POLICY BRIEF NO. 6

RICE FLOOR PRICE POLICY

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Executive Summary

1. Three changes in the current policy environment – a policy conflict, a macro crisis constraint, and an institutional limitation -- have caused the rice floor price policy to become unfeasible. Either the costs of rice procurement will become unrealistically high, draining government budgetary resources, or the floor price will not be defended successfully, disappointing rice farmers.
2. In September 1998 the government announced that traders in the private sector could import rice without restriction. If rice imports are permitted to flow freely into Indonesia, the price of rice on Indonesian markets will tend to be determined by movements in the world price of rice. Open imports of rice thus create a policy conflict with price stabilization of rice.
3. Before the macro-economic crisis, BULOG defended the rice floor price with a virtually unlimited line of credit. To support the floor price at the policy-chosen level, the food agency must have adequate financing to permit it to purchase all rice that is offered to it for sale. An integral part of the government's macro-economic adjustment program is to impose tight financial restraints on all government agencies. The macro crisis constraint – a financial limitation on BULOG's ability to procure rice – puts successful defense of the floor price in great jeopardy.
4. Currently, the floor price for rice is higher than the import price of rice. Since importers have an incentive to bring in imports for re-sale to BULOG at the higher floor price, there arises a potential for rent-seeking. Either private traders could mix the imported rice with domestic rice and then sell it to BULOG as if it were all domestic rice. Or DOLOG officials could agree illegally, for a side payment, to purchase the imported rice at the floor price.
5. The main purpose of the floor price is to provide insurance to rice farmers. In the 1970s and 1980s, this policy helped to overcome poorly working rural financial markets and induce farmers to adopt unfamiliar high-yielding rice varieties (HYVs). Insurance against abnormally low rice prices now is less critical because almost all of Indonesia's rice farmers have had long experience with HYVs and rural financial markets have begun to improve. In the absence of a floor price

policy for rice, the government could help to provide insurance to all farmers by improving the rural financial system.

6. The government of Indonesia would incur costs if it were to resolve its policy conflict by ending rice floor prices. Rice farmers would be forced to bear increased risks of downward rice price fluctuations, and they would have to forego the limited income gains associated with the floor price. However, rice farm incomes have tripled in the past thirty years, and the recent large depreciation in the Indonesian exchange rate has added to rice profitability. The substantially higher incomes in rice farming and gradual diversification into other high value crops have given rice farmers a greater ability to bear the adjustment costs of occasional downward price movements.
7. Three kinds of benefits would follow from a decision to resolve the policy conflict by ending the rice floor price policy. The first gain would be the budgetary savings from downsizing the food agency. The second benefit would be the removal of the potential opportunities for rent-seeking presented by the attempt to implement a floor price policy with open private imports of rice. These two specific gains would be furthered by any indirect gains that Indonesia might experience from boosts in international and domestic investor confidence associated with policy changes that increase efficiency in the economy. These benefits would greatly exceed the likely costs of ending the floor price policy.
8. Efforts to defend a rice floor price, therefore, should be abandoned, because the costs of trying to continue this once successful policy significantly outweigh its current benefits.

RICE FLOOR PRICE POLICY

During the past three decades, a central dimension of Indonesia's rice policy has been the defense of a government-set floor price for rice. The floor price has been established after a review by an inter-ministerial committee, usually in the October cabinet meeting, before the planting season for the main rice crop. That annual policy price then has been defended by the food agency (BULOG), which has purchased and stored all rice that farmers or traders wish to sell. The purpose of the floor price policy has been to guarantee a minimum price to rice farmers and thus to prevent their having to adjust to unexpectedly low rice prices.

As a result of the macro-economic crisis and associated policy changes, Indonesia currently is facing a new policy environment for rice. Unless several fundamental conflicts of policy can be resolved, the government will not be able to continue its policy of setting and defending a floor price for rice. Under existing conditions, that policy is inconsistent, unfeasible, and thus bound to fail. Either the costs of rice procurement will become unrealistically high, draining government budgetary resources, or the floor price will not be defended successfully, disappointing rice farmers. This policy brief addresses the elements of this policy conflict, the purposes and impact of the floor price policy, and the costs and benefits of ending this policy. It concludes that efforts to defend a rice floor price should be abandoned, because the costs of trying to continue this once successful policy significantly outweigh its current benefits.

