4. A strategic framework for strengthening rural incomes

In proposing a strategic framework for strengthening rural incomes it is helpful to make a distinction between the short- to medium-term issue of how best to support incomes, reduce poverty and tackle food insecurity (beyond immediate questions of humanitarian relief), and deeper long-term questions regarding how best to strengthen incomes via economic development. There may be complementarities, with programmes that are effective in the short term sowing the seeds for longer term development, but there may equally be trade-offs, particularly with respect to public spending, so it is conceptually helpful to distinguish social policy from development policy.

A long-term strategy for development needs to acknowledge the inevitability of the structural transformation that accompanies economic development. The strategy proposed below consists of: (i) enabling smallholders to become competitive or boost their incomes from other sources (through diversification or exit); (ii) promoting a broader rural development strategy that does not focus exclusively on agricultural development, but seeks to create a more diversified rural economy; and (iii) strengthening institutions with a view to reducing the need for second best instruments.

The proposed framework suggests potential roles for government policy in providing the optimal balance of opportunities both within and outside agriculture. Following a discussion of the ability of alternative policy instruments to address short-term and long-term objectives, we illustrate the positive role that government can play with a case study of Thailand, which has successfully transformed from an agrarian country to an urbanised economy based around manufacturing. Rural poverty has fallen dramatically, as have hunger and malnutrition, while agricultural production has increased and a new class of commercially viable farmers has emerged.

Short- to medium-term policy options

The fundamental concern here is with how to improve incomes, and address poverty and food insecurity, over a time frame in which economic structures and household livelihoods are essentially fixed. If the adopted policies do not also raise incomes via long-term development, their income effects correspond to social protection.

Agricultural policies are not the ideal way of providing social protection. As shown in Section 2, they are likely to be less efficient than direct social transfers in raising incomes, and – in the absence of targeting – they fail to achieve pro-poor outcomes. The distributional effects of agricultural policies could be improved by targeting but this may be difficult for both practical administrative and political economy reasons. For example, it is difficult to restrict price guarantees to smaller farmers without using a deficiency payment system (in which case other forms of social payment must surely be feasible), or to limit fertiliser subsidies to those who would not otherwise purchase fertiliser.

Direct social transfers are in principle the most efficient way of supporting incomes, since they do not distort production and consumption decisions, and induce the efficiency losses examined in Section 2. However, there may be practical difficulties:

One is that the necessary institutions and infrastructure may not exist for cash-based instruments to be used. For example, there may be no registry or information base by which to establish criteria of eligibility; remote farmers may not have a convenient way of spending cash; and – with weak institutions – such programmes may be particularly susceptible to corruption. However, across a range of developing countries, conditional cash transfers (CCTs) have become particularly popular over the past decade. These programmes transfer cash to generally poor households on the condition that they make pre-specified investments in the human capital of their children. CCTs have been found to be effective at increasing consumption levels among the poor, and have led to behavioural changes, although their impact on *final* outcomes in health and education has been less clear (Fiszbein and Schady, 2009). This may be due to the need for CCTs to operate in conjunction with complementary investments (e.g. in schools and hospitals). An issue with CCTs is when the "conditional" element is warranted. For example, it may not be worth incurring the monitoring and enforcement costs associated with the condition that parents put their children in school if they would do so anyway.

A second concern is that social transfers are seen as explicit "welfare", whereas market interventions are often justified on other grounds (even if they are disguised welfare). In low income countries, where family and social networks are the main form of social protection, there is some wariness about potentially weakening that aspect of the social fabric.

Various forms of market and price stabilisation have been suggested as alternatives to social protection, on the grounds that in poor countries there may be few other ways of containing the impacts of adverse price shocks on poverty and food security than by seeking to offset those impacts directly (for example by releasing/buying stocks, or by changing tariffs). Interest in input subsidies has similarly revived, notably in Africa, as a practical way of increasing food production in order to reduce poverty and hunger, while also "jump-starting" markets and enabling households to escape from poverty traps. While neither of these policies may be the optimal way of addressing either short-term or long-term objectives, the specific features of developing country agriculture – in particular the greater prevalence of market failures – have led to these policies being proposed as practical alternatives that are straightforward to implement. These arguments are assessed in Sections 5 and 6.

