CHAPTER 1

AGRICULTURAL TRADE LIBERALIZATION AND THE LEAST DEVELOPED COUNTRIES

Introduction

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THE DEBATE

The agenda for the round of trade negotiations that started in 2001 was called the Doha Development Agenda. Its name was a signal to developing countries that their interests would be prioritized. Agriculture was at the core of the agenda. It is a vital sector in most developing countries, particularly the least developed ones, and it is heavily protected in high-income countries, resulting in severe trade distortions. The round started with high hopes that agricultural trade reform would strongly benefit the developing world. However, the negotiations were slow and experienced several breakdowns and an inability to meet deadlines. They ended in a state of deadlock in July 2006. However, we do not believe that the Doha Round is dead. While it may be stalled for a period of time, informal as well as more formal efforts are being made to continue the trade negotiations. The uncertain outcome makes the content of this book even more critical because it provides an input into the debate and decision-making as to whether the least developed countries should take policy action to protect themselves against the current trade-distorting policies in the OECD countries or prepare for a future with liberalized agricultural trade.

In view of the large potential gains that could be achieved by the multilateral reform of agricultural trade, the failure of such reform would be extremely unfortunate. While high-income countries stand to gain much from the removal of existing distortions in agricultural markets, developing countries would also benefit

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greatly because of the tremendous importance of the agricultural sector in their economies. Removal of trade distortions would raise their earnings from agricultural exports. Besides, expanded opportunities for investment and trade would generate multiplier effects that would further enhance economic growth and poverty alleviation.

The multilateral reform envisaged by the Doha agenda was commonly equated with 'trade liberalization'. The precise meaning of this and how far it should go were subjects of debate. Economists have presented ambitious liberalization scenarios and estimated their benefits to the developing world to be around one percent of its GDP[1]. However, these *ex ante* estimates tended to disregard distributive effects and adjustment costs. They also ignored potential endogenous price fluctuations that might be strengthened by trade liberalization, and they made the strong assumption of a smooth transition of labour and capital between sectors (FAO 2006; Gérard et al. 2003; Polaski 2006)[2].

This book addresses a specific issue: how the least developed countries (LDCs) would fare under a trade liberalization scenario. Freer trade in agricultural commodities might be expected to benefit these countries because the agricultural sector plays such an important role in their economies. However, many of these countries are net importers of food and would therefore be negatively affected if trade liberalization were to result in an increase in their import prices. Moreover, trade liberalization would erode the value of the preferential access that many LDCs have to various OECD markets. Poor domestic infrastructure, limited access to credit and technology, and poor domestic agricultural policies in many of the LDCs would hamper their ability to benefit from expanded export opportunities. As a consequence, the benefits of international trade liberalization for developing countries could become concentrated in a few middle-income countries such as Brazil, Argentina and Thailand, while poorer countries stand to lose (see Polaski 2006 and the chapter by Yu in this volume). On the other hand, such negative expectations provoke the objection that they are based on static comparisons that ignore induced internal development effects. Expanded trade opportunities would induce investment in rural infrastructure, technology and institutions which, in turn, would promote agricultural development and economic growth in the LDCs. As a consequence, even if the immediate net effects for the LDCs were to be negative, the longer-term effects could still be positive.

The debate concerning the impact of trade liberalization on the LDCs coincides with the rising interest in why so many of these countries are trapped in stagnation. Bad governance, insufficient social capital and other socio-political conditions have often been identified as the major causes (e.g. Bates 1981; Collier and Gunning 1999; World Bank 1981). Many assumed that these conditions could be corrected through donor conditionality and structural adjustment. However, the results of these actions have proven to be rather disappointing. Renewed attention has been given to the complex poverty traps in which LDCs find themselves and which may produce institutional and political problems as endogenous results (e.g. Sachs 2005). Several observers doubt whether trade liberalization can remedy this situation (e.g. UNCTAD 2004; Östensson, this volume). Such doubts would be reinforced if the LDCs were to lose from trade liberalization, at least in the short run.

In order to provide an input into the debate about the impact of trade liberalization on the least developed countries, Cornell University, Wageningen University and the African Economic Research Consortium organized a workshop on "Agricultural Trade Liberalization and the Least-Developed Countries" at the end of 2004. Most of the chapters in this book are based on papers presented and discussed during that workshop.

