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AFRICA BUREAU POLICY ON AGRICULTURAL INPUT SUBSIDIES

Contents

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Preface

Because of the complex and controversial nature of agricultural input subsidies as development tools, this topic was examined at the AA/AFR's Issues and Answers Session on September 17, 1981. At that time, Tridib Mukherjee, Regional Agricultural Economist, REDSO/WA, discussed his paper entitled, "Agricultural Input Subsidies in Developing Countries: The Case of Niger."

In follow-up to this presentation, Donald Brown, AFR/DR/ARD, prepared a Discussion Paper in which he examined difficulties in the use of subsidies as a development tool, as well as conditions under which subsidios are more likely to be successful. That paper was then circulated to missions in Africa for comments. This policy paper, prepared by Don Brown and Tom Zalla, is a revision of the discussion paper and incorporates some reactions of field personnel and other AFR/DR/ARD staff members. References have not been cited even though many parts of this paper have been lifted verbatim from cable replies.

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I. Introduction

More than many developmental questions concerning less developed countries in Africa, the issue of agricultural input subsidies reveals conflicts between economic principles and political realities on the one hand, and between optimal and second-best solutions to those conflicts on the other. There is a clear need to consider input subsidies in the context of overall agricultural and industrial policies as these impact on output prices as well as on input prices. Under certain specific conditions agricultural input subsidy programs can be an important element in a country's efforts to increase agricultural production and national income, though these conditions are probably not as pervasive as most African governments would like to believe. In the final analysis subsidies are undesirable, regardless of economic and political justification, if they are detrimental to national growth and development.

For policy purposes we need to distinguish between subsidies on marketing services and purchased inputs, those on publicly provided services which a farmer does not normally control such as research and extension, and those on credit. Few would agree with the difficulty of measuring the impact of research and extension in general and of creating mechanisms that internalize these costs to users in African countries. The fact that all consumers benefit from these programs has served as justification for continuing to cover this cost largely from the public treasury. This will, no doubt, continue to be the case until such time as private sector research and input supply firms become more prevalent.

Subsidies on the cost of credit are often intermingled with those on purchased inputs, but it would be more useful to separate the two. Available evidence is quite convincing that the cost of credit is not a major constraint on the adoption or use of new inputs in Africa. Rather, credit subsidies disrupt rural financial markets and discourage mobilization of rural savings for agricultural investments. Removing subsidies on credit will give clearer economic signals to farmers concerning the cost and returns of selected purchased inputs. Appropriate levels of subsidy on purchased inputs can then promote more efficient use of those inputs.

II. Justification for Agricultural Subsidies

Arguments for agricultural subsidies usually contain one or more of the following basic premises:

- Subsidies on agricultural inputs are important instruments by which developing countries can influence the behavior of poor, small-scale farmers, inducing them to use selected inputs or new technological practices at a level that is economic. Part of this argument relates to offsetting unrealistic perceptions of risk related to undertaking new technological practices; part to the need to offset disincentives to the economic use of inputs resulting from taxing, trade and pricing policies; and part relates to the perceived tendency of African peasant farmers to use fully costed cash inputs at sub-optimal levels. This latter phenomenon appears to arise from a substantial divergence between the social discount rate facing rural farmers and that which is appropriate for public sector investments. Without subsidies, it is argued that poor farmers either would not or could not purchase the inputs necessary to make the new technologies work, or would use them at a sub-optimal level.

- Subsidies are required to transfer income from the relatively wealthy urban population to the rural population. These shifts are required in order to increase equity between urban and rural areas in the context of a wide range of public policies which cause a persistent drain of rural surpluses to urban areas.

- Subsidies are necessary to keep food prices and/or other prices low. Without subsidies, food prices would have to be raised, causing potential political instability and reducing the availability of food to the poor.

- Subsidies should be used to adjust for other necessary economic inequalities in the system, such as taxes on the agricultural sector or a low food price policy.

III. Criticisms of Agricultural Subsidies

Under actual conditions in many African countries agricultural input subsidies have been found to be relatively weak instruments for increasing agricultural production because other elements needed to increase crop production are often limited or lacking. For example, many African countries have few proven technological packages, weak distribution systems for inputs, poor pricing policies, unreliable markets, limited farmer knowledge and an overriding influence on production of highly variable weather conditions. Agricultural input subsidies can do very little to increase production unless these other production problems are being solved or circumvented. The real problem retarding advances in agricultural production in much of Africa stems from the added economic costs of new techniques when weighed against the continuing possibility of crop failure due to weather and other factors against which the new technique offers no sure protection. It may be better to insure farmers against losses rather than subsidize inputs in order to promote adoption.

A major problem with subsidies is that they often hide key policy, institutional and infrastructural problems that are causing the production problem which the subsidies are intended to address. In addition, they distort market prices and thereby remove an important source of discipline for encouraging economically viable production practices. Too often subsidized production practices would not be economically viable in the absence of subsidies. Moreover, the fiscal burden of subsidy programs can become overwhelming in the weak economies of many of the poorer African countries. Limitation of funds has led to allocation problems (who gets the subsidies) which in turn have led to regulatory and administrative burdens on those trying to carry out the programs. Thus, subsidy programs can drain resources and energy away from efforts to deal with fundamental problems in the agricultural sector.

