Module 2.
Identifying Potentials, Constraints and Policy Issues
Questions in Module 2

- How to identify agricultural potential?
- Where does comparative advantage come into the picture?
- How can policies facilitate the fulfillment of a country’s potentials?
- How can growth constraints be identified?
- What is the government’s role in agricultural development?
- What are roles of fiscal expenditures?
- What are criteria for making policy choices?
A successful agricultural strategy is based in part on careful identification of the sector’s main areas of potential and of the constraints that need to be overcome in order to realize the potential.
Identifying potentials
Small countries need to export more in order to grow rapidly

Developing-country exports are usually labor-intensive and therefore their promotion helps create employment and reduce poverty. These are important potentials.
How do we know a given product can be competitive in export markets?

International market prices at a country’s border (fob prices) represent useful reference points for evaluating competitiveness by comparing them with domestic costs of production, appropriately adjusted for processing, marketing and transport costs.

However, the comparison may need to be adjusted for differences in quality.
Every country has comparative advantage in some products or services.

Comparative advantage lies in those products or services that are produced relatively more efficiently, even if all are inefficient by world standards.

The challenge for policy and for the private sector is to turn comparative advantage into competitive advantage.
Comparative advantage in numbers

- Suppose the world price of all items is 20, for simplicity.
- Suppose the country’s cost of production is higher than 20 for all items.
- The country would have comparative advantage most in item 1, then in item 2.
Creating competitive advantage through broad policies

- Suppose policy could reduce the cost of marketed production of all items, say by 6 units. Perhaps this could be done by investing in improved port and road facilities.
- Then item 1 would become COMPETITIVE.
Creating competitive advantage through specific policies

- Suppose the country focuses research and extension and marketing support on items 1 and 2, reducing their costs of production.
- These items acquire COMPETITIVE ADVANTAGE.
Comparative advantage is dynamic. It can change rapidly, because of both external and internal factors.

Mexican cotton disappeared because of increasing costs of pest control.

Costa Rican pineapple gained markets because of technology and marketing support.

Colombian coffee is dropping because of lower cost production in Vietnam and Brazil.
Maintaining comparative advantage requires:

- Continuous adaptation of technology, seeking improvements in yields, reduction in costs, and improvements in quality.
- Continuous contact with markets to perceive rapidly changes in market preferences and requirements.
- Integration of the value chain of production, post-harvest handling, transport, marketing.
- Continuous improvements in public infrastructure, institutions and policies that support production.
Comparative advantage exists not only by product but also with respect to market locations.

For example, East Africa would have a comparative advantage to some extent in serving markets in the Middle East and other parts of Africa.
Other ways to determine products with potential:

- Products with a high value to weight ratio, given the high costs of transport.
- Products in which the country was a major exporter in the past.
- Consensus of the *private sector*: producers, processors, marketing agents.
- Products with proven potential (on the basis of experience of some producers) for significant increases in yields and quality.
A cautionary note:

The fact that a product is imported in significant quantities, and also is produced within the country, does not necessarily mean it has potential to replace the imports. It could be a product in which the country is very far from a comparative advantage.
Policies for realizing potentials
Policies to encourage comparative advantage

- Provide farmers more secure access to productive assets (land, water).
- Develop an integrated export marketing strategy and measures to facilitate exports (case of cold storage in Jordan).
- Train farmers in market requirements, quality issues, the value of sales contracts.
- Make research relevant to farmers’ needs and to products with comparative advantage.
Policies to encourage comparative advantage, continued

- Strengthen mechanisms of rural finance.
- Improve marketing infrastructure, including rural roads, ports and airports, and improve the cold storage chain.
- Link producers to processors and exporters (e.g., contract farming).
- Develop internationally-recognized product certification and food safety systems, including traceability.
Policies to encourage comparative advantage, in broad policy areas

- Make effective economic protection rates as uniform as possible across products, so comparative advantage can guide the selection of products for future growth.
- Simplify regulatory regimes, especially for investing, exporting, business start-ups.
- Assist farmers, including women, with farmer organization for marketing.
Identifying constraints to be overcome
The purposes of identifying constraints are: 1) to be able to overcome them quickly and efficiently, and therefore 2) to move toward creating an enabling environment for agricultural development.
Constraints can be identified through a structured series of questions in each policy area, arising from international experiences.

