In most developing countries, distorted costs of foreign capital go hand-in-hand with an incorrect valuation of domestic capital. Thus, the interest rates for loans have been, and still are, usually kept at an artificially low level to stimulate investment, including investment in the rural areas. According to the World Bank, negative real interest rates could be encountered worldwide at various times in the 1970s. The HWWA studies mentioned above show that from the early 1970s to the early 1980s interest rates were seriously distorted in 16 out of 33 countries, i.e. the real rates were on average less than -5% p.a.⁸ Positive rates were noted only in Thailand and Singapore.

Like wrongly valued currencies, the low cost of capital increases the danger of an incorrect allocation of resources. In particular, capital-intensive production methods are encouraged, which in countries with high unemployment is incompatible with the labour market requirements of both the urban and the rural areas. Furthermore, the corresponding effects are often intensified by additional interest subsidy programmes.⁹

Account must also be taken of the fact that in many countries the capital markets are characterized by segmentation into regional sub-markets. The small number of bank branches and functioning credit unions, the inadequate material security available from smallholders, bureaucratic restrictions, etc. mean that in most rural areas it is possible to take advantage of none or only a very few of the benefits of low interest rates even within the context of special farm subsidy programmes. The benefits of such measures are usually concentrated upon the towns, their catchment areas and large agricultural enterprises. Under the given conditions on the capital market, the disadvantages of a low interest-rate policy exceed the advantages for the national economy, and especially for the rural regions, because they include not only the encouragement of capital-intensive processes and the

increase of unemployment, but particularly the creation of inflationary tendencies and the reduction of the incentives for creating capital resources.

The use of capital-intensive technologies at the expense of labour-intensive production methods, a process encouraged by the low-interest policy, has particular consequences for the labour market in urban areas. It also means, however, that many members of the labour force who have been released from the agricultural sector and migrated to the towns cannot find jobs and are therefore handicapped in transferring money to their families who have remained in the rural areas. This curtails a frequently mentioned – but disputed – advantage of the flight from the land from the point of view of the rural areas.

Price Distortions in the Factor Labour

The development of real wages would at least be expected not to encourage further the use of capital-intensive technologies. For political reasons, however, some governments and/or trade-unions are anxious to achieve a relatively high wage level in the towns. So the undesirable effects upon the labour market will be intensified by the rise in real wages which can be observed in some countries. Thus in 7 of the 31 countries examined by the World Bank the rise in real wages in the manufacturing/construction sector is higher than the growth in productivity.¹⁰ According to the HWWA studies mentioned above, in 8 of the 20 investigated countries¹¹ the labour costs in manufacturing or in the non-agricultural sector must be considered excessive when measured against the trend in the productivity of labour and the per-capita GDP.

Additional Financial Intervention

The price distortions outlined above in the external value of the currency and in the production factors labour and capital differ in intensity in the various countries but they often mutually increase each other's detrimental effects. In addition, they are often supplemented by measures which cause a further relative discrimination against the rural areas. For example, a study¹² of effective protection in Nigeria confirms the thesis that measures to encourage trade favour the cities; approximately 90 % of the subsidies for that purpose are allotted to the Lagos region.

⁸ Particularly high negative real interest rates of over 9 % were observed in Argentina, Brazil, Indonesia, Nigeria, Peru und Turkey.

⁹ For example, at the end of the 1970s in Korea these accounted for 40 % of the total volume of credit.

¹⁰ Cf. inter alia R. Agarwala: Price Distortions and Growth, in: Finance and Development, Vol. 21, No. 1, March 1984, p. 35, *ibid*: Price Distortions and Growth in Developing Countries, *op. cit.*, pp. 24ff.

¹¹ Pronounced distortions can be observed in 5 countries, i.e. Chile, Egypt, Jamaica, Portugal and Zambia.

¹² Cf. T. Bertrand et al.: Industrial Policy in Nigeria, IBRD 1978.

