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The Role of the Agricultural Sector in LDCs

by Dietrich Kebschull, Hamburg*

The growth strategies pursued by the vast majority of developing countries considerably neglect the agricultural sector. The following article discusses the main determinant factors for this discrimination, namely the shortcomings of macroeconomic as well as sectoral and project policies.

In most Third World countries the agricultural sector is of key importance to the economy as a whole. It represents the main source of income for the majority of the population. In addition, via the substantial contribution of this sector to GDP and export earnings it determines the course and the success of the overall process of economic development, especially in the poorer countries.

These facts have been known to developing country research for many years. More recently, they have been substantiated by the findings of econometric analyses of the interrelationship between agricultural production and the growth of the economy as a whole.¹ These facts and findings alone, however, do not explain why the World Bank devotes a large section of its World Development Report 1986 to the role of the agricultural sector in the process of development. The main reason for focusing on this aspect is the all too obvious neglect of and discrimination against this sector in the overwhelming majority of growth strategies and concepts pursued in practice.

Up to now, priority has unmistakably been given in most developing countries to modernising the economy via industrialisation. This was generally understood to mean a high level of economic development and steady growth. Structural change via a reduction in the significance of the agricultural sector and an expansion of the industrial sector was regarded as the decisive objective. Despite considerable effort in this respect the hopes for success were, however, generally unable to match expectations.

This was due to numerous factors inside the developing countries themselves as well as others of an external origin. Especially at international conferences emphasis was generally placed on the distortions of the world economy during the last twenty years and on the frequently adverse effects on development of the policies pursued by many industrialised countries.² These accusations are justified. Yet they only relate to

one side of the coin. In many developing countries a whole series of factors share the blame for the poor growth performance. Knowledge of these factors, their elimination and future prevention are extremely important for practical development policy measures, which as a rule involve "second-best" solutions. The appropriate steps have to be taken by the developing countries themselves. Such shortcomings exist in the macroeconomic as well as the sectoral and project policy fields.

The decisive factor for unsatisfactory development is, above all, the discrimination against agricultural production and against the corresponding foreign trade relations in comparison with the industrial sector in developing countries. This is frequently justified by arguing that „infant industries“ require special protection.

In macroeconomic policy terms this approach drastically reduces the scope for agricultural expansion. This becomes particularly clear in the credit policy field. In the case of high rates of inflation, which often result from the fact that an expansionary monetary and fiscal policy has not been scaled down following boom periods, attempts are frequently made to step up growth in key sectors via extremely low or negative real interest rates.³ As this is accompanied by a reduced incentive to save and an increase in capital flight this automatically

¹ As regards the German literature on this subject cf., above all, publications by Baade, Blanckenburg, Boesch, Besters and Priebe. The World Development Report 1986 refers to research findings by C. Ranganathan: Agricultural Growth and Industrial Performance in India, International Food Policy Research Institute, Research Report 33, Washington D.C. 1982, and by P.B.R. Hazell, A. Roell: Rural Growth Linkages – Household Expenditure Patterns in Malaysia and Nigeria, International Food Research Institute, Research Report 41, Washington D.C. 1983.

² The analysis by the UNCTAD in its Trade and Development Report 1986, for example, is typical for this approach. The report describes the behaviour of Western industrialised countries as one of the main obstacles to development.

³ Cf. J. A. Hanson, C. R. Neal: Interest Rate Policies in Selected Developing Countries, 1970-1982, World Bank Staff Working Paper 429, Washington D.C. 1985; A. Virmani: The Nature of Credit Markets in Developing Countries: A Framework for Policy Analysis, World Bank Staff Working Paper 524, Washington D.C. 1982.

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leads to credit control measures. The rationing of the supply of capital decreed because of this produces a situation in which investments in the agricultural sector and in remote rural regions are generally of only secondary importance. Priority is given to the apparently more productive investments in the industrial sector, since these are expected to produce favourable effects on foreign trade and employment.

