

Distortions to Agricultural Incentives in Transition Economies

Average protection levels in ECA are relatively low, yet some countries need to do more

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Incentives for agricultural producers and food consumers were massively distorted in European and Central Asia (ECA) transition countries under central planning. The distortions resulted from a combination of collective farm property rights, centrally controlled organization of production allocation, processing, input provision and marketing, price-setting unrelated to demand-supply conditions, and state controlled trading and exchange rate systems. There may have been a net subsidization of agriculture relative to other sectors, but data are too inadequate to tell with certainty.

How have policies affecting agriculture evolved in the region over the past two decades? We assess the changing landscape of agricultural protection or taxation patterns in 11 Central and Eastern European (CEE) countries (the ten new EU members plus Turkey), and seven CIS countries. Together these coun-

tries in 2000-04 accounted for 89% of the region's agricultural value added, 91% of its population and 95% of total GDP.

Our analysis shows that beginning in the early 1990s, many trade and price distortions were removed throughout the region. Price, exchange rate, and trade policies were all liberalized, subsidies were cut, hard budget constraints were introduced, property rights were privatized, and production decisions were shifted to companies and households. Support for agriculture fell to very low levels (Table 1). Between 1992 and 1995, nominal rates of assistance to agriculture (NRA, defined as the percentage by which government policies have raised gross returns to producers above what they would be without the government's intervention) averaged just 12% in the CEE-10 and were below zero in Bulgaria, the three Baltic nations, Russia and Ukraine.

In the second half of the 1990s, assistance to agriculture increased again, to an average of 22% in 1996-99 for all ECA countries, before it fell somewhat to an average of 17% in 2000-03.

Distortion levels vary considerably among countries and across commodities. The CEE-8 countries moved first and most rapidly towards market-based systems. The reforms in Romania and Bulgaria were initially half-hearted and involved many inconsistencies during most of the 1990s, with government interventions continuing to heavily distort incentives. In Russia, Kazakhstan and Ukraine, governments continued important controls of the agricultural economy through a variety of interventions such as regional trade controls, input supply controls, and the continua-

tion of soft budget constraints. While the Kyrgyz Republic liberalized relatively quickly, the other Central Asian countries have restricted reforms and liberalization. In particular, major controls still remain in place in Uzbekistan and Turkmenistan.

In the 1980s virtually all commodities were supported, but some more than others. With transition there is substantial variation among commodities and in the CIS producers of some commodities are now effectively taxed. Government intervention and controls are especially important in a few key commodities within each country, often because of food security concerns or the need to raise government revenue to meet other priorities, or because the government wishes to extract rents from those activities.

Changes in Agricultural Policy Instruments

In ECA, most support for agriculture was and, despite the reforms, still is provided via highly distortive and hence inefficient policy instruments. Under the communist regime, output price distortions (which accounted for more than 80% of the NRA) were complemented with heavy distortions in input prices, in particular low fertilizer and energy prices and subsidized irrigation, while in the 1990s the majority of farm support in the CEE countries was provided by output prices being kept above border prices.

In the CIS countries, soft loans and debt forgiveness continue to play an important role, although fiscal constraints for most of the 1990s limited the government's ability to support farms by this means. Due to the improved budgetary situation this may well become an even more important source of government assistance to farmers in the near future.

The inefficiency of policy instruments is typically correlated with the distortions that they cause. In general, the most efficient instruments (such as lump sum transfers) cause least distortions. In con-

Table 1. Nominal Rates of Assistance to Agriculture*, 1992 to 2005 (percent)

	1992-95	1996-99	2000-03	2004-05
Bulgaria	-19	-10	0	13
Czech Rep	20	19	27	na
Estonia	-14	20	20	na
Hungary	19	18	34	na
Latvia	-15	30	36	na
Lithuania	-19	29	32	na
Poland	10	24	7	na
Romania	24	30	55	67
Slovakia	28	26	30	na
Slovenia	64	79	80	na
CEE-10	12	22	24	na
Turkey	15	25	22	30
Russia	-8	25	13	22
Ukraine	-21	-1	-11	-3
All ECA studied countries	3	22	17	na

* Weighted average, with weights based on gross value of agricultural production at undistorted prices
Source: Ch. 1 of Anderson, K. and J. Swinnen (eds.), *Distortions to Agricultural Incentives in Europe's Transition Economies*, Washington DC: World Bank, forthcoming 2008.

trast, price and trade interventions, such as price supports or import tariffs, are much less efficient.