In other countries the relatively small advantages which the agricultural sector obtains from over-valued exchange rates are nullified or reduced by import duties¹³; in Latin America especially a particularly heavy charge is imposed on imports for that sector. For example, the taxes on farm machinery range from 10 % to 30 % and on agro-chemicals from 18 % to 55 % in Uruguay and Colombia. The World Bank classifies the taxation of agriculture in 7 of the 31 countries it studied as "very high".¹⁴

In other countries, however, the prices of selected basic foods are deliberately kept low by law or by government purchasing agencies. For example, between 1975 and 1980 the farmers in Tanzania received only about 33 % of the world market price for maize and in Pakistan only about 57 % of that for rice. In some nations this consumer-oriented price-fixing finds its equivalent in the form of an export-oriented, low-price policy for selected agricultural produce. During the same period of observation, producers in Ghana, Cameroon and the Ivory Coast obtained only up to 34 % of the world market price for cocoa beans or green coffee.

Nevertheless, opposite examples of a more production-oriented pricing policy must be cited: the farmers in Kenya and the Philippines receive more than 75 % of the world market price for green coffee, while in Mexico, the Philippines and the Ivory Coast the producer prices for rice or maize more or less correspond to the world market prices. Other countries, such as Colombia, have adopted a differentiated policy towards basic foods and exported products; between 1975 and 1980 the producers received less than half of the world market price for coffee while considerably higher – i.e. subsidized – prices were paid for maize. This policy seems to have been continued in recent years (1979/1983); with an average inflation rate of 25 % the price for maize rose by about 30 % and for coffee about 9 % p.a. In 3 of the 31 nations studied by the World Bank, agriculture enjoyed a considerable level of tax concessions.¹⁵

Attempts are sometimes made to limit the disadvantages of the rural areas by means of

quantitative restrictions on agricultural imports and/or subsidies for farm inputs. For example, the subsidies provided for fertilizer prices total 35 % in Indonesia, 50 % in Sierra Leone and Tanzania and as much as 75 % in Nigeria. This form of protection is not without risk: quantitative restrictions often place too great a burden upon the bureaucracy and/or encourage corruption. In many cases the subsidized seed, fertilizers, etc. are not distributed to regions with bad communications and this helps to intensify regional disparities. Preference is also frequently given to large farmers and plantation companies which is in turn reflected in unequal distribution of incomes. But, quite apart from these and similar consequences, the funds are generally insufficient to offset the disadvantages.

Table 1
Average Distortions in Selected Developing Countries

Country	Exchange Rate ¹	Capital ²	Labour ³
India	High	Medium	Medium ⁴
Indonesia	Medium	High	Low
Malaysia	Slightly under-valued	Medium	Medium ⁴
Philippines	Medium	Medium	Low
Singapore	Low	Positive real interest rates	Low
Thailand	Low	Positive real interest rates	Low ⁴
Papua N. G.	Low	Medium	Medium
Argentina	Low	High	Low ⁴
Bolivia	High	High	Low
Brazil	Greatly under-valued	High	Low
Mexico	Medium under-valued	High	Low
Egypt	High	Medium	Medium
Morocco	Slightly under-valued	High	–
Syria	High	High	Medium
Tunisia	Greatly under-valued	Medium	Low
Cameroon	Medium	High	Low
Kenya	High	Medium	Medium ⁴
Nigeria	High	High	Medium ⁴
Zimbabwe	High	Medium	–

¹ Unless otherwise stated, these are over-valuations of the currencies between 1970 and 1983.

² With 2 exceptions, negative real interest rates which usually cover the period 1970-1982. Differences in duration must be mentioned for Indonesia (1979-1982), Mexico (1978-1983) and Cameroon (1976-1983).

³ Over-valuation of the factor labour compared with the mean annual relative change in the productivity of labour and/or the per-capita GDP, usually between 1970 and 1980/82.

⁴ The data relate to the World Bank's studies during various multi-annual periods in the 1970s.

Sources: M. Holthus, K. Stanzel: Die "Bonität" von Entwicklungsländern, in: Schriften des Vereins für Socialpolitik, NF 144, Berlin 1984, pp. 264 ff.; *ibid.* working papers; R. Agarwala: Price Distortions and Growth in Developing Countries, World Bank Staff Working Papers, No. 575, Washington D.C. 1983, pp. 16 ff.

¹³ Cf. on this and the following points International Federation of Agricultural Producers (IFAP): Agricultural Development Strategies and Pricing Policies in Developing Countries, Paris, March 1984, pp. 8 ff.; R. Agarwala: Price Distortions and Growth in Developing Countries, World Bank Staff Papers No. 575, Washington D.C. 1983, p. 17.

¹⁴ Brazil, Cameroon, Ghana, Nigeria, Senegal, Tanzania and Uruguay.

¹⁵ Bolivia, Korea, Peru. Cf. on this and the following points: R. Agarwala: Price Distortions and Growth in Developing Countries, op. cit., pp. 16 ff.

For example, IFAP studies have concluded: "In Egypt, even with fairly substantial input subsidies, it is estimated that these compensated for only 41 % of the income foregone by farmers through fixing relatively low producer prices."¹⁶

Consequences for the Rural Areas

When we consider that the price distortions are, in some cases, partially offset by government measures and in other cases reinforced by them, there are only a very few countries, such as Korea, where we can observe any protection of the agricultural sector – the sector which characterizes the rural areas. In other countries, however, the essential food production sub-sector is encouraged as part of an import substitution policy, often by means of dirigistic interventions. Nevertheless, in most developing countries the industrial and commercial firms characterizing the urban areas and cheap food supplies for the urban population are given biased preference (cf. Table 1).

In the rural areas that policy is detrimental to both the macro-economic allocation of resources and factor input at the farm level. This results in impediments to growth. Depending upon the scale and duration of this biased policy, its outcome, among other things, is that:

- the regional disparities between town and country are further intensified and, as a result:
- the increasing pull and push effects (of the urban and rural regions respectively) encourage an undesirably large flight from the land;
- the gap between national food production and domestic demand constantly grows;
- more and more scarce foreign exchange has to be spent on food imports;
- but rural poverty increases.

Even though it may be considered wise, or at least justifiable, for the agricultural sector to make a limited contribution towards urban development, it can often be observed that the surplus transfer is excessive. Thus Schäfer states that development policy-makers have sometimes killed the agricultural chicken before it has laid the industrial eggs. Lipton emphasizes that the principal class struggle is not between labour and capital but between the rural and urban groups.¹⁷

As far as the attempted development of disadvantaged rural regions and the reduction of poverty are concerned, price distortions and

supplementary dirigistic interventions in favour of urban agglomerations mean that the targets fixed for those purposes must be very modest and/or a disproportionately large input of funds is needed. Yet most countries lack both the necessary financial potential and an adequate administration which could ensure efficient use of subsidies, etc. – especially in remote areas.

Gradual Deregulation

So at least some reduction of the most serious price distortions is necessary, as has been very successfully done in Somalia, for example. Yet this does not necessarily mean that market prices or prices determined by the level of performance have to be fully and immediately applied. Examples such as Peru show that deregulation measures alone are insufficient and have to be combined with suitable general conditions.¹⁸ Further regional, multisectoral and social measures are needed, especially in particularly disadvantaged regions. Gradual deregulation measures are also advisable in view of the periods of adjustment needed in the industries which have hitherto enjoyed preference and/or in favour of the urban poor. The politically explosive effect of any reduction of price distortions was demonstrated by the disturbances which accompanied it in several North African countries in 1983/84.

Yet the consequences are not entirely beneficial even in favoured urban areas. The advantages of agglomeration are beginning to turn into disadvantages, especially in large cities. The harmful effects of incorrect allocation of the production factors, such as excessive capital intensity, surplus capacities, a low level of competitiveness and/or a small net product of the favoured industries at world market prices, are becoming evident.¹⁹ Job creation programmes, slum clearance and social measures are frustrated due largely to the migration from rural areas induced by those very operations. From the point of view of the national economy, the harmful effects upon the market control of supply and demand, inflation, foreign indebtedness and borrowing capacity, economic growth, etc. are becoming increasingly obvious. Yet perhaps it is precisely these experiences which will permit gradual deregulation in favour of the rural areas too.

¹⁷ Cf. H. B. Schäfer: *Landwirtschaftliche Akkumulationskosten und industrielle Entwicklung*, Berlin, Heidelberg, New York 1983, p. 5, M. Lipton: *Why People Stay Poor*, London 1976, pp. 13 and 307 ff.

¹⁸ Cf. D. Kerschull, K. Fertig, op. cit.

¹⁹ Cf. inter alia R. Agarwala: *Price Distortions and Growth*, op. cit., p. 34.

¹⁶ International Federation of Agricultural Producers (IFAP), op. cit., p. 7.