A “no” answer to one of the following questions indicates the likelihood of a constraint in that area.
Have the trends in real agricultural prices been satisfactory in recent years?

Have been the trends in costs of production vs. border prices (import and export prices) been satisfactory?

Is the exchange rate in market equilibrium? (Not applicable in crises.)

Does government refrain from intervening in product markets and controlling prices?
Constraints: questions to ask about human capital

- Are farmer organizations effective, especially for purposes of irrigation management and product marketing?
- Is there sufficient training of farmers in issues of quality control?
- Is there sufficient training in areas of farm management and marketing?
- Is agricultural research carried out with significant farmer participation?
Constraints: questions to ask about physical capital

- Are poor rural families able to gain secure access to farm land?
- Do farmers in general have long-term (≥50 years) security of land tenure?
- Are soil erosion and deforestation being controlled adequately?
- Are possibilities for irrigation (with surface water and groundwater) developed appropriately?
Constraints: questions to ask about infrastructure

- Is the farm-to-market road system adequate?
- Is the electricity supply sufficient and reliable in most producing areas?
- Are there sufficient facilities for drying, sorting and packing products, and for cold storage?
- Are the port and airport facilities adequate for agricultural shipments?
Constraints: questions to ask about the institutional environment

- Do rural credit institutions function well from a farmer viewpoint, and are they viable in the sense of not being decapitalized over time and being well managed from a financial viewpoint?

- Are research and extension services responsive to farmers’ priorities, and to small farmers have sufficient access to extension advice?
When the answer to these questions is “no,” the existing policies and programs should be re-examined so that in the future the answer can be “yes” to as many questions as possible. Agricultural development requires actions on multiple fronts.
Roles of government in agriculture
In a market economy the role of the government is complex

- It sets fair and transparent rules of the game and enforces them.
- It provides special assistance to bring the poor and marginalized into the ambit of economic development.
- It provides economic leadership and programs to catalyze the sector.
- It facilitates private sector growth.
A government also provides public goods (infrastructure, some kinds of agricultural research, etc.) in which the private sector would under-invest or not provide (e.g., land registries).

It ensures other vital productive services are available, from the private sector or if necessary from the public sector.

It provides assistance for emergencies.

It mediates conflicts over natural resources and other issues.
Fair and transparent rules of the game

- Secure property use rights and clear rules for access to property (land, water, forests).
- Informative guidelines for contracts (land rental, exchange of water use rights, sale of products, borrowing capital) and swift and impartial enforcement of contracts.
- Clear system of weights, measures and standards in product markets.
Help for the poor and marginalized

- Targeted subsidies for access to land, water, inputs and extension advice.
- Targeted programs of micro-credit, irrigation.
- Participatory agricultural research.
- Seed capital grants for livestock, tree crops and inputs.
- Assistance in farmer organization.
- Training in marketing.
- Payments for natural resource management.
Economic leadership and facilitation

- Fundación Chile created State companies for new technologies and products, launched them and then sold them to the private sector.

- In Peru competitive grants have been awarded to groups of small farmers for entering new markets.

