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Agricultural Trade Protection: A Perspective from India

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Ever since the Uruguay Round negotiating mandate sought "greater liberalization of trade in agriculture", WTO Members have been locked in an intense debate on the nature and extent of trade liberalization in agriculture. Various perspectives on the agricultural trade liberalization have come to the fore in this debate. While the proponents of the trade liberalization agenda have argued in favour of dismantling the protective walls for this would bring significant global welfare gains, there have been contra voices that have emphasized that there are significant non-trade concerns which would have to given precedence over the trade agenda. This policy brief reviews traditional arguments for trade liberalization and provides a closer look at the additional reasons for use of government intervention, including trade policy, in agriculture in a developing country, with a particular reference to India.

TRADE THEORY AND THE USE OF INTERVENTIONS

The case for liberalizing agricultural trade has been built on arguments, that can be traced back to the pure theory of international trade. Accordingly, free trade provides the "optimal solution", but only under "ideal" market conditions.[1] While earlier studies enumerated the welfare implications of laissez faire policies in largely conceptual terms, more recent studies have provided precise estimates of the welfare gains resulting from trade liberalization, including liberalization in agricultural trade.[2]

In this context it is useful to be reminded that trade theory had long underlined that free trade remains the "optimal policy" *only* in the absence of market distortions. Jagdish Bhagwati (1971) provided one of the best expositions of this position while putting forth his "generalized theory of distortions". According to Bhagwati, free trade ceases to be the optimal policy if any or all of the following distortionary situations occur in the free-trade equilibrium: (i) factor market imperfections, (ii) product market imperfections, (iii) consumption imperfections, and (iv) trade imperfections. These distortions might be market-determined a policy-imposed. In each case, it was further argued, specific policy interventions directly aimed at addressing the source of the distortions are required. According to this prescription, distortions in the labour market should be addressed by using a combination of domestic taxes and subsidies. In the same vein, trade distortions caused by the existence of foreign monopolies (or imperfect market conditions, as later analysts have assumed), import tariffs would be the optimal policy intervention.

Although the generalized theory of distortions argues that labour market distortions should be addressed through the use of domestic policy measures and that intervention with trade protection would be welfare reducing, some of the more recent studies have provided different evidence. Contrary to the view held by the proponents of free trade[3], these studies have pointed out that the episodes of trade liberalization have different implications in economies with distorted labour markets. It has thus been argued that trade liberalization could hurt the workers because rigidities in the labour market are quite pervasive[4].

The reality of labour market rigidities, in particular involving labour engaged in the rural sector, is the reality facing many developing countries. In these countries, the share of rural population has not declined much even though the relative importance of agriculture in GDP has declined quite significantly in recent years. Table 1 captures this reality for some larger developing countries.

Footnote 1-4: page 2.

Table 1: Changing importance of agriculture and rural sector in selected developing countries

Years	China		India		Indonesia		Low income developing countries	
	Agriculture, value added (% of GDP)	Rural population (% of total)	Agriculture, value added (% of GDP)	Rural population (% of total)	Agriculture, value added (% of GDP)	Rural population (% of total)	Agriculture, value added (% of GDP)	Rural population (% of total)
1970	35.2	82.6	46.1	80.1	44.9	82.5	43.6	81.3
1975	32.4	82.6	41.3	78.8	30.2	80.5	39.7	79.7
1980	30.1	80.4	38.9	77.0	24.0	78.4	36.6	77.4
1985	28.4	77.0	33.7	75.7	23.2	73.6	34.3	76.1
1990	27.0	72.3	31.3	74.5	19.4	69.7	32.4	74.7
1995	19.8	68.9	28.2	73.4	17.1	64.2	29.9	73.2
2000	14.8	64.4	23.7	72.1	15.6	58.3	26.8	71.6
Change between 1970 and 2000 (%)	**57.9**	**22.1**	**48.6**	**10.0**	**65.3**	**29.4**	**38.6**	**11.9**

Source: World Development Indicators, 2006.

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The asymmetry between fast decline of agriculture's share in GDP and slow fall of the share of rural population is most significant in China and India. The situation looks particularly challenging for India which has seen a halving of agriculture's share in GDP over the past three decades, but the share of its rural population has declined by a mere 10%. It is also important to note that paid employment in agriculture in India (around 5% in 2004) falls very much behind the one in China (60% in 2003), Indonesia (44% in 2005) or some other developing countries (ILO Online Statistics and ADB Key Indicators).

