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# Part I

## AGRICULTURAL TRADE AND POVERTY

Can trade work for the poor?





# Part I

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# 1. Introduction and overview

The debate over the role of trade in economic growth and poverty reduction has a long history. This often contentious debate dates back more than 50 years at FAO and lies at the very roots of economics.

Advocates of freer trade argue that trade promotes growth and that growth reduces poverty. This view maintains that trade barriers such as import tariffs and subsidies generally benefit a powerful, protected few at the expense of the many. Reducing trade barriers promotes more efficient resource use.

Greater efficiency means that societies can produce more of the things people want, within their limited resources, raising overall social welfare. The poor are able to improve their levels of nutrition, health and education, creating a virtuous circle of rising productivity and poverty reduction.

Critics of freer trade argue that this “neoclassical” model is flawed and that it fails to account adequately for market imperfections and for inequitable power relations that govern the multilateral trade negotiation process. Trade liberalization damages food security, they argue, because liberalization benefits only the larger and more export-oriented farmers, leads to scale incentives and size concentration, marginalizes small farmers and creates unemployment and poverty.

Critics also maintain that trade liberalization holds no guarantee that everyone will benefit, even in the long run, arguing that in reality it is the poorest and vulnerable members of society who suffer most from the market disruptions arising from the reform process.

They claim, moreover, that agricultural imports from developed countries undermine the economic and social fabric of poor rural areas, stalling the traditional engine of growth in agrarian societies. Their fear is that the more the developing countries open their borders, the more they expose poor food consumers to price shocks and small food producers to risks and disincentives.

Pointing to the existing international trading system for agriculture, many criticize the import barriers, export subsidies and domestic support retained by some industrial countries in spite of recent progress under the World Trade Organization (WTO) Agreement on Agriculture. They question how farmers in developing countries can compete when their governments had already agreed to trade and agricultural policy changes promoted by the World Bank and the International Monetary Fund (IMF) under structural adjustment programmes.

Advocates of agricultural trade liberalization argue, on the other hand, that this view is too pessimistic and one-sided, and that the adjustments associated with policy reform are temporary and the efficiency gains from trade outweigh these transitory costs. They claim that trade barriers are a costly and ineffective way of supporting food security and agricultural development in poor countries. Rather, productivity-enhancing investments in market institutions, infrastructure, technology and human capital represent a better strategy for pro-poor growth.

While recognizing the imperfect nature of the WTO trade reform process, supporters

## BOX 1

**What other multilateral agencies conclude about trade and development**

Four recent reports on trade and development highlight the importance the international community places on the promise of trade. In common with *The State of Food and Agriculture 2005*, these other UN agencies all call for:

(i) an end to OECD countries supporting their agriculture sectors in ways that harm developing countries; (ii) more effective approaches to the risks caused by negative commodity price shocks; (iii) more effective market access for developing countries; and (iv) enhanced South–South cooperation in the field of trade and investment.

Each agency arrived at the common conclusions presented above even though they focused on different trade- and development-related themes. For example, the WTO's *World Trade Report 2004* examines the impact of domestic policies on trade, arguing that the benefits from good trade policy may be undermined if governments do not also pursue appropriate domestic sector-specific policies. While trade policy can have a positive impact on a country's

growth and development prospects, the WTO report stresses the importance of ensuring coherence in policy formulation, pointing out that inconsistencies in policy stances or neglect in particular areas can diminish valuable trading opportunities.

UNCTAD's *Least Developed Countries Report* for 2004 assesses the relationship between international trade and poverty within the least developed countries (LDCs), concluding that international trade has not fulfilled its major potential role in poverty reduction in LDCs. Reasons include weak trade performance, weaker linkages between trade and economic growth than in the more advanced developing countries and a tendency for export expansion in very poor economies to be associated with an exclusionary rather than inclusive form of economic growth.