The inadequate adjustment of exchange rates to the rates of inflation also has a detrimental effect on the agricultural sector and, due to the significance of this sector, on the economy as a whole.⁴ The overvaluation of domestic currencies not only makes it more difficult to export agricultural products, but also encourages additional food imports, the prices of which are – for political reasons – already kept as low as possible for the urban population. Overvaluation is tantamount to a subsidisation of imports. It diminishes the competitive strength of domestic producers and reduces production incentives accordingly, especially since the majority of farmers cannot make full use of the lower-priced imports of agricultural inputs.

The degree of discrimination is even greater if (and because) the promoted branches of industry are protected by foreign trade restraints. Increases in domestic demand caused by growth of income, for example, lead to rising prices for the relatively rigid range of industrial goods shielded from foreign competition, whereas imports prevent price increases in the less protected agricultural sector.⁵ This results in a change in the internal terms of trade to the detriment of the agricultural sector.

Adverse Effects of Fiscal and Price Policies

In many cases fiscal policy decisions also have adverse effects on the primary sector. Especially in the less developed countries the exports of traditional export products – i.e. natural raw materials and foodstuffs – which are relatively easy to register, are heavily taxed or subjected to duties in order to raise fiscal revenue.⁶ In cases where there is a budget deficit, which can become a particular problem for

governments following boom periods, due to the commitment to long-term government investment programmes, there is a clear tendency to exhaust these sources of income even further and, at the same time, reduce existing subsidies for agricultural inputs. It is obvious that this results in a lasting deterioration of the conditions for profitable agricultural production and its expansion.

Similarly adverse effects for an economy's internal structure frequently result from price policies which are not orientated towards supply and demand, but which primarily serve to protect and ensure an expansion of the industrial sector. As a rule, the "inward-looking" industrialisation strategies guarantee comparatively high prices for domestically produced industrial import substitutes. This also applies to the domestic production of agricultural inputs, whereas the prices of agricultural products are kept low – in the case of both import substitutes and export products.⁷ This policy of deliberate price distortions, which is common practice for both plantation crops and basic foodstuffs in many Third World countries,⁸ makes it more profitable to produce protected industrial goods. Capital and labour are withdrawn from the agricultural sector without a proper assessment of the actual costs and benefits for the economy as a whole.⁹ An increase in the level of wages can have an additional adverse effect on the agricultural sector. Its competitiveness declines, production and yields fall, and the possible contribution of the agricultural sector to the development of the economy is reduced.

These adverse effects are compounded by sectoral policies which were originally supposed to increase the prosperity of the economy as a whole. Above all, price-setting practices, policies pursued by marketing organisations and sectoral taxation must be mentioned in this context.

In an effort to improve the supply of food for the urban population many developing countries try to keep their food prices below international price levels in

⁴ The causes and effects of distorted exchange rates are dealt with in M. Holthus, K. Stanzel: Kriterien zur Einschätzung von Verschuldungslagen, in: U. E. Simonis (ed.): Externe Verschuldung – Interne Anpassung, Schriften des Vereins für Socialpolitik, new series, Vol. 144, Berlin 1984, pp. 257-288. Cf. also R. Gulhati, S. Bose, V. Atukorala: Exchange Rate Policies in Eastern and Southern Africa, 1965-83, World Bank Staff Working Paper 720, Washington D.C. 1985.

⁵ Cf. A. Valdes: Exchange Rates and Trade Policy: Help or Hindrance to Agricultural Growth?, International Food Policy Research Institute, Washington D.C. 1985.

⁶ Cf. J. Sharpley: Economic Policies and Agricultural Performance. The Case of Kenya, Paris 1986, pp. 85 ff.; D. Ricardo: The Principles of Political Economy and Taxation, reprint, New York 1973.

⁷ Cf. K. Fertig, S. Hestermann: Bemerkungen zu Preisverzerrungen im Agrarsektor, in: DSE: Erzeugerorientierte Markt- und Preispolitik in den ärmsten Entwicklungsländern, Feldafing 1985, pp. 121-133; T. W. Shulz: Distortions of Agricultural Incentives, Bloomington and London 1980; G. S. Tolley, F. Thomas, C. M. Wong: Agricultural Price Policies and the Developing Countries, Baltimore and London 1982.

⁸ This also results in a distortion of exchange rates via overvaluation to the detriment of the agricultural sector. In this case the real exchange rate, which reflects the relationship between the prices of traded and non-traded goods, drops without an adjustment of the nominal rate.