It may be argued that most developing countries distortions in their labour market were policy-imposed by adopting policies that provided excessive protection to industrial sector. In many cases, agriculture was also taxed, since the imperatives of providing the population with the basic food items at affordable prices took precedence and this meant that agricultural producers were unable to obtain remunerative prices for their products.

The policy bias against agriculture in developing countries was reflected in the inadequate flow of investment to the sector. Here again, India stands out as a case in point. In the early 1980s, the share of agriculture in the country's gross capital formation was close to 20%, which, by the turn of the century had declined to a mere 6%, despite overall growth in investment across the whole economy.

If in the earlier decades, trade theorists were addressing issues relating to distortions as departures from the free-trade ideal, the seventies saw the initiation of a discourse that challenged the fundamentals of the traditionalist's view of trade theory. This body of literature was based on the premise that global markets are characterized by imperfect competition. Using the conceptual bases from the theory of industrial organization, the proponents of this view argued that under imperfect competition, there is a possibility that interventionist trade policies may have beneficial "strategic" effects (Helpman and Krugman, 1989). Based on this understanding, the strategic trade theorists have analyzed various situations in which government intervention can be justified.

The original idea of strategic trade theory was propounded by Brander and Spencer (1981, 1984)[5], who showed that government intervention can raise national welfare by shifting oligopoly rents from the foreign to the domestic firms. They argued that the grant of export subsidies would have the effect of a deterrent on foreign exports as a result of which profits of the home firm would rise more than the amount of subsidy. This would result in a rise in home income through increased rent capture by a domestic firm. No or little consideration however was given to domestic consumers in these early models on strategic trade policy.

The large body of literature that has emerged since has provided analytical insights into the functioning of the various sectors (largely in the United States) in which interventions of the kind that this variant of trade theory has tried to conceptualize are prevalent.[6] These studies have assessed the potential gains from using strategic trade policies and have concluded that carefully designed import tariffs or export subsidies can ensure better outcomes than free trade in certain markets, mostly in differentiated manufactured products associated with oligopolistic market structures. However, a number of agricultural products markets are also associated with a high concentration of "agents" indicating potential applicability of "strategic" policy interventions in the agricultural sector by developing countries.[7]

Furthermore, it is also argued that governments in the developed world (in particular the US and the EU) have used discriminatory policies like export subsidies and tariffs, to maintain a dominating position in the global markets for major agricultural commodities in the past decades.[8] Both the US and the EU Members countries have been using farm policy instruments for managing output in markets that have often suffered because supplies have far exceeded what the markets can carry. These policies were not subjected to the discipline introduced by the General Agreement on Tariffs and Trade (GATT)[9]. And, perhaps more importantly, effective disciplines for reining in the discriminatory policies have eluded the global community even after two decades of multilateral negotiations on agriculture.

The use of policy instruments by the US and the EU to promote their interests in the global agricultural markets has resulted in an interesting debate in the context of the re-shaping of the global agricultural policies that the WTO is currently engaged in. Initiated by the developing countries, this debate makes the point that "strategic" interventions on their part would be justified to counter persisting distortions in agricultural markets. These interventions combined with sound distributive policies, they argue, are necessary for safeguarding the livelihoods of the multitude of marginal farmers that dot the agricultural landscape in their countries besides ensuring that the food security concerns are met.

SPECIAL PRODUCTS AS STRATEGIC INTERVENTION

Developing countries base their development concerns on the imperatives of meeting the objectives of food security and safeguarding livelihoods. By so doing, these countries have emphasized that the focus of trade policy shift away from the realization of the free-trade ideal, as has been the case hitherto, to one that provides the space to use instruments for meeting these development concerns.

The cornerstone of this changed focus of trade policymaking is the proposal by most of the major developing countries to adopt the twin

[1] Some of the key assumptions that are made in this regard are the following: (i) markets are assumed to be perfectly competitive, (ii) producers minimize costs subject to constant returns to scale, (iii) consumers maximize their utility and (iv) all markets, including for labour, are cleared with flexible prices.

[2] The most quoted of these papers are by Kym Anderson, Will Martin and Dominique van der Mensbrugghe. See references for details.