Drawing on the chapters of the book, the rest of this introduction is organized around four key questions:

- Is agriculture an important driver of pro-poor economic growth in LDCs?
- Would LDCs gain from international agricultural trade liberalization?
- Should LDCs erect protective import tariffs?
- Why are there such large differences of opinion regarding the impact of agricultural trade liberalization on LDCs?

IS AGRICULTURE AN IMPORTANT DRIVER OF PRO-POOR GROWTH IN LEAST DEVELOPED COUNTRIES?

The common starting point of the authors of this volume is that most – if not all – LDCs need agricultural growth to get their economies moving. In this they follow Johnston and Mellor (1961), who reacted against the older idea that industrialization, based on taxation of agriculture, could do the job. In their seminal paper, these authors emphasize that agricultural growth provides opportunities for upstream and downstream activities as well as savings, labour and food (as a wage good) for other sectors. Follow-up research highlighted the effect on rural consumer demand for non-farm products (e.g. Block and Timmer 1994; Delgado et al. 1998; Hazell and Röell 1983). Empirical support came from Kuznet's (1966) demonstration that in developed countries, the onset of industrialization had almost always been linked with an economic revolution in the agricultural sector. Other studies confirmed the stimulating effect of agricultural growth on non-farm activity in developing countries (e.g. Liedholm et al. 1994) and the relative importance of domestic demand in early phases of their development (e.g. Balassa 1978; Heller and Porter 1978; Urata 1989). These and related findings were validated by experiences of several Asian countries, including China, Korea and Indonesia.

Nevertheless, after 1980 some economists began to doubt whether a domestic demand push was still a *conditio sine qua non* for development. In a globalized economy, they thought, export demand could be an alternative booster of growth. As a consequence, any suitable non-agricultural export sector could function as a promoter of development. In spite of the apparent logic of this reasoning, however, the success of the Asian tigers' industrialization was squarely based on rapid agricultural growth (e.g. Francks et al. 1999). This begs the question whether, in addition to the market-mediated linkages highlighted by Mellor and his followers, agricultural development might have vital non-market-mediated external effects on non-farm growth. Timmer (1995) suggests that effects on skills may be important. Social capital is another possible candidate (Koning 2002).

The authors in this volume agree that agricultural growth is indeed needed to start up non-farm development in many LDCs. However, achieving agricultural growth requires important conditions to be fulfilled. There is consensus that public investment in hard and soft infrastructure should increase. Without roads and suitable technologies, agricultural development will not take place. There is also agreement that effective market chains are needed to provide farmers with inputs and credit, assure quality and allow them to benefit from value added products. Rather than a simple dismantling of inefficient parastatal organizations, new forms of public–private cooperation may be needed to achieve this. Moreover, there is consensus that adequate farmgate price relations are needed to allow farmers to invest in sustainable agricultural intensification. This may require a further correction of domestic policies that exploit agriculture to pay the expenses of ineffective bureaucracies. Moreover, it requires the reform of agricultural trade policies in other countries as well as in LDCs themselves. There is agreement that OECD dumping is harming LDCs, and that what was emerging from the negotiations before they stalled would do little to improve the situation for LDCs. However, it is at this point that the consensus stops. The authors in this volume have widely divergent opinions on whether liberalization by OECD countries would be beneficial for LDCs, and on whether LDCs would be well-advised to protect their own farmers against cheap imports with which they cannot compete.

WOULD LEAST DEVELOPED COUNTRIES GAIN FROM INTERNATIONAL AGRICULTURAL TRADE LIBERALIZATION?

There is consensus that the ability of the LDCs to benefit from agricultural trade liberalization is limited by severe supply constraints. Nevertheless, some authors in this volume are convinced that, on balance, the LDCs would gain (see chapters by Badiane, Nassar, and Tutwiler and Straub). Other authors are less optimistic. Olle Östensson notes that LDC economies are already very open. Many small farmers do not produce export crops and are vulnerable to import competition. Poorly functioning markets, deficient rural infrastructure, and lack of access to technology and credit result in very low aggregate supply elasticities that prevent LDCs from taking advantage of expanded trade opportunities. Removal of OECD import tariffs is not a substitute for domestic investment for improving these conditions. Rather, the latter is a pre-condition for gaining from the former. Besides, private standards that are introduced by supermarkets may be more restrictive for LDC exports than public trade barriers.