Long-run policy priorities

Analysis of the agricultural transformation has suggested that agricultural strategies should (a) offer multiple pathways to higher incomes; and (b) situate agricultural policy among a broad set of instruments necessary to ensure sustained growth in real incomes.

Elements of a long-term strategy for agricultural development, with a focus on smallholder adjustment, are set out in Table 4.1. Smallholder adjustment here is understood to be a path to higher long-term income, be that through improved competitiveness within the sector, income diversification (from agricultural or non-agricultural sources), or exit to other sectors. Adjustment pathways are described in the columns, and policy instruments in the rows. The first column (improving competitiveness within agriculture) applies to farm households only, but the other columns may apply to both farm households and wage earning (often "landless") worker households. Note that the adjustment pathways (columns) are not mutually exclusive: for example, one household member can enhance the farm's competitiveness while another provides off-farm income. Also, the instruments (rows) do not exhaust all possible policies, but focus on those with persuasive arguments. Social protection is seen here not as a way of offsetting transient shocks, but as the provision of long-term support for households that are unable to adjust.

Table 4.1. Strategic framework for smallholder adjustment

<table>
<tr><th></th><th colspan="5">Adjustment pathway</th></tr>
<tr><th rowspan="2">Policy instrument</th><th rowspan="2">Help farmers become more competitive within agriculture</th><th colspan="2">Diversify income sources</th><th rowspan="2">Leave the sector for off farm work</th><th rowspan="2">Social protection for those unable to adjust</th></tr>
<tr><th>Within agriculture</th><th>Outside agriculture</th></tr>
<tr><td>Price policies</td><td>Treats symptoms of uncompetitiveness rather than causes</td><td colspan="3">May impede adjustment</td><td>Price stabilisation proposed as a second best safety net</td></tr>
<tr><td>Input subsidies</td><td>Treats symptoms of uncompetitiveness rather than causes</td><td></td><td colspan="2">May impede adjustment</td><td>Proposed as second best instrument for the poorest countries</td></tr>
<tr><td>Credit policies</td><td>May correct market failures</td><td>Indirect impacts</td><td></td><td></td><td></td></tr>
<tr><td>Investment in human capital</td><td>Minor effects of formal education for this generation; technical training more appropriate for productivity</td><td>Can help farm family members and rural workers move into skilled jobs</td><td>Important for farm family members and rural workers</td><td>Important for managing inter-generation change</td><td></td></tr>
<tr><td>Investment in infrastructure</td><td>Helps with market integration</td><td colspan="2">Helps improve local job opportunities</td><td>Can ease migration decisions for offspring</td><td></td></tr>
<tr><td>R&D and extension</td><td>Public and private sector important; gains from adoption and adaptive research</td><td>Can expand agricultural employment</td><td></td><td></td><td></td></tr>
<tr><td>Labour market reforms</td><td></td><td colspan="3">Important for raising employment opportunities and wage incomes</td><td></td></tr>
<tr><td>Income transfers (possibly conditional cash transfers)</td><td></td><td></td><td></td><td>Conditional school attendance may complement investments in schools</td><td>Preferred policy for those unable to adjust.</td></tr>
<tr><td>Regional policies</td><td>Important for improving market integration</td><td>Expanded non-farm activity would raise farm wages</td><td colspan="2">Important for building a diversified rural economy with wider job opportunities</td><td></td></tr>
<tr><td>Develop producer associations</td><td>Reduce transaction costs and help exploit economies of scale</td><td>Indirect impacts</td><td></td><td></td><td></td></tr>
<tr><td>Land policies and property rights</td><td>Need to encourage rental markets and facilitate land purchases by small farmers</td><td></td><td></td><td>Secure property rights and rental markets can ease exit decisions</td><td></td></tr>
</table>

