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Peter Warr

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Subsidizing the Rich, Squeezing the Poor

By Peter Warr

Using protectionist trade policies to assist the rural poor is futile and misguided. It is important to find ways to help people trapped in poverty, but to do this through trade policy simply does not work.

TRYING TO PROTECT farmers ends up helping rich landowners and corporate processors of agricultural commodities at the expense of the poor, both rural and urban. There are other policies available to governments which really can assist rural people. I will describe some.

STRUCTURAL TRANSFORMATION AND RURAL POVERTY

First, I must set out some economic background. As economies grow, agriculture's share of national output shrinks. The process is inexorable - the faster the growth, the faster this realignment of the economy.¹ A central reason for the structural change, though not the only one, lies on the demand side. As people become richer they spend a smaller proportion of their income on food and an increasing proportion on manufactured goods and services. Although this produces problems, it is important to recognize that the combined process of growth and structural transformation raises average incomes and generates a better life for the vast majority of people.

As a consequence, the share of agricultural employment in the total workforce also contracts, as agricultural workers and farmers leave the countryside for better opportunities elsewhere. But the relocation of workers occurs more slowly than the change in the composition of national output. In rapidly growing Asia, this is reflected in the fact that agriculture constitutes a declining proportion of national income, but a much higher proportion of total employment. In Thailand, for example, agriculture's share of GDP is currently about 10 per cent while its share of employment is at least three times that.

This disparity between the changing structure of output and the resulting readjustment of employment has an obvious consequence. Incomes in agriculture are lower than incomes

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1 For more on this, see C. Peter Timmer, "The agricultural transformation", in: H. Chenery and T.N. Srinivasan, eds., *Handbook of Development Economics*, Vol. I (North-Holland, Amsterdam, 1988), 275-331

2 Peter Warr, 'Food Policy and Poverty in Indonesia: A General Equilibrium Analysis', *Australian Journal of Agricultural and Resource Economics*, Vol. 49, No. 4, (December 2005), 429-451

elsewhere. People don't leave the declining sector, agriculture, quickly enough to avoid the outcome that income per person in agriculture declines relative to income in manufacturing and services. At any one time, there are just too many farmers. The outcome is genuine economic hardship for rural people. Low average agricultural income is the brutal mechanism by which a market economy compels rural people to look for opportunities outside farming.

The more slowly people leave agriculture compared with the overall rate of economic growth, the worse this impoverishment becomes. In Thailand again, according to the official poverty measure, 93 per cent of all poor people reside in rural areas. This is a feature of all rapidly growing economies with substantial rural populations. In China today, it is a tremendous social problem. In the long run, this process sorts itself out, as the rural population gradually declines. But as John Maynard Keynes pointed out, in the long run we are all dead. One might add that truly poor people will be dead sooner than others. In the meantime, millions of people, trapped in rural poverty, continue to suffer. How can they best be assisted?

PROTECTION BENEFITS LARGE LANDOWNERS

In food importing countries it might seem natural to blame imported agricultural products for the rural malaise. Restricting these imports through protectionist trade policies seems sensible. This misunderstands the main cause of rural poverty. But more to the point, it doesn't work.

Recent events in Indonesia illustrate my central argument. Indonesia is a staple food importing country. Rice, by far the most important food source, was a major import until 2000 and Indonesia was the world's largest rice importer. But in that year, imports were banned. The ban

remains in place today, despite some smuggling and occasional exemptions apparently granted to influential importers.

The import ban was advocated by the Indonesian Ministry of Agriculture and *Bulog*, a government institution charged with managing food policy. These agencies claimed that the import ban would assist poor farmers by raising the price of rice. A heavy import tariff had originally been proposed, but it was opposed by the Ministry of Finance. Since a tariff is a form of tax, the Ministry of Finance has the power to veto it. But a ban is not subject to Ministry of Finance approval. Since the ban was imposed, rice prices have indeed increased, relative to other prices, by at least 35 per cent.