Östensson expresses UNCTAD's view that the LDCs' dependence on commodities that receive low and unstable prices in world markets results in a poverty trap that involves generalized poverty, high population growth and under-funded governments, and which hampers diversification (see also UNCTAD 2004). In a similar vein, Kimsey Savadogo, and Andrew Dorward, Jonathan Kydd and Colin Poulton highlight more specific poverty traps that interact with trade policies. Savadogo focuses on the widespread soil degradation in Sub-Saharan Africa. In his view, extreme poverty makes parents discount the future of their children in their

decisions on land management, causing an intergenerational tragedy of the commons even where land is bequeathed within families. Trade liberalization will not change this situation. Rather, massive development aid is needed to allow farmers to escape from this trap. Dorward and his colleagues focus on a low chain investment trap that hinders the development of supply and marketing chains that are needed for effective agricultural intensification. As a consequence, farmers and rural traders remain locked into 'atomistic relational market systems' rather than shifting to 'market and hierarchy reputational systems' as is needed for development (cf. Fafchamps 2004).

Daryll Ray and Harwood Schaffer question the validity of the widely held position that the decoupling of agricultural subsidies in OECD countries would reduce existing trade distortions. They believe that agricultural markets can only be balanced by supply management (and, on the multilateral level, managed trade). Because the shift to direct payments in the US was coupled to an abandoning of supply management, it did not reduce agricultural production but exacerbated the fall in international agricultural prices in the late 1990s. This prompted an increase in direct payments themselves and led to the current situation where this form of support has become an instrument of disguised dumping.

David Blandford and Wusheng Yu highlight the problem of preference erosion. LDCs have preferential access to various OECD markets where they benefit from relatively high prices. These benefits would decline if preference-providing countries were to reduce their own price supports. Yu presents results from analyses based on the latest version of the GTAP database. In his baseline liberalization scenario, where non-LDCs halve their MFN tariff rates of agri-food products, LDCs lose out because they receive lower prices for their exports. His results support those of Polaski (2006) and the arguments of Panagariya (2005), who also contend that preference erosion will cause poor countries to lose rather than gain by OECD liberalization.

Blandford and Yu believe that preferences should be increased to compensate LDCs for losses they incur as a result of international trade liberalization. Even if preferences turn out not to be sustainable in the long term, the continuing absence of a level playing field in international trade and the economic challenges facing the LDCs make an increase in preferences desirable in the short term. Additionally, preferences should be extended to a larger number of products, as well as being deepened by increasing the tariff concessions and quotas involved, or better still, by providing tariff-free and quota-free access as in the Everything-But-Arms initiative of the EU. Moreover, the number of preference-providing countries should increase and also expand to include middle-income countries. To illustrate this point, Yu compares his baseline liberalization scenario (where LDCs lose) with one where all advanced economies provide the Everything-But-Arms preferences of the EU. In the latter scenario, the negative outcome for LDCs disappears. He also presents a scenario where important middle-income countries provide the same far-reaching preferences. However, this appears to benefit LDCs less than open access to the markets of developed countries – a finding that contradicts the widespread belief that LDCs would especially benefit from more South-South trade.

Increasing preferences presupposes that the countries that provide them would not abandon their own price supports fully and immediately. This makes proponents of rapid and radical OECD liberalization wary of preferences. Ousmane Badiane contends that preferences are of little use to African countries because they are a pretext for maintaining OECD policies that are crippling the development of their export capacities. It may be questioned, however, whether OECD liberalization would indeed entail a quick release of supply constraints in LDCs, as he thinks. The experiences of the recent liberalization of the textile market point to another possibility: that a few well-placed countries would out-compete LDCs in their efforts to increase exports. Due to their advantage in scale and technology, countries like Australia and Brazil would rapidly be able to fill any new room that OECD liberalization were to create in the international market. André Nassar, who argues for liberalization from the viewpoint of one such country (Brazil), is critical of preferences. In his view, LDCs that are hurt by preference erosion should be compensated by the countries that provided the preferences – a viewpoint that deviates from the welfare economic principle that the winners of a policy reform (which include Brazil) should compensate the losers.