- Seals of quality assurance can be provided, or support programs provided for them, for products sold in foreign markets.
Economic facilitation, continued

- Competitive grants are given for agricultural research by academic institutions, farmer organizations, NGOs and the private sector.
- Competitive grants are also awarded to co-finance small irrigation systems built by farmer groups and NGOs.
- Simplifying bureaucratic regulations helps the private sector.
- Helping train and organize farmers facilitates private initiatives.
Fiscal expenditures in agriculture
Arguments for generalized support for agriculture

- Agriculture provides social benefits (an externality) through poverty reduction.
- Agricultural growth reduces rural-urban migration and its associated economic and social costs – another externality.
- Agriculture’s strong multiplier effects on the economy are yet another externality.
- International agricultural prices are subsidized by industrial nations and these subsidies need to be compensated.
Implicit and explicit subsidies

Explicit subsidies involve expenditures of government funds (fiscal outlays). Implicit subsidies are created by government regulations or allocations of rights. They generate additional sources of income for their recipients that are called economic rents.
Common explicit subsidies

- Expenditure on irrigation systems, whose costs are rarely recovered.
- Payments for reforestation.
- Interest rates on government loans that are below market rates.
- Provision of research and extension services at below cost.
- Grants of access to State-owned farmland without charging fees or at fees below the land’s opportunity cost.
Some explicit subsidies are justified on grounds of:

- Environmental externalities (reforestation).
- Or economic externalities (agricultural research).
- Or that beneficiaries cannot pay full cost (irrigation systems, land access) but that society benefits from the poverty reduction and multiplier effects.
However, other subsidies may inhibit the creation of more efficient private services.

Example: provision of credit at artificially low interest rates. It decapitalizes lending institutions and undermines the development of viable private financial institutions.
Another example of a counterproductive subsidy

- Sale of agricultural inputs at below-market prices. This inhibits development of a private input distribution system, which is more sustainable than the public subsidies.

- The dilemma is how to create purchasing power for inputs among poor farmers, which creates a market for agro-dealers. Ditto for providers of private extension services.
Common implicit subsidies

- Higher-than-usual import tariffs for some items.
- Lower-than-usual or zero tariffs on some items (which can be an implicit tax on competing domestic producers).
- Weak efforts at agricultural loan recovery.
- Price controls (which can be implicit taxes or subsidies).
Arguments against subsidies

- They tend to be given to the least competitive sub-sectors or products.
- Once established, they are hard to eliminate.
- They are costly to the Treasury (including implicit subsidies).
- They encourage producers to seek subsidies rather than improve productivity (rent-seeking behavior).
- They undermine the development of sustainable institutions and markets.
Arguments for subsidies

- They are important for poverty alleviation.
- They may be justified by the benefits of environmental and economic externalities.
- They can facilitate a transition to a less-subsidized policy.
- They are needed during emergencies.
- They can compensate for imperfect information and other kinds of market failure.
The balance of arguments about subsidies depends on the circumstance, but cases should be avoided where the “against” arguments have strong weight.
Making policy choices
Classical economic analysis of consumer and producer surplus is of limited use for making policy choices.

In most cases the available information does not allow calculations of surpluses.

*Surplus analysis is static.* Surplus analysis does not take into account other objectives such as equity.
Some helpful steps for choosing among optional policies

- Define sub-objectives for the policy topic. Examples: 1) For extension, greater relevance to farmers’ real needs and access to extension by small farmers. 2) For rural credit, creating viable institutions and reaching more farmers with credit. These objectives can be constraints to overcome.

- Assess options for effectiveness in achieving these objectives, cost to the national budget, sustainability and administrative simplicity in implementation.
Helpful steps for choosing among optional policies, continued

- Review which options are more consistent with the five sustainability principles for agricultural policy.
- Review which options would place more initiative in the hands of farmers and other participants in the private sector.
- Review which options would most help the lowest-income rural families.
- Review which options would most enhance the role of rural women.
A complete Strategy or package of policies should include policies that:

- Help realize a country’s comparative advantage and therefore promote growth.
- Reward initiative and efficiency by producers (e.g., award grants for small irrigation to the best proposals; provide export marketing grants to producers who have the best ideas).
- Support a transition for producers who will be losing subsidies or competitiveness.
A complete Strategy or package of policies should include policies that:

- Reduce rural poverty and support rural women.
- Enjoy a consensus backing from producers.
- Are feasible fiscally when taken all together.
- Enhance the human capital in the sector.
- Improve natural resource management.
Above all, a strategy with multiple policies should represent national aspirations and national approaches to solutions.