Before proceeding with this Indonesian example, a little economic theory is helpful. An import tariff – a tax on imports – may be understood as having two components. First, it is a tax on domestic consumption and second it is a subsidy for domestic production. Under an *ad valorem* tariff, a proportional tax on the value of imports, the rates of the consumption tax and production subsidy are the same, the rate of the tariff. By definition, consumption exceeds production for any imported commodity and this means that the tariff raises government revenue because the implicit consumption tax *exceeds* the revenue spent on the implicit production subsidy.

An import quota sets a limit on the amount of permitted imports. Its effect is similar to a tariff except that the revenue accrues not to the government but to private individuals who are granted quota licenses – the right to import specified quantities of a commodity. Because the quota raises the domestic price well above the import price, quota licenses can be extremely valuable. It need hardly be added that there is great scope for corruption in this system. An im-

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port ban is the extreme form of a quota, where the permitted quantity is zero, except for any “exemptions” granted to particular individuals – the chances for corruption is obvious in the granting of these lucrative exemptions.

It is convenient to think of an import quota or an import ban in terms of its tariff equivalent – a combined production subsidy and consumption tax. My point is that in the case of agricultural commodities the beneficiaries of the production subsidy are mainly large producers, whereas the burden of the consumption tax falls mainly on poor consumers. Whether the protection occurs through a tariff, a quota or an import ban, it is a transfer from poor consumers to rich producers. How could that help the poor?

In a recent study, I tried to analyze the economic effects of Indonesia’s rice import ban using a detailed general equilibrium model of the Indonesian economy.² I treated the policy as a 90% reduction in the quantity of imports before the ban, in the year 2000. This kind of modeling is useful because a ban on rice imports affects the distribution of income in complicated ways that are difficult to track without an economic model. First, it affects the prices people pay for

consumer goods, especially the rice subject to protection. Second, it may affect incomes if the economic adjustments it spurs affect returns from production inputs that people own, especially their labor and land. Finally, it may affect government revenue and thereby the capacity of the government to fund the services that people need. The model takes explicit account of the how rural and urban people in different income categories earn money and how they spend their incomes on goods and services.

The analysis finds that large landowners are the only major socio-economic group to benefit significantly from the import ban, whether they reside in rural or urban areas. Small farmers, landless rural workers and the urban poor either gain next to nothing or lose heavily. The incidence of poverty actually increases by about 1% of the population as a result of the ban. The reason that rich farmers gain the most is elementary. The benefit a producer obtains from a price increase depends on the amount of produce he has to sell. The larger the output, the larger is the benefit. Most of the benefit goes to large producers who own the most land.

Smallholders both produce and consume rice. Truly small farmers grow staple crops mainly for their own consumption. Their marketed output may be quite small or nil and they receive correspondingly little or no net benefit from a price increase. This point has one clear implication – if the government really wants to help poor farmers, a policy which operates through the prices of agricultural products is a very blunt instrument indeed.

Landless employees of rice farmers only lose. They receive no direct benefit from the price increase unless their wages increase as a result. According to my analysis, their wages do not rise because the market for unskilled labor is so

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competitive. But the price of the rice they eat goes up and their real income falls. The same outcome applies to poor urban consumers.

PROTECTION BENEFITS AGRICULTURAL PROCESSORS, TOO

It is obvious that rich landowners benefit from a price increase. But large-scale food processors benefit as well. Indeed, protection is even more of a boon for rice millers than large farmers. The rice sold by farmers, large or small, is unmilled rice – raw paddy. Protection policy raises the price of imported rice, which is already milled. Paddy is not traded internationally at all. The prices of imported milled rice and paddy are linked, but only loosely. An increase in the price of imported milled rice raises the domestic wholesale price of milled rice. The two are not necessarily perfect substitutes, so the price of imported milled rice may increase somewhat more than the derived effect on the price of domestically produced milled rice.