[3] Gottfried Haberler had argued thus: "We may conclude that in the long run the working class as a whole has nothing to fear from international trade, since, in the long run, labour is the least specific of all factors. It will gain by the general increase in productivity due to the international division of labour, and is not likely to lose at all seriously by a change in the functional distribution of national income". See Haberler, Gottfried, "The Theory of International Trade", quoted by Stolper, Wolfgang and Paul A. Samuelson (1941).

[4] See Krishna et al. (2002) shows that "a labor market distortion prevalent in developing countries might lead to a fall in welfare, especially for a large country, when such economies open up to trade" (p. 23). See also Wacziarg and Wallack (2004).

[5] See also Krugman (2000).

[6] For a comprehensive survey see, Brander (1995).

[7] There are only a few attempts to look at "strategic trade" issues in agriculture. For example, Reimer and Stiegert (2006) argue that oligopoly better describes international food and agricultural markets than perfect competition. They base their claim on the situation in the undifferentiated primary commodities such as corn and soybean with highly concentrated production in the United States. It is also true that there may be a high concentration on a buyer's side too, for example in China and Japan.

[8] While US and the members of the EU control nearly 50% of the wheat exports, the US has a share in excess of 50% in the exports of soybeans and maize.

[9] Although the US has been using its farm policy to provide strategic advantage to its farm sector since the 1930s, it received legal sanction to use the farm policy instruments after the GATT Contracting Parties agreed to grant waiver from the application of Articles II and XI of the GATT (see GATT, 1955). In 1957, the Treaty of Rome (known more often as the Treaty establishing the European Economic Community) established the basis of the Common Agricultural Policy (CAP) that has directed agricultural policy of the EU Member States.

instruments of Special Products (SPs) and Special Safeguard Mechanism (SSM) as a way to address concerns of food security, livelihoods and rural development.[10] Through this proposal, developing countries have emphasised that "strategic" interventions are essential for the realization of development objectives.

The developing countries have proposed that the SPs would receive higher tariff protection given their critical importance in realizing the objectives of food security and livelihoods, besides rural development. Higher tariffs on SPs would help the developing countries in several ways, which can be best understood using the logic provided by the generalized theory of interventions and the strategic trade theory explained above.

The immediate impact of granting higher tariff protection to SPs would be a rise in local prices of those products. This causes redistribution of income from consumers of these products (presumably mostly urban consumers) to domestic producers (presumably small farmers). Whether or not this tariff would shift rent from foreign to local producers is not very certain. However, for the objectives of the policy defined as in the G-33 proposal, shift of rent is not necessary. It is the increase of domestic production which meets the G-33 goals. Thus, to achieve these goals a tariff is only one policy instrument, perhaps easiest to use. Others, like subsidies, would require budgetary expenditures which is out of reach for many developing countries.

As was indicated in the foregoing, developed countries have been granting large doses of subsidies to their farm sector, which has enabled these countries to dump subsidized products in several developing country markets. The low levels of tariffs maintained by the developing countries allowed proliferation of dumping of agricultural commodities.

Higher tariff protection to SPs would benefit the producers for they could realize higher value for their products than would have been the case if they had to compete with cheap imports. But when the SPs are the nature of essential commodities, there is a possibility that the higher prices would affect the poor among the urban consumers. In other words, the interests of the agricultural producers get pitted against the interests of the urban consumers. Many commentators have argued that such a situation could lead to an increase in poverty and would hence decrease welfare (Ivanic and Martin, 2006). However, this argument does not take into consideration the fact that the increase in commodity prices would benefit agricultural producers (accounting for nearly two-thirds of the country's workforce) who can then provide a boost to the country's economy as consumers. It may be argued that the main reason for using the instrument of SPs is to ensure reversal of the secular decline in commodity prices, in particular prices of commodities that are critical for providing livelihood security for farm households. In the past decades, low commodity prices have reduced the farmers in developing countries to marginalized existence and this situation can get far worse if the subsidized commodities are allowed to enter the developing country markets for "promoting" trade.

An important consequence of protecting SPs could be the diversion of resources into agriculture, a sector that has been grossly neglected by most developing countries. This occurrence, we would argue, would be justified in the overall context of developing country economies since investment in agriculture would help ameliorate the conditions of some of the most disadvantaged in these countries.[11] Consequently, resources would be diverted away from activities that generate high market returns to a sector that would yield the highest social returns.

The above mentioned arguments supporting the use of SPs by developing countries seem to have eluded analysists like Ivanic and Martin. These authors have tacitly assumed that sectors other than agriculture yield higher social return. However, crowding-in of investment in sectors other than agriculture is an unerring reminder that it is market returns that are highest in these sectors. It is particularly important to recognize that these sectors protect only the interests of capital, since rapid growth of services and more than adequate growth in manufacturing in the recent decades, has not been able to bring about appreciable changes in the sectoral employment of labour.

That domestic agriculture needs to be promoted for realizing the objective of food security seems to be have been disregarded, although nations, both individually[12] and collectively,[13] have emphasised the need for doing so. The empirical justification for the above mentioned positions can be provided on at least two counts. In the first place, global trade in major commodities has not expanded during the past decade, and this, despite the enhanced focus on trade expansion, particularly since the establishment of WTO. Table 2 captures this fact.

Table 2: Share of Global Exports to Production in Major Cereals (%)

Global Exports to Production	1995	1998	2000	2002	2003	2004
Rice	6	8	6	7	8	7
Wheat	23	22	24	26	25	23
Maize	17	14	15	16	15	13

Source: FAO

As can be seen from Table 2, rice has been the least traded among the major cereals, with global exports as a share of production not exceeding 10%, since 1995. Even in case of wheat, which is the most traded of the major cereals, the share of global exports have not been significantly higher that a quarter of the global production. Given such a scenario, countries would indeed be risking their future if they decide to rely on the global market for their food supplies.

This point is further corroborated by the fact that the global stocks of major cereals have been declining rather sharply since the late 1990s. Figure 1 captures this phenomenon.

It can be seen from Figure 1 that global stocks for the major cereals have experienced steep declines since the late 1990s to reach the lowest levels since 1990. The sharpest decline has been in case of maize – global stocks have declined by nearly 54% since 1999-2000.

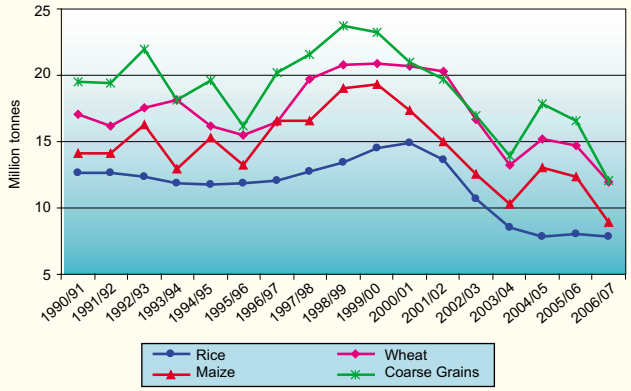
[10] The G-33 group of developing countries took the lead in proposing that SPs and SSM should be included in the new agriculture deal. Subsequently, the G-20 group also lent its support to the G-33 proposal.

[11] In most developing countries, incidence of rural poverty is often considerably higher than urban poverty. For details see World Development Indicators 2005, Table 2.5.

[12] President George W. Bush, defending the US Farm Policy in 2002 stated the following: "We are a blessed nation because we can grow our own food and, therefore, we are secure. A nation that can feed its people is a nation more secure", House Agriculture Committee (2002).

[13] In 1996, the World Food Summit proposed, "each nation must adopt a strategy consistent with its resources and capacities to achieve its individual goals and, at the same time, co-operate regionally and internationally in order to organise collective solutions to global issues of food security." See FAO (1996)

Figure 1: Year-wise Ending Stocks of Major Cereals



Source: USDA, Production, Supply and Distribution Online (http://www.fas.usda.gov/psdonline/psdHome.aspx)

In summary, the message for policymakers is the following: it is necessary to retain enough policy space for "strategic" interventions that seek to address development concerns as important as food security and rural employment and livelihood. Such policy space may include ability to set import tariffs on selected agricultural products, as an affordable way to counterbalance direct or indirect (and possibly "strategic") support provided mainly by developed countries to their own agriculture sector. This is also a policy that may encourage allocation of resources to rural areas, where most of the developing countries' poor still live. The literature has often failed to distinguish between policy interventions of the kind suggested above and the use of protectionist measures for supporting the dominant interest groups. It is hoped that this policy brief will contribute to more careful and fuller consideration of the motives underlying the use of trade policy instruments in future analyses.

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