Studies on the income transfer effect of subsidies have shown that often the results are perverse; the powerful and well-to-do in the community gain the advantage over the poor producers whom the subsidy may have been intended to help. These perverse results occur because subsidized inputs are viewed as low cost inputs that can be diverted from the purpose for which they were intended into other profitable areas. The greater the subsidy, the more profitable the diversion from the private point of view. This has been found to be true for both cash credit subsidies and in-kind subsidies. Furthermore, the lack of discipline in repayment typical of many subsidized credit programs makes the resources provided even more enticing for diversion. To control such diversion the state often enacts regulations and controls. These partially offset the benefit of subsidies by increasing transaction costs, especially for small borrowers who have difficulty obtaining the subsidized input in the first place.

The argument that agricultural input subsidies are needed to adjust for economic inequalities between urban and rural areas has flaws as well. To the extent that the subsidies themselves, or the additional resources used to control the diversion of subsidized inputs, come from the rural sector itself through general tax revenues there is no net redistribution between urban and rural areas. You can't raise all incomes and lower all costs, yet this is often the intended sum of all the subsidies proposed for all the sectors taken together. Thus, adjustment by subsidies for other economic inequalities frequently doesn't work. In practice, the farmer usually is taxed more than he receives. In most cases this results from intentional public policy. The presence of agricultural input subsidies is often used to justify cheap food pricing, taxing and trade policies.

The argument for the use of subsidies on agricultural inputs to keep food prices low is a strong one politically but a weak one economically. The problem is that in many cases these subsidies do not result in increased production for the reasons noted above. Moreover agricultural input subsidies do not, in general, address the problem of lowering the real economic cost of food production. In many cases these programs have been found to raise the cost of production through encouragement of overly expensive technology, sophisticated animal traction or tractor mechanization packages being two cases in point. Finally, if the goal of policy makers is to lower real consumer food costs, there are other means more effective than subsidies on agricultural inputs. One of these could be a direct subsidy to consumers or an increase in the minimum wage.

IV. Reconsideration of Assumptions

Subsidies on agricultural inputs in Africa are, in general, low when compared to the subsidies on imported food supplies and other consumer subsidies. Reduction in the former without reducing the latter would be detrimental to the interests of farmers and may reduce rather than increase the economic allocation of resources in the nation as a whole. This does not detract from the fact that most countries would be better off economically, and in the long run, politically, if subsidies in both urban and rural sectors were reduced.

The assumption that agricultural input programs in developing countries must be based on subsidies should be reconsidered by African governments. Reconsideration will require that they clearly define the aim of subsidy programs in all sectors. In many cases, subsidized input programs do nothing more than carry out a price control policy in such a way that the supply of inputs available to farmers is reduced, thereby making the task of controlling output prices still more difficult. In addition, this type of subsidy program puts major fiscal burdens on the economy, and creates allocation problems leading to regulation and management difficulties.

Administratively, one must anticipate that there will be inefficiencies and diversions involved in subsidy programs. In many cases these will be substantial. Whether these costs are worth the benefits involved in a specific program needs to be determined on a case-by-case basis.

V. Conclusions

The agricultural input subsidy issue is both an economic and a political question - and a complex one at that. Nevertheless, subsidies are an important part of the dialogue we need to undertake with host countries in order to establish a policy atmosphere conducive to increased agricultural production.

AID is aware of the importance of the political aspects of this question to African governments and officials. Recent food riots and governmental coups attest to the sensitivity of this issue in the political climates of many countries where we work. This does not imply that AID should continue to fund inappropriate subsidy-related projects and programs, but it does indicate the need to look at the subsidy issue, not just from an economic point of view but from within a total social, economic and political context.

There are many instances where input subsidies can expand the economic use of inputs and the overall level of growth and development. There are, perhaps, even more instances where the opposite occurs. The implications and ramifications of subsidies vary from input to input, crop to crop and from one area in the same country to another, depending on existing policies in other sectors. Thus, each mission must develop its own policy according to the particular conditions of each host country.

To have a positive effect on increasing food production and agricultural productivity subsidy programs should aim at offsetting unrealistic perceptions of risk, overcoming other economic distortions, or promoting new techniques of production. To be successful, this type of subsidy program must meet three requirements.

First, the technical package being supported by the subsidy program must be viable at real market or social prices when this package is fully adopted.

Second, the subsidy program should not produce excessive demand for the subsidized input and thus create allocation problems. In other words, the institutional and infrastructural constraints to supplying an adequate quantity and quality of the input should be assured.

Third, the subsidy program should be phased so as to reduce the subsidy over a period of time to bring the price of the input up to either a free market level or to a level that is consistent with socially desirable levels of use of the input, in the event that this diverges from the free market level. Subsidy programs of this type have proved to be effective in increasing agricultural production and are worthy of our support.

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