This controversy leads to another issue. Are all aspects of OECD protection equally harmful for agricultural development in the LDCs? Arguably, a distinction should be made between price support itself and the effect of this support on OECD production volumes. It is the latter that leads to import substitution and dumping, but in principle, this effect could be prevented by supply management. Thus, after the WTO sugar ruling, EU farm interests and ACP countries joined hands and demanded a further reduction in the production quotas for EU producers to avoid a strong reduction in prices. This issue is linked to that of the functioning of agricultural markets. The idea that liberalization would entail global gains (that could potentially benefit LDCs) presupposes that markets are able to balance demand and supply at prices that lead to equal marginal rates of transformation of farm products into other commodities. However, whether agricultural markets can also achieve this is subject to debate. A few decades ago, most agricultural economists agreed that this was not the case. They were convinced that the inelastic demand for food, and the way in which small-scale farm enterprises were encapsulated in the production-increasing environment of a modern industrial economy, were causing chronic oversupply and price instability (Schultz 1945; Cochrane 1958; Hathaway 1964; Tweeten 1970). The micro-economic revolution and the changed political climate after 1980 have altered this consensus (Gardner 1992), but there is still something unsatisfactory about the empirical foundation of this shift in opinion. Farm household income statistics that have been cited to disprove the existence of sub-normal farm earnings include off-farm incomes and are not corrected for sectoral differences in working hours (ibid.; also, e.g., Hill 2000; OECD 2003). Moreover, they refer to supported farm incomes whereas Schultz and his followers focused on farm income under free market conditions. Therefore, a minority of agricultural economists, including Ray and Schaffer and Koning in this volume, adhere to the older consensus. They believe that only a handful of countries with exceptional advantages in agriculture – like Australia, Brazil and Thailand – can hope to achieve normal earnings and a normal increase in

productivity under global free trade. All other countries need some form of farm income support to achieve such aims. Balanced multilateral coordination of farm policies can only be based on a rationing of the market – managed trade, not free trade. 'Liberalization' is just an ideological smoke screen behind which the US and the EU are replacing one form of offensive protectionism with another. In this view, which also appears in the contribution by Sophia Murphy, the trade distortions caused by OECD farm policies should be redressed by restoring the original GATT principle that farm income support should be linked with supply management and export controls. Murphy concludes that LDCs have a strong interest in a multilateral, rule-based system of agricultural trade, but that the Doha agenda had little to offer to LDCs. Rather than concentrating on global deregulation, a real 'development round' should focus on stronger rules against dumping, stabilization of commodity prices, linking tariffs to supply management and export controls, stronger transparency requirements for large agribusiness companies, and the protection of social and environmental standards and of national development needs.

SHOULD LDCS ERECT PROTECTIVE TARIFFS?

Tariff protection by LDCs is generally accepted as an anti-dumping measure. This begs the question of what dumping exactly is: exporting below domestic prices, or below costs of production in exporting countries? The latter definition, which is advocated by Murphy, is relevant because the production costs of major export crops of the US and the EU are significantly above world market prices (Ray et al. 2003).

The real issue, however, is tariff protection that goes beyond anti-dumping. LDC tariffs on agricultural imports are generally low, and it might be asked whether raising them could help to get agriculture moving. Of course, the idea that protective tariffs might benefit LDCs is entirely at odds with equilibrium models that suggest that developing countries would benefit even more from reducing their own tariffs than from OECD liberalization. However, what if low tariffs lead to import competition of domestic producers while alternative earning possibilities are not forthcoming? This could occur if farmgate prices are a cog in poverty traps in which LDCs are caught. Accordingly, Dorward and his colleagues argue that price support and tariff protection might help to break the low chain investment trap in which farmers and rural traders are locked. In their view, tariff protection can be part of the policy package that is needed to shift LDC economies to a higher-level equilibrium. This would become even more important if OECD countries do not manage supply and allow their 'decoupled' support to lead to disguised dumping, as discussed by Ray and Schaffer and by Koning.