Improving the competitiveness of farm households

It is important to have a realistic view of which farmers have the potential to succeed commercially within the sector. In some regions agro-ecological conditions may be such that farming may not be inherently commercially viable. More generally, the appropriate adjustment pathway may depend on the basic type of farming system. For example, in East and Southern Africa the scope for agricultural growth in areas where a mixed maize and cash crop system dominates is inherently stronger than the potential in areas where rainfed sorghum and millet combine with pastoral agriculture (Dixon *et al*., 2001). Yet even when agro-ecological conditions are inherently favourable, the nature of structural change is such that farm operations tend to consolidate into fewer and more efficient enterprises, and some farmers will leave the sector.[1]

Given the need to acknowledge that some farmers will become competitive while others will not, and the impossibility of identifying exactly which farmers fall into each category, the main role for policy would appear to be in providing public investments that can improve competitiveness, but impose few distortions to incentives at the margin, for example in rural infrastructure, skills and training, and R&D.[2] Such investments are unlikely to crowd out the development of other activities and potential income streams, although they are likely to accelerate the shakeout between more and less competitive farmers. Most of the relevant expenditures would need to be made at the economy-wide or sectoral level rather than in the form of payments to individuals. A further role for policy is when there are endemic market failures, for example in credit markets. Access to credit is important for smallholders, and private credit markets may find it not worth their while to engage with smallholders, simply because of their size and the difficulties of becoming informed about the creditworthiness of many small operations.

In many developing countries, farmers may have insecure land rights, while land rental markets function poorly or do not exist at all. Secure land rights can improve incentives for investment in the land, and can also facilitate the development of rental markets. The latter can in turn help compensate for market failures, provide flexible responses to economic and productive incentives, allow farmers to invest in farming capital, and help the poor and young gain access to land under conditions that are less demanding than those required to participate in land sales markets. Renting land may also be a first step to future land acquisition. The underdevelopment of rental markets may prevent the consolidation of land into more productive units, thus impeding agricultural investment and making it more difficult for uncompetitive farmers to diversify out of the sector. Finally producer associations and vertical co-ordination along the value chain may enable small farmers to benefit collectively from economies of scale.

Income diversification

Income diversification is essential for many farm households. For the poorest farm households, this is likely to provide some insurance and is in effect a "coping" strategy. For other farm households, having one or more family members draw income from outside agriculture may be the start of a successful move into more remunerative activities. Policies that support farm income alone, such as market price support, act as a disincentive for income diversification outside agriculture, and create an obstacle to one of the key "adjustment pathways". The key policies required to help households diversify their income sources are again those that improve human capital. Regional development policies, including the development of rural infrastructure, may also have an important role.

Leaving the sector for skilled employment

Ultimately, the majority of smallholders in developing countries will have stronger prospects outside the agricultural sector than within it. The most important need, if not for this generation then for the next, would therefore appear to be investment in the education and skills that would enable households to obtain higher wages. At the same time well-defined property rights, especially with respect to land, are important for farmers to be able to cash in their assets, and exit the sector on favourable terms.

Regional development programmes, by targeting economic assistance to less developed regions, may also have a role in bringing jobs to people (rather than the other way round) and so can prevent the problems associated with mass migration into cities. However, rural policies are not fundamentally agricultural policies (nor vice versa). Regional policies can boost development within and outside agriculture, but without biasing household decisions about how best to invest for the future. Spending on infrastructure, and policies to encourage private investment, can also help balanced development, allowing the most profitable mix on agricultural and non-agricultural activities to emerge.

In many middle income countries the conditions of salaried agricultural work are at least as important as the development of small scale farm entrepreneurs. In Chile, for example, two-thirds of all households receiving the majority of their income from agricultural sources are salaried workers, not farmers. Labour market policies have an important role in ensuring that core standards of employment are met, while improved labour market flexibility has been suggested as a way of reducing informality (OECD, 2008).