The efficiency of policies used by ECA countries is often low. In replacing budgetary transfers to the food sector under the communist system, a different set of inefficiencies has been introduced, such as transfers from consumers to producers by way of import restrictions. Up to the mid-1990s, policies in all countries except Turkey and Slovenia imposed the equivalent of low or negative taxes on food consumers, which thereafter have become positive.

Many of the direct subsidies to producers do not reach the farmer. This is due to a combination of institutional constraints and induced reactions to policy changes. For example, benefits targeted at the farms dissipate to other groups, e.g. agribusiness or food industries or landowners; they often go to a subset of the farms, typically those with the best political connections. Other important constraints include poor physical infrastructure; corruption; inadequate human capital; the incompatibility between the large-scale input supplying or food processing firms and the small farmers; as well as policy interventions, such as trade controls by regional authorities.

Table 2: Relative per Capita Income*, Agricultural Comparative Advantage Index, and NRA, 2000-03**

	Relative per capita income	Agricult. comparative advantage	NRA
Slovenia	216	52	80
Czech Rep.	135	61	29
Hungary	122	90	34
Estonia	102	199	20
Poland	93	105	7
Slovakia	92	57	30
Lithuania	80	176	32
Latvia	76	364	36
Turkey	55	131	22
Russia	47	53	13
Romania	41	74	55
Bulgaria	39	143	0
Ukraine	17	112	-11

* Income per capita relative to the world average, 2000-04

** Agriculture and food's share of national exports as a percentage of agriculture and food's share of global exports, 2000-04

Source: Ch. 1 of Anderson, K. and J. Swinnen (eds.), *Distortions to Agricultural Incentives in Europe's Transition Economies*.

Political Economy Forces Behind Policy Choices

On average, farmer assistance tends to be higher in higher-income countries, and in countries with weaker comparative advantage in agriculture (Table 2). However, these correlations are becoming weaker over time as international forces (particularly accession to the EU) become relatively more important than domestic political forces.

The forces underlying the political economy of agricultural taxation and assistance in the ECA region have changed considerably during transition:

- *Rent extraction.* Heavy negative government intervention tends to be concentrated on commodities that have the potential to provide export tax revenue for the government. This is especially the case in the cotton sectors of Uzbekistan, Turkmenistan and Tajikistan, where governments expressly control the cotton value chain so as to extract rents.

- *Increases in agricultural support* in the second half of the 1990s in CEE and more recently in the CIS are the result of the interaction between domestic political forces and international events. The EU accession process has induced changes in policy instruments and increased support in CEE. In the CIS the improvements in the government's budgetary situation has reduced fiscal constraints on agricultural subsidies.

- *Crises, political change, and reforms.* Most often the policy reforms come only after new elections induce a change in government, reflecting changed electoral preferences. However, democratic political change is not a sufficient condition in itself for better agricultural policies, as evidenced for example in Ukraine and the Kyrgyz Republic.

- *International agreements.* The CEE-8 countries that joined the EU in 2004 have raised domestic agricultural and food prices and have been gradually increasing subsidies towards EU-15 levels, and have changed trade policies and improved regulatory environment to stimulate their markets. WTO accession has not strongly disciplined ECA countries.

Prospects for Reducing Distortions

With the major reductions in distortions to agricultural incentives in ECA over the past two decades, average protection levels there are now relatively

low. However, some of the ECA countries still have considerable scope for removing the remaining distortions.

- Removing the most distortive taxation of agriculture would allow a substantial improvement in incentives to domestic producers in the cotton sectors in some Central Asian countries.

- Countries should focus on efficiency improvements, i.e. a shift from a focus on quantity and minimum standards to a policy framework focused on quality and high standards. Other reforms remain important, e.g. macroeconomic and regulatory reforms to stimulate food industry investment, labor market reforms to enhance off-farm employment opportunities, and credit reforms to stimulate access to rural credit.

- Increased funding should be focused on upgrading infrastructure, quality and efficiency of the agri-food system, and the introduction or improvements of a variety of institutions to support rural markets.

- Competition and anti-trust policy are important across the region. In supply chains where farms have to sell their products to trading, processing, and retailing companies, the ability to choose freely between companies is of crucial importance in getting better returns.

- Across ECA countries, and particularly in countries where the continued high energy prices may lead to 'Dutch disease' effects for agriculture, exchange rate distortions and adjustments will continue to have very substantial impacts on farmers' incentives.

While it is important to understand the political economic forces identified above that may constrain the prospects for further reducing distortions to agricultural incentives in the foreseeable future, it is equally important to identify areas where there is potential for policy improvement so that advisors can try to influence outcomes whenever and wherever opportunities arise.

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