On the other hand, it should be remembered, as David Dawe remarks in his chapter, that agricultural tariffs are a regressive tax on consumers, including rural labourers and small farmers who are net buyers of food. Besides, higher food prices may raise wage costs affecting the competitiveness of the economies of LDCs. The question is whether these negative effects are outweighed by increases in farm employment and linkage effects on the non-farm economy. This is an empirical

issue, which makes it useful to look at *ex post* experiences with trade liberalization or protection. Dawe looks at recent instances of agricultural trade liberalization in South and South-East Asia. Most occurred rather spontaneously, without being enforced by WTO decisions or other external forces. Apart from the reduction of tariffs on vegetable oil in India, they did not produce the tragic effects that NGO activists have depicted. In various cases, the effects were quite positive. Dawe also contrasts the experience of the Philippines, where increasing rice protection coincided with stagnating yields in the 1990s, with that of Thailand, where free trade coincided with continued yield growth. He refrains from drawing conclusions, though, as the stagnation in the Philippines could also have been due to an exhaustion of the Green Revolution that had not been fully introduced in Thailand at the time. Koning surveys historical experiences in OECD countries and Taiwan that could be relevant for LDCs. Between 1880 and 1930, agricultural free trade in Britain entailed total stagnation of productivity growth in agriculture, while in Germany the introduction of protection was followed by rapid farm progress that probably contributed to the country's rapid GDP growth. The German experience was repeated in Japan, South Korea and Taiwan in the Interbellum and the post-World War II period. Conversely, in Italy and France before World War I (WWI), agriculture stagnated in spite of protection.

These contrasting experiences suggest that other conditions determine whether the positive effects of agricultural import protection outweigh the negative ones. Perhaps innovation support, infrastructural policies and property rights can help to explain the difference. Germany before WWI led in the field of farm education and research, and underwent various phases of land reform. Similarly, the East-Asian countries benefited from far-reaching land reform, large investments in rural infrastructure and farm progress, and international green revolution research. Where such conditions are present, agricultural price support might accelerate farm progress, whereas without them, price support may achieve little more than a static redistribution of incomes. This latter may explain the slow increase in farm productivity in France and Italy before WWI, and possibly also that of the Philippine rice sector in the 1990s. The lessons to be drawn are that any protection that goes further than anti-dumping should be part of an encompassing policy package to increase productivity, including investments in rural infrastructure, research and technology, land reform and domestic market institutions.

It may further be noted that if LDCs were to introduce more systematic tariff protection, they could best do so in the frame of subregional customs unions. Internally, these could apply free trade to deter smuggling and allow specialization according to comparative advantage. Although most LDCs are currently net food importers, tariff protection could increase their food production beyond self-sufficiency. In that case, import tariffs alone would no longer be effective. This also means that raising tariffs in LDCs is no substitute for multilateral reform to improve agricultural prices in the world markets.

WHY DIFFERENCES OF OPINION?

The above discussions are influenced by different theoretical perspectives. In the standard neoclassical view, trade liberalization leads to global benefits. This view lies at the foundation of world trade models like GTAP. In fact, economists have a bad habit of calling the benefits indicated by such models ‘welfare gains’. They are *potential* welfare gains (potential Pareto improvements), which only would become real gains if the winners were to compensate the losers (Koning and Jongeneel 1997).

Other theoretical perspectives question whether the standard model gives an adequate description of the real world. One of these perspectives is that of *new trade theory* (Krugman 1996; Krugman and Obstfeld 2006) and *endogenous growth theory* (Romer 1986; Lucas 1988). A central element of this is a virtuous cycle: investment in capital involves economies of scale or positive external effects that facilitate further growth. This perspective plays an important role in the ‘hunt for large numbers’: faced with the limited benefits of trade liberalization that are shown by static general equilibrium models, many economists are looking for economies of scale or endogenous growth mechanisms that would amplify the benefits of trade liberalization (e.g. Pack 1994; World Bank 1993). More simple dynamic amplifiers are built into some of the model studies that Ann Tutwiler and Matthew Straub cite to underline the benefits that agricultural trade liberalization would have for developing countries. A similar notion is also implicit in Badiane’s idea that OECD liberalization will relax existing supply constraints in African countries. It should be noted, though, that new trade theory and endogenous growth theory also point to the possibility that any room for increased exports may be filled by well-placed countries like Australia and Brazil rather than by LDC producers.

A second perspective, and the logical counterpart of the previous one, is that of *poverty trap* (endogenous stagnation or decline). In this view, LDCs appear as multiple equilibrium systems that may be locked into low-level equilibrium. This perspective is central to the discussion by Savadogo, Dorward et al. and Östensson of problems in land management, chain investment and export specialization. The idea of multiple equilibriums leads to the necessity for a big policy push (which may or may not include tariff protection) to achieve a transition to a higher-level equilibrium.

A third perspective is that of dynamic sectoral disequilibrium. While the previous perspectives focus on local effects, this highlights the possibility that unbalancing forces inherent in economic growth dominate the equilibrating forces in global markets. This perspective lies at the heart of the idea of Ray and Schaffer and of Koning that agricultural markets are prone to chronic oversupply. Dynamic disequilibrium has some serious implications for standard trade models. The statistical data on market volumes and prices that are used for calibrating these models are seen as reflecting equilibrium. If they really pertain to a disequilibrium situation, the power of the model to predict the changes caused by an alteration of trade policies is compromised. Moreover, the ‘benefits’ shown by the models can no longer be interpreted as potential Pareto improvements.

Proponents of the above three perspectives welcome a more empirical approach to supplement the theoretical models that underlie *ex ante* assessments of the effects of trade liberalization. This would seem to resemble the old *Methodenstreit* between the Historical School and the (Neo-)Classical School in economics. However, the issue is not one of an inductive approach versus a deductive approach, but of a sound dialogue between theory and experience. This latter should go further than an improved empirical calibration of models; it should also include comparative case studies – the viewpoint chosen by Dawe and Koning in this volume.

SO WHAT IS THE BOTTOM LINE?

We, the editors, started out on this project because we were both convinced that investment in farm progress is vital to get LDC economies moving, and because we very much wanted an open discussion on the relation of trade policies with this standpoint, on which we held different opinions. Having participated in the workshop discussions and having read the papers presented in this volume, as well as other relevant literature, we agree on the following conclusions:

1. Agricultural and rural development continues to be the strongest driver of broad-based economic growth and poverty alleviation in LDCs. However, for this driver to generate the multiplier effects essential for achieving pro-poor growth, LDCs must increase investment in rural infrastructure, research and technology, as well as designing and implementing policies that will facilitate appropriate institutions and well-functioning input and output markets. Without such investments and policy changes, any benefits gained from the OECD liberalization of agricultural trade will go primarily to middle and high income countries, leaving LDCs with little or no benefits. In the short run, LDCs may in fact lose out.
2. Without some form of extra-market supply management, removal of trade-distorting OECD policies is unlikely to reduce OECD supplies as much as predicted by current models. Thus, price increases in the international markets may be less than expected, as will export opportunities for developing countries.
3. LDC tariff reduction is a very poor substitute for multilateral reform to remedy trade-distorting policies by OECD countries.
4. Anti-dumping tariffs may be appropriate for LDCs to protect domestic agriculture against imports with prices that are significantly below the costs of production in the exporting countries. Such tariffs would be limited to the size and duration in which the (thus defined) dumping would occur.
5. If LDCs were to choose to apply protective import tariffs that go beyond anti-dumping, they should couple this to very significant increases in investments in domestic markets, infrastructure, research, technology and other public goods, and with policy changes in favour of agricultural and rural development. Without such policies, protective import tariffs could strongly harm low-income consumers, and risk stifling economic growth and productivity increases in the non-agricultural sector.

6. In the absence of multilateral reforms, preferential arrangements for LDCs should be increased, and safeguards and exclusion of sensitive products from special agreements such as the EBA should be removed. Truly free access to OECD markets for all commodities and products from LDCs in unlimited quantities should be granted. This would include the elimination of tariff escalation for all processed agricultural commodities.

NOTES

[1] Somewhat larger gains that World Bank economists presented at one point had to be revised (World Bank 2003; Anderson and Martin 2005).

[2] Only a part of these objections is answered by more elaborate model studies that try, for example, to include the differential effects on different categories of households (Hertel and Winters 2005).

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