Social policies for households that cannot adjust

Many poor households, notably older ones, face severe limitations in their adjustment potential, irrespective of the policies that are in place (for example, resource poor and post retirement age farmers). Hence there is always a need for social programmes. Investments in human capital (notably education) and measures such as contingent cash transfers can ensure that the next generation makes a quantum leap in terms of development. As noted previously, the potential difficulties of implementing such programmes in poor countries have led to market interventions such as input subsidies being proposed as a practical alternative.

Note that the identification of a role for government intervention in agricultural markets, either to boost long-term competitiveness or to protect incomes over the short term (i.e. provide a safety net), hinges on the argument that such interventions provide practical alternatives that are likely to be more effective than theoretically ideal instruments. These arguments are investigated for price stabilisation and input subsidies in the following sections.

Box 4.1. Thailand's agriculture: Transition and sustained growth

The agricultural transformation

Since 1960 Thailand has transformed from agrarian country to an urbanised economy based around manufacturing. Agricultural output has grown more quickly than population, with two distinct periods of growth.

From the early 1960s to the early 1980s, agriculture grew by about 4% per year. It did so by opening up new lands for farming, and using more labour, to produce more of the main staples for both domestic market and for export. During this period, agriculture was a main driver of the economy. In 1980, more than 70% of the active population and most of the country's poor was employed in agriculture. The sector produced cheap food for the growing urban population and was a major export earner, with rice exports prominent. This was achieved despite taxation of the sector to fuel industrial growth. Rice exports were taxed directly and exporters were further penalised indirectly by over-valuation of the baht.

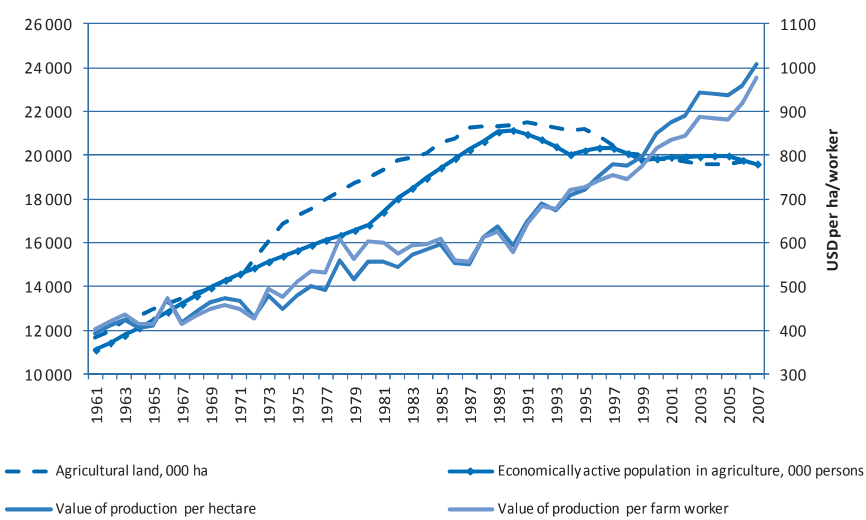
From the mid-1980s, agriculture began to transform. Labour left agriculture, attracted by jobs in manufacturing, urban services and the rural non-farm economy. At the same time, the land frontier was closing and it became harder to add new land. Consequently, agricultural growth slowed to about 2%–3% per year, although productivity increased notably. Given opportunities in both domestic and international markets, new activities emerged such as rubber, cassava, pineapples, and high value perishables for the fast-growing cities. Most farm households diversified their income sources, while some became more specialised in higher-value agricultural products sold into more sophisticated marketing chains. The rural non-farm economy has thus grown to the point where it now provides around half of all rural jobs. Successful industrialisation of the country has allowed direct and indirect net taxation of farming to be virtually eliminated.

In the early 1960s more than 60% of the rural population lived in poverty. By the early 2000s that had been cut to only a little more than 10%. From 1988 to 2007, the number of households affected by food poverty declined from 2.55 million to 418 000. With more abundant and cheaper staples, and reduced poverty, child malnutrition has also declined. The incidence of underweight young children fell from 17% in 1987 to 7% in 2006; while that of stunting was reduced from 25% to 16%. During the 1960s and 1970s, most of the improvements came from increasing farm incomes. Subsequently, incomes from rural non-farm jobs and remittances from migrants have become important. Not only has poverty fallen, but the reductions have been similar across the provinces.

The role of government policy

The Thai story is an example of a successful transition from an initial situation in which it was possible for agriculture to grow by putting underused factors of production to work, with only limited improvements in productivity, to a later stage where land and labour have become increasingly scarce and growth could only continue through improved returns to these scarce factors. Figure 4.1 shows how, from the late 1980s onwards, land and labour have started to leave farming, while productivity growth of these two factors has accelerated.

Figure 4.1. Land, labour use and productivity in Thai agriculture, 1961 to 2007



Source and notes: Computed from FAOSTAT data. Agricultural land and economically active population in agriculture, left scale; value of production per hectare and per worker, right scale. Labour force in agriculture taken as the estimated economically active population in agriculture.

continued

The Thai story is an example of a successful transition from an initial situation in which it was possible for agriculture to grow by putting underused factors of production to work, with only limited improvements in productivity, to a later stage where land and labour have become increasingly scarce and growth could only continue through improved returns to these scarce factors. Figure 4.1 shows how, from the late 1980s onwards, land and labour have started to leave farming, while productivity growth of these two factors has accelerated.

Success has been achieved primarily through private initiative, with the state playing a strategic role in setting an investment climate, investing in roads and research, and also supporting agricultural credit to overcome market failures. Specifically:

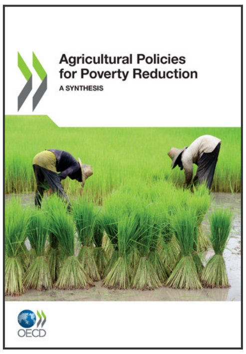
- The opening of new land was encouraged by tenure rules that allowed family farmers to clear enough land, 4 to 8 hectares, for a small farm and then gain secure property rights so long as they paid taxes.
- The state built roads that provided access to new lands and constructed irrigation works that were especially important before 1980 or so. Thereafter these investments were complemented by more spending on rural education, electrification, and telecommunications. Public investment in large-scale irrigation gave way to policies supporting private investment in smaller-scale irrigation.
- Public agricultural research has contributed as well. With intensification of Thai agriculture, uptake of agriculture research outputs has increased; as seen with modern rice varieties, use of improved rubber trees, and improved varieties for maize, soybean and cassava.
- To resolve failing rural credit markets, the Bank of Thailand instructed all commercial banks to allocate 5% of all commercial loans for agriculture at an interest rate lower than the market. The Bank for Agriculture and Agricultural Cooperatives (BAAC) has subsequently expanded provision of agricultural credit to 90% of farm households and all farm co operatives, using a group liability guarantee which enables small farmers to access short-term credit without land title deeds as collateral.
- More recently the state has promoted certification to allow farmers to develop premium domestic markets.
- Government has sought to promote agricultural exports through active participation in trade talks, in multilateral, regional and bilateral negotiations.
- Although agriculture was taxed heavily in the early stages of industrialisation, the state had the wisdom to ease this subsequently, once manufacturing was not so dependent on farming for resources.

Source: Material provided to OECD by Leturque and Wiggins, 2010.

Notes

1. Poulton and Wiggins (2005) present some evidence of declining farm sizes in developing countries, mostly for countries where the average farm size is a hectare or less. This is more likely to represent a fragmentation of operations, for example due to inheritance laws and property rights systems, than it is the relative efficiencies of small farms (e.g. ease of labour supervision; local knowledge) versus larger operations (knowledge of markets and technology; access to credit and inputs; ease of risk management; ability to assure quality).

2. There is evidence to suggest that improvements in agricultural productivity have a strong effect in reducing poverty (Irz *et al.*, 2001). There is also evidence that agricultural growth has helped support broader economic growth (for example, Tiffin and Irz, 2006), although agriculture's role as a necessary driver of development has been questioned (Gardner and Tsakok, 2008).



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