The Current Environment for Rice Floor Price Policy

As a consequence of recent changes in the policy environment, the ability of the government to defend a rice floor price has been seriously eroded. Three changes – a policy conflict, a macro crisis constraint, and an institutional limitation -- have caused this policy to become unfeasible.

Policy Conflict: Private Sector Imports of Rice. In September 1998 the government announced that traders in the private sector could import rice without restriction, thereby ending BULOG's previous monopoly on rice imports. This policy change was made in the spirit of liberalizing foreign trade in accordance with agreements with the international donor community negotiated during the macro-economic crisis. It was intended both to satisfy IMF-related commitments and to bolster investor confidence in the Indonesian economy. The expectation was that the private sector could import rice more efficiently than BULOG and that open trade in rice would end the potential for rent-seeking that had existed under the government monopoly on rice imports.

These benefits from private importation of rice, however, come at the cost of the government's inability to carry out rice price stabilization, including defense of the floor price. A first principle of commodity price stabilization – including defense of a floor price -- is that the government food agency must be able to control imports. If rice imports are permitted to flow freely into Indonesia, the price of rice on Indonesian markets will tend to be determined by movements – upward or downward – in the world price of rice. In July, for example, BULOG procured over 500,000 tons of rice. Much of this amount must have been imported since July is not a month of primary rice harvest. In the extreme case, Indonesia could find itself in the impossible position of trying to set a floor under the world price of rice, thereby inadvertently serving as the food agency for all of Asia. Open imports of rice thus create a policy conflict with price stabilization of rice. The government must choose to have either one or the other. It is not feasible to do both at once.

Macro Crisis Constraint: Credit Restraints on BULOG. Before the macro-economic crisis, BULOG defended the rice floor price with a virtually unlimited line of credit. It is widely asserted that this financial independence was undesirable because it led to occasional abuses by BULOG management. However, a second fundamental principle of commodity price stabilization is that the implementing food agency must have adequate financing to permit it to purchase all rice that is offered to it for sale. Otherwise, it cannot act as a buyer of last resort and serve to support the floor price at the policy-chosen level. The developing world is filled with examples of failures by food agencies to defend floor prices, because the government restrained the agency's access to credit; the National Food Authority in the Philippines presents a nearby illustration.

An integral part of the government's macro-economic adjustment program, as agreed with the IMF, is to impose tight budgetary controls and financial restraints on all government agencies. This has been necessary to guarantee strict fiscal discipline and monetary control within the anti-inflation program. BULOG has been a large government borrower, because of its requirements to finance domestic purchases of rice in defense of the floor price and to buy public rice imports. Because of the size of BULOG's credit needs and the allegations of past improprieties in the agency's management, it is very unlikely that BULOG will be granted an exception to the stringent credit limits. In this circumstance, it will be extremely difficult for BULOG (or any possible successor food agency) to defend the floor price of rice in years with an unusually good harvest. Even if harvests are average or poor, the agency can be expected to run out of financing quickly if open private imports of rice are permitted. Hence, the macro crisis constraint – a financial limitation on BULOG's ability to procure rice – is made much worse by the policy conflict – the attempt to have both rice price stabilization and open private imports of rice. Either constraint alone ought to be sufficient to create policy failure. Together they guarantee that the floor price cannot be defended successfully.

Institutional Limitation: Potential for Rent-seeking. Currently, the floor price for rice is higher than the import price of rice. BULOG is not supposed to purchase privately imported rice at the floor price. But it is difficult to prevent this outcome. Either private traders could mix the imported rice with domestic rice and then sell it to BULOG as if it were all domestic rice. Or DOLOG officials could agree illegally, for a side payment, to purchase the imported rice at the floor price. This potential for rent-seeking adds to the difficulties of the policy conflict, since private importers would have an incentive to bring in imports for re-sale to BULOG at a higher price. It also means that the food agency would run up against its credit limit very quickly. Because of unusually high purchases of rice so far this fiscal year, it seems likely that BULOG soon will run out of financing to purchase domestic rice. Either the government will have to provide additional credit or the agency will not be able to defend the floor price. This is a predictable outcome given the policy conflict, the macro crisis constraint, and the institutional limitation – open private imports, limited credit, and rent-seeking combine to ensure that the floor price cannot be defended.