The World Bank's *Global Economic Prospects* for 2004 concentrates heavily on the international trading regime and its implications for developing countries. The report argues the case for trade liberalization and the positive impact on developing countries, illustrating a

argue that the situation for developing countries could have been much worse without the disciplines of the Agreement on Agriculture. They point to the "subsidy wars" of the mid-1980s that generated huge surplus stocks in Europe and North America, severely depressing and destabilizing global commodity prices. WTO disciplines helped reduce these excesses and may have prevented far worse.

They maintain that the structural adjustment programmes implemented by many developing countries in the 1980s and 1990s were essential in order to correct unsustainable budget deficits and overvalued currencies. To the extent that structural adjustment reforms have actually been implemented – and the experts are divided sharply on this question – the severe "urban bias" that penalized agriculture in many developing countries has been reduced.

It took 50 years of successive multilateral trade negotiations to bring down tariffs

on industrial goods. Supporters say that the process has just begun for agriculture and further real reform is needed, but if governments manage the adjustment properly within the broad policy latitude they retain under the WTO, opportunities will open up for those displaced by competition from imports.

So, which story best fits reality? Does agricultural trade liberalization condemn agrarian societies to remain in poverty? Is the improved economic efficiency that comes from trade liberalization enough to offset job and income losses experienced by vulnerable groups and individuals? How are poverty and food security affected as borders open up? Are development policies evolving in ways that take best advantage of emerging trade opportunities?

Are the institutions, infrastructure and safety net programmes available in developing countries sufficient to cope

pro-poor programme of trade liberalization in all sectors, which, if implemented over five years to 2010 could produce gains for developing countries of nearly \$350 billion by 2015 and reduce poverty by 8 percent. This report contains a chapter devoted specifically to agricultural trade, providing a detailed analysis of trends and patterns in world agricultural trade and of patterns of agricultural protection, and a review of reform proposals in the Doha Round. In its summary, the chapter lays out the main components of a pro-poor agenda for policy change in agricultural trade.

UNDP's *Making global trade work for people* (2003) concludes that trade should be seen as a means to development rather than an end. Trade has enormous potential to contribute to human development, yet the current system has fallen far short of expectations and its many inequities are at the core of continuing controversies surrounding economic globalization. Among the key lessons, the report highlights the experiences of industrial countries and

successful developing countries. First, economic integration with the world economy is an outcome of growth and development, not a prerequisite. Second, institutional innovations – many of them unorthodox and requiring considerable domestic policy space and flexibility – have been crucial for successful development strategies and outcomes.

Finally, the UNDP report argues that the design of the multilateral trade regime needs to shift from one based on a market access perspective to one based on a human development perspective. It should also be evaluated not on the basis of whether it maximizes the flow of goods and services but on whether trade arrangements – current and proposed – maximize possibilities for human development, especially in developing countries.

Source: WTO, 2004a; UNCTAD, 2004; World Bank, 2003 and UNDP, 2003.

with the risks to vulnerable groups? How can developing countries compete with the economic and political clout of the much larger and much richer industrial countries? Can freer trade help overcome the mismatch between abundant global food supplies and starving families?

Can trade work for the poor? This is the key question that this year's *State of Food and Agriculture* addresses. It is also a key question for the international development community. The United Nations Millennium Declaration underscores the importance of international trade in the context of development and the elimination of poverty.<sup>1</sup> In the Millennium Declaration,

governments committed themselves, *inter alia*, to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading system.

FAO, along with other international organizations, focuses substantial attention on this all-important debate on trade and poverty. FAO, the United Nations Conference on Trade and Development (UNCTAD) and the United Nations Development Programme (UNDP), along with the WTO and the World Bank, have each published recent reports addressing the links between development and trade (see Box 1).

*The State of Food and Agriculture 2005* highlights the common lessons, insights and issues – both resolved and unresolved – presented in these and related publications. The report focuses more directly on how trade and poverty linkages can be best used to enhance food security, address inequality and improve overall economic growth.