Rising prices for domestically produced milled rice benefits millers directly. The subsequent effect on the price of paddy is a derived effect. The price of paddy is dragged upwards by the greater demand from rice milling, which is now much more profitable than before. But the price of paddy can be expected to rise proportionately less than the price of milled rice. The difference is a windfall gain to millers. It can be very large.

An Indonesian academic colleague once described a meeting he was asked to attend at the Ministry of Agriculture when the rice import ban was under consideration. He represented the group opposing the ban and spent most of

his allotted time talking about the harmful effect the ban would have on poor consumers. The representative of “farmers” was a business consultant who is often engaged by large rice millers. He spent his time arguing passionately for a rice import ban to help poor farmers. He characterized opponents of the ban as “heartless” and “unpatriotic.” After the meeting, as my colleague made his way back to his aging Toyota to drive home, the “farmers” representative whizzed by in a late-model Mercedes Benz.

FOOD “SECURITY” AND THE POOR

The reference to patriotism is important in the Indonesian context, as in several other Asian food importers. It draws attention to another motive for agricultural protection that has nothing to do with assisting farmers, rich or poor. Indonesia’s policy makers have long sought “food security,” meaning less dependence on imports. This objective is closely linked to Indonesian nationalism, hence the link to “patriotism.” Food security is seldom mentioned in food exporting countries like Thailand, but net food importers like Indonesia, Laos, South Korea and Japan, regularly offer security as a reason for restricting imports.

The point is that what politicians understand by “food security” – reduced imports – is achieved through protection policy only by *raising* the price of food. This price increase reduces imports – the difference between consumption and production – because it induces a reduction in consumption and an increase in domestic production. The effect is mainly on the former because the supply response of domestic staple food production to a price increase is known to be quite small. A price

³ For a good discussion of the Thai case, see Ammar Siamwalla and Suthad Setboonsarng 'Thailand', in A.O. Krueger, M. Schiff and A. Valdes (eds) *The Political Economy of Agricultural Pricing Policy: Vol.2, Asia*, (Baltimore: John Hopkins University Press, 1991)

increase reduces imports mainly by reducing consumption. This translates into *less*, not more, food security for millions of poor people.

The effect of a food price increase is concentrated on poor, rather than rich, consumers. As income rises, the proportion spent on staple foods declines. The poorest people may spend half or more of their income on staple foods alone. For the rich, the proportion is a small fraction of that. When prices rise, rich consumers can afford to maintain their consumption levels. The poor do not have this luxury because staple foods are a major expenditure. As the price rises, they *must* contract their food consumption correspondingly because the original pattern of consumption is no longer affordable. The protection of agriculture can mean hunger for large numbers of poor people.

PROTECTION FOR SUGAR

Throughout Asian agriculture, one commodity stands out as a recipient of high levels of protection – sugar. Whether we look at the Philippines, Indonesia, Vietnam or Thailand, sugar receives special treatment. Why? The answer is not that protection helps small farmers. On the contrary, production of sugar cane often, but not always, involves large-scale plantation operations linked to enormous sugar millers. The answer lies in the economics of sugar milling, a manufacturing activity, not in farm-level production of sugar cane. Sugar cane grown by farmers is not traded internationally because it is perishable and bulky. The cane must be crushed and processed within a few days of cutting.

Sugar milling is a highly capital-intensive and large-scale business and due to the technology of sugar milling, mill ownership tends to be concentrated. Moreover, the huge investment in equipment can be recouped only if the mill is used

around the clock during cane-cutting season and this requires careful scheduling of the highly perishable crop. To maintain a timely supply of cane, large millers often form close contractual arrangements with sugar farmers – the larger the better. This concentrated ownership structure makes sugar millers and the associated large producers a formidable lobbying force.

High levels of protection for processed sugar is the outcome, both in countries where sugar is a net import, like Indonesia, and even countries where it is a net export, like Thailand.³ The raw material, sugar cane, is a small proportion of the costs of the sugar millers. Protection of the processed commodity, refined or semi-refined sugar, has only a muted effect on the price of the sugar cane actually produced by farmers. Millers are the true beneficiaries. Protection of sugar is ubiquitous throughout Asia. This protection means that consumers, rich and poor alike, pay for the subsidization of large, corporate sugar millers and large sugar growers, not for assistance to poor farmers.

WHAT DOES WORK?

What policies, if any, do assist poor rural people? Effective policies exist, but they are not cheap. The over-riding point is that the process of structural change with which I began this essay must be recognized. To resist it, and to attempt to hold people in agricultural production, is to condemn large numbers of rural people to protracted economic hardship. Asia has too many farmers. Rural people, especially the young, must be assisted in finding better opportunities outside agriculture, and for many this means leaving rural areas altogether. Education policy is the key. If young rural people do not receive a quality education, they will be condemned to life at the bottom of the economic ladder. Sadly, throughout Asia, ru-

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4 For a detailed discussion in the context of Thailand, see Sirilaksana Khoman 'Education: The Key to Long-term Recovery', in Peter Warr (ed.) *Thailand Beyond the Crisis* (London: Routledge 2005), 251-284

5 The classic study on this subject is still Theodore W. Schultz, *Transforming Traditional Agriculture* (New Haven: Yale University Press, 1964)

6 I have discussed these issues more fully in Peter Warr, 'The Failure of Myanmar's Agricultural Policies', *Southeast Asian Affairs 2000* (Singapore: Institute of Southeast Asian Studies, 2000), 219-238

ral education is of poor quality and is given few resources. It is not surprising that the drop-out rates in rural schools are high, especially at the secondary level. Because it is of poor quality, the education provided in rural secondary schools is seen to be of limited value.⁴

Recently released data from Thailand show clearly the relationship between poverty and education. According to the National Economic and Social Development Board, of the total number of poor people in 2002, 94.7 per cent had received only primary education or less. A further 2.8 per cent had lower secondary education, 1.7 per cent had upper secondary, 0.48 per cent had vocational qualifications and 0.31 per cent had graduated from universities. Thailand's poor are overwhelmingly uneducated. They also tend to be rural and living in large families. But they are not necessarily landless.

A further policy direction is to raise the low levels of agricultural productivity.⁵ This means investing in agricultural research, which is badly under-funded throughout Asia; improved water management; and plant and animal disease mitigation. In some poorer countries of Asia, inadequate basic rural infrastructure, especially roads, is a serious impediment to raising productivity. Laos and Cambodia are good examples. In the sad case of Myanmar, these failings are compounded by the continued suppression of rural markets and the prohibitive taxation of agricultural exports, blocking any chance of raising agricultural productivity through market-based development.⁶

The use of agricultural trade policy to "protect" poor rural people is futile. Other special interests, especially large landowners and agricultural processors, are the true beneficiaries. These groups are often behind the lobbyists actually pressing for protection, cynically using assistance

In the long run, this process sorts itself out, as the rural population gradually declines. But as John Maynard Keynes pointed out, in the long run we are all dead.

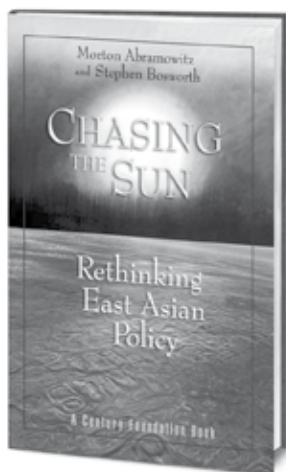
One might add that truly poor people will be dead sooner than others.

In the meantime, millions of people, trapped in rural poverty, continue to suffer. How can they best be assisted?

to poor farmers as a smoke-screen for policies designed to benefit themselves and which actually harm the poor, rural and urban. Well-meaning non-governmental organizations all too often play into their hands, albeit unwittingly. They need to think both harder and smarter.

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