Purpose and Impact of the Rice Floor Price Policy

The main purpose of the floor price is to provide insurance to rice farmers. The original idea in introducing a floor price was to guarantee that rice farmers would not have to bear the risks of unexpectedly low rice prices. Because rural financial institutions then were poorly developed, it was hoped that rice farmers could be induced to invest in and adopt new high-yielding rice varieties (HYVs) by providing them with insurance against price falls. This insurance was expected to substitute for the inability of many farmers to gain easy access to rural finance. Analysts of Indonesia's successful Green Revolution (based on HYVs) believe that the floor price was an integral part of the success of that program. Insurance against abnormally low rice prices now is less critical because almost all of Indonesia's rice farmers have had long experience with HYVs and rural financial markets have begun to improve. In the absence of a floor price policy for rice, the government could redouble its efforts to improve the rural financial system by ensuring better access for farmers and traders of all crops.

The floor price program has never resulted in much direct subsidy of rice farmers, nor was it ever expected to. The floor price is intended to insure against two types of price falls – intra-year dips of the seasonal rice price immediately after the main harvest, and inter-year downward swings in the world price of rice during years when the world rice price falls below its trend. In both instances, the benefit to farmers who market rice -- of receiving a floor price above the price that otherwise would have prevailed – is later offset in large part by a cost to those farmers -- of receiving lower market prices for sales later in the year, after the food agency disposes of its rice in the market. The direct subsidy to farmers thus is very small. Moreover, the benefits accrue principally to those who own rice farm land and not to the landless rural poor. The floor price policy, therefore, cannot serve as a critical vehicle for transferring income to the rural poor. This goal can be achieved only by other programs such as targeted subsidies for rice consumption.

Costs of Ending the Rice Floor Price Policy

The government of Indonesia would incur costs if it were to resolve its policy conflict by ending rice floor prices. Rice farmers would be forced to bear increased risks of downward rice price fluctuations, and they would have to forego the limited income gains associated with the floor price. But rice farm incomes have tripled in the past thirty years, and the recent large depreciation in the Indonesian exchange rate has added to the profitability of growing rice. The seasonal pattern of rice prices has altered markedly; the peak to trough percentage change has declined by more than half between the 1970s and the 1990s, reflecting improvements in private rice marketing. Seasonal movements would increase without a floor price, but this is not expected to create difficulties for many rice farmers. The absence of a floor price would mean that farmers also would have to adjust to lower prices caused by downswings in world rice prices or appreciation of the Indonesian exchange rate. The substantially higher incomes in rice farming and gradual diversification into other high value crops have given rice farmers a greater ability to bear the adjustment costs of occasional downward price movements. These would be offset in other years by upward price swings, which are more likely to occur because of rises in the world rice price and depreciation of Indonesia's exchange rate. Rice farmers, consequently, ought to be able to assume the burden of adjusting to price falls without undue hardship.

Benefits from Ending the Rice Floor Price Policy

If the government decides to resolve the policy conflict by ending the rice floor price policy, it would be able to continue open private imports of rice and it would not need to be concerned with the food agency's line of credit. Three kinds of benefits would follow from this decision. The first gain would be the budgetary savings from downsizing the food agency. Before the macro-economic crisis, the costs of all of BULOG's rice price stabilization activities were estimated at about $100 million per year. The annual cost of defending the floor price is not known, but it is likely to be a major share of the total. This annual saving could be applied to other uses such as providing rehabilitation of rural infrastructure or better information for producers and marketers of food crops in general. The second benefit would be the removal of the potential opportunities for rent-seeking presented by the attempt to implement a floor price policy with open private imports of rice. These two specific gains would be furthered by any indirect gains that Indonesia might experience from boosts in international and domestic investor confidence associated with policy changes that increase efficiency and reduce high costs in the economy. These direct and indirect benefits would greatly exceed the likely costs of eliminating the floor price policy.