<sup>1</sup> Adopted in September 2000, at the United Nations Millennium Summit, where world leaders also agreed to a set of timebound and measurable goals and targets for combating poverty, hunger, disease, illiteracy, environmental degradation and discrimination against women. These are referred to as the Millennium Development Goals.



### **Trade, poverty and food security: what are the linkages?**

The economic linkages among trade, poverty and food security are complex and national experiences with trade reform have been highly variable. Simple, unambiguous messages are thus difficult to identify, although some policy conclusions can be drawn.

Trade–poverty–food security linkages are diverse in nature. The first linkage occurs at the border. When a country liberalizes its own trade policies by lowering tariffs, for example, this will result in lower market prices for imports at the country's border. When other countries liberalize their trade policies, this will affect border prices of the first country's imports and exports.

The second linkage focuses on how prices are transmitted from the border to local markets within the country: to producers, consumers and households in general. The extent to which households and businesses in the economy experience these price changes depends on the quality of infrastructure and the behaviour of domestic marketing margins, as well as geographical factors.

The empirical literature suggests that the degree of price transmission from the border to the local market can vary widely, even within a single country.

The initial impact of trade liberalization on households occurs once the local market price changes have been determined. Not surprisingly, households that are net sellers of products whose prices rise, in relative terms, benefit in this first round. Net purchasers of such goods lose.

However, the literature also demonstrates that first-round effects are altered significantly in the wake of subsequent household adjustments in consumption and production. In response to changing relative prices, households modify their consumption basket, adjust their working hours and possibly change their occupation. Changes in relative prices can even affect a household's long-term investment in human capital.

As households change their spending levels and employment patterns and as landowners and firms adjust their hiring, a wide range of effects ripple throughout the

economy. For example, trade reforms that stimulate agricultural production often lead to a general increase in wages for unskilled labour. This, in turn, benefits households that are net suppliers of unskilled labour.

Finally, the long-run growth effects associated with trade liberalization need to be considered, including increases in firm productivity due to access to new inputs and technologies as well as potential gains due to the disciplining effect of foreign competition on domestic mark-ups.

Exactly how trade affects poverty and food security depends upon each country's specific circumstances, including the situation and location of the poor and food-insecure and the specific reforms undertaken. Understanding and managing these relationships requires country-specific research and country-specific policies. One size does not fit all.

FAO's ongoing studies and analyses, to date, provide encouraging lessons and overall policy guidance. Among the many important lessons is the need for policy-makers to consider more carefully than they have in the past how trade policies can be used positively to promote pro-poor growth. This involves actively implementing policies and making investments that complement trade reforms and enable the poor to take advantage of trade-related opportunities, while establishing safety nets to protect vulnerable members of society.

The analysis presented in this report concludes that multilateral trade liberalization offers opportunities for the poor and food-insecure by acting as a catalyst for change and by promoting conditions in which the food-insecure are able to raise their incomes and live longer, healthier and more productive lives.

It also demonstrates that trade liberalization can have adverse effects, especially in the short run, as productive sectors and labour markets adjust. Opening national agricultural markets to international competition – especially from subsidized competitors – before basic market institutions and infrastructure are in place can undermine the agriculture sector, with long-term negative consequences for poverty and food security. Some households may lose, even in the long run.

To minimize the adverse effects and to take better advantage of emerging opportunities, governments need answers to a wide range of questions: How does trade policy fit into the national strategy to promote poverty reduction and food security? How will the trade reform process and the broader set of economy-wide and sector-specific policies affect relative prices at the border? How will local markets and distribution networks pass on these price effects? What are the expected effects on employment? Which sectors, which parts of the country, and what types of skills will be affected? What will be the revenue effects for the domestic treasury?

Not only are answers to these questions needed, but immediate actions are required. Consistent and sustained policy interventions are needed to provide appropriate signals for pro-poor, pro-growth outcomes to trade. Investments are needed in rural infrastructure, human capital and other public goods. Policy-makers need to give priority to the expenditures and investments that are most essential to the poor and to the long-run viability of their livelihoods.