⁹ Cf. Y. Mundlak: Intersectoral Factor Mobility and Agricultural Growth, International Food Policy Research Institute, Research Report No. 6, Washington D.C. 1979.

¹⁰ Cf. M. D. Bale: Price Distortions in Agriculture and their Effects: An International Comparison, in: American Journal of Agricultural Economics, No. 1, 1981, pp. 8-22.

accordance with their lack of purchasing power.¹⁰ Government purchasing agencies and compulsory sales of agricultural products to the state are designed to prevent selling on parallel markets. This approach is just as typical for the famine-stricken sub-Saharan regions as for countries with extensive food aid programmes (e.g. Egypt, Mexico). The immediate effects are a general drop in agricultural production due to a lack of, or substantially reduced, profitability and an increase in smuggling and black-market activities (e.g. in West African states) accompanied by a corresponding deterioration in the food supply situation of the population as a whole.¹¹

Measures taken by marketing institutions cause similarly unwelcome effects.¹² Initially, these institutions were primarily established to stabilise the appreciable price fluctuations of agricultural export products. Furthermore, the revenue resulting from the difference between the producer price paid by these marketing organisations and the export price (less storage costs, transportation costs etc.) was supposed to finance horizontal and vertical diversification measures inside and outside the agricultural sector. In the meantime, however, these organisations have generally degenerated into mere government taxation institutions whose often extremely high levies are probably a major reason for the decrease in agricultural production in developing countries.¹³

This applies to an even greater degree if, apart from the export taxes and duties imposed for budgetary reasons, sectoral taxes which lead to an even further reduction in the producers' revenue share of the already low domestic price also have to be paid.

Admittedly, it is often attempted to support the agricultural sector via sector-related promotion measures. The effects of the inputs generally subsidised, however, are by and large overrated.¹⁴ The widespread overvaluation of exchange rates already more than offsets such "promotional" effects. This also applies to moderate increases in producer prices if the remaining sources of discrimination are neglected.

Project Policy Shortcomings

The above inadequate coordination between macroeconomic and sectoral policies can also be seen at project level, where the overall economic setting and

the characteristic features of specific sectors are not adequately taken into account. In the planning and implementation of projects, which are generally intended to play a key role in the process of development, priority is on the whole given to financial aspects which solely relate to the project in question. In some cases attempts are made to include overall economic aspects by means of a cost-benefit analysis. On the whole, however, there is no comprehensive analysis of general economic conditions and the links between macroeconomic and sectoral policies due to the considerable effort involved.

Distortions and discrimination, therefore, can only in rare cases be eliminated via project policies. On the contrary, the false signals emitted by macroeconomic and sectoral policies are generally picked up at project policy level. This leads to even greater discrimination. There are numerous practical examples in this respect.

Project policies in isolation, therefore, are not sufficient to enable an improved utilisation of the productive resources of developing countries and eliminate existing discrimination. To achieve this, they would have to become an integral part of a consistent development policy coordinated at all levels.

Against the background of previous experience it seems essential not to pursue "structural change at all costs" in order to make better use of existing growth opportunities, but to utilise specific sectoral production advantages in an optimum manner. The following underlying principles can generally be assumed:

- ☐ In the majority of developing countries agricultural production is of key importance, both with regard to the provision of domestic supply as well as for achieving export revenue.
- ☐ The transfer of resources from the agricultural sector to the other sectors of the economy is an important prerequisite for growth.
- ☐ During the course of an economy's growth there is generally a long-term drop in the share of the agricultural sector in GNP.
- ☐ The extent of the intersectoral transfer of resources must be based on economic criteria. It is most easily effected via growing productivity in the agricultural sector. A cutback in production and a reduction in activities on political grounds is counter-productive.

¹¹ Cf. M. Lipton: *Why Poor People Stay Poor*, London 1976, pp. 307 ff.

¹² Cf. World Bank (II): *Thailand, Pricing and Marketing Policy for Intensification of Pnce Agriculture*, World Bank Country Study, Washington D.C. 1985; S. Singh, L. Squire, J. Kirchner: *Agricultural Pricing and Marketing Policies in an African Context: A Framework for Analysis*, World Bank Staff Working Papers 737, Washington D.C. 1985.

¹³ Cf. K. Fertig, D. Kebschull: *Auswirkungen von Eigenanstrengungen auf den Entwicklungsprozeß*, Federal Ministry of Economic Cooperation Research Reports, Vol. 70, Munich, Cologne, London 1985, pp. 37 ff.

¹⁴ Cf. D. K. Meilke, T. K. Warley: *Agricultural Protectionism in the Developing World*, Washington D.C. 1986

□ The declining long-term price trends for most agricultural products generally result from the substantial productivity gains connected with technological improvements. These trends are not an indicator of reduced investment profitability and hence of a greater diversion of public and private resources towards industry.

□ The actual response of farmers to price changes shows that there is a high short and long-term price elasticity of supply in the agricultural sector. At present, however, the ability to respond is frequently impaired by very low producer prices and widespread discriminatory practices.

Elimination of Discrimination

The main task of a growth-orientated development policy based primarily on internal resources is to eliminate the discrimination against the agricultural sector and to create equal competitive conditions.¹⁵ This implies a strengthening of the coordinating mechanisms of the market economy and the abandonment of economically unjustifiable government intervention.¹⁶

□ In this context top priority should be given to straightening out the distorted price system. Protectionism for the – allegedly import-substituting – industries must be dropped. Infant industries should at most be protected for a limited period.

□ The adjustment of prices should not, of course, be limited to domestic prices, but should also relate to foreign trade and thus exchange rates.

□ The price of capital must correspond to scarcity relationships, thus preventing a false substitution of capital for labour. A considerable mobilisation of domestic capital can be expected via corresponding interest rates, which would facilitate the elimination of credit rationing.

□ The situation can also be improved by taking the economy's actual performance capacity as a yardstick for the extent of taxes and duties instead of the planning targets for future spending. A more fundamental look should be taken here at which tasks the government should perform, where they could be stretched out over a longer period and in which cases private institutions should be considered for their implementation.

The key aspects of a reform of sectoral policies in the agricultural sector are corrective measures in the field of internal price relationships, a better functional

classification of the marketing boards, and the reorganisation of sectoral taxation:

□ As regards the price system, the main task should be to eliminate the generally very low level of food prices in order to provide renewed incentives to production and to make production in the corresponding branches profitable to begin with.

□ The manipulation of prices in the case of cash crops, which is frequently carried out with the aim of ensuring food self-sufficiency should also be examined. Above all, this practice cannot be justified if it prevents exports and if, at the same time, cheap food imports are available.

□ There is a particularly urgent need for the elimination of tariffs and duties on exports. Although these may provide government revenue in the short term the long-term result is a substantial fall in exports and thus a reduction in the scope for expansion.

The demands to be made of project policies in order to achieve the objective of an improved utilisation of agricultural potential should primarily consist of:

□ coordinating project policy objectives and measures with macroeconomic, sectoral and regional policy measures. It is hardly realistic to try and achieve a change in the overall economic setting via the generally selective project policy approach;

□ primarily concentrating on activities which enable an increase in productivity via the systematic utilisation of research and development findings and the introduction of broadly-based technological improvements;

□ finding institutional solutions which match economic policy objectives, have clearly delineated areas of responsibility, and prevent the additional costs associated with a further increase in the size of the government's bureaucratic apparatus;

□ strengthening the directly productive sphere via direct cooperation with the farmers instead of setting up planning authorities, marketing institutions, distribution systems or national extension services.

Even if it is only effected within a national framework such a reorientation of agricultural policy in Third World countries can bring about substantial increases in productivity and growth. However, this policy reform can only be really successful if it is accompanied by an elimination of the highly protectionist agricultural policies of the industrialised countries, which in many cases impair competitive production in developing countries. The demand for a reform of these anachronistic policies cannot be repeated often and emphatically enough.

¹⁵ Cf. V. Thomas: *Linking Macroeconomic and Agricultural Policies for Adjustment with Growth*, Baltimore 1985.

¹⁶ Cf. K. Fertig, D. Kebschull, *op. cit.*, pp. 361 ff.