Safety nets are needed both to protect vulnerable groups from trade-related shocks and to allow the poor to take advantage of economic opportunities arising from trade. Of course, trade and trade reforms are not the only source of shocks faced by the poor and food-insecure. A host of other shocks – natural, human-induced and market-related – can spell disaster in the absence of effective safety nets.

Safety nets are not, however, a substitute for addressing weak institutions, inadequate infrastructure and distorted factor markets, or for making essential investments in health, sanitation and education for rural people. Safety nets merely complement these fundamental actions in preparation for more open markets.

## Overview of the report

*Chapter 2* presents an overview of patterns of production and trade in agriculture, with particular emphasis on developing countries.

Developing countries are increasingly net importers of food and many have negative

net agricultural trade balances. This trend is likely to continue for many developing countries (even if OECD countries reduce their agricultural protection and support policies).

Agricultural exports account for less than 10 percent of the total exports from developing countries, and less than 20 percent in the case of LDCs. Some countries remain much more dependent on agricultural commodity exports, however; these countries are particularly vulnerable to commodity price shocks and weather-related risks.

Over the past two decades, the share of LDCs and net food-importing developing countries (NFIDCs) in global agricultural exports has declined and their share in global food imports has increased. FAO projections suggest a continuing rising trend in the net food imports of developing countries to the year 2030.

The LDCs have seen a rise in their food import bills relative to total export revenues, creating balance of payment difficulties for many of these countries. Many LDCs depend primarily on agriculture for their economic development, so unless they raise their competitiveness in agriculture or diversify their economies, they will become increasingly dependent on aid and more indebted. From a food-security perspective, these countries are particularly vulnerable.

Exports of processed agricultural products are expanding significantly more quickly than those of semi-processed and bulk commodities, and now account for one-half of global agricultural trade. Processed goods offer more possibilities for product differentiation and more opportunities for adding value. They also have a larger potential for intra-industry trade, (i.e. trade that occurs when a country exports and imports goods in the same industry). For example, cocoa-exporting countries are unlikely to import cocoa beans. Chocolate bars, however, are more likely to be exported and imported by the same country. A variety of technical, institutional and market barriers restrict the participation of many developing countries in this more labour-intensive, value-adding growth area.

The share of agricultural trade among developing countries has increased sharply during the past decade, partly as a result

of the emergence of regional trade agreements and partly because developing countries represent the key growth markets for agricultural goods. Income growth, urbanization and expanding numbers of women in the labour force are creating new opportunities for increased trade among developing countries, especially in processed food.

Large transnational food companies and supermarkets are influencing domestic food-supply chains through retail procurement logistics, inventory management and distribution networks, and a rapid rise in private standards and gradual rise in the use of contracts.

*Chapter 3* examines the trade-policy landscape for agriculture, including an assessment of the reforms that have occurred under structural adjustment programmes and the WTO's Uruguay Round Agreement on Agriculture (AoA).

It is argued that the reform process begun under the Uruguay Round of trade negotiations was an important first step, but has resulted in little real reform of agricultural policies so far. Much remains to be done to complete the multilateral reform process.

Although countries have generally complied with their commitments under the Agreement, international agricultural trade continues to be highly distorted. A review of the state of agricultural protection in the world suggests that protection remains high in many countries, with the highest protection being applied by developed countries and higher-income developing countries. Tariff peaks and tariff escalation create severe distortions that systematically work against the efforts of producers in developing countries to enter the rapidly growing markets for processed products.

Many countries complied with their AoA commitments on domestic support by adopting policy measures that are exempt from disciplines. The degree to which the support measures that are currently exempt are decoupled from production continues to be debated, but the evidence suggests that they are not entirely production-neutral. Further effective disciplines are needed to ensure that domestic support measures are minimally trade-distorting.

Export competition appears to be an area where significant reform is likely in the

current Doha Round of trade negotiations. WTO members appear to be ready to eliminate direct export subsidies, although issues of timing and of equivalence with other export competition measures remain contentious. Effective disciplines are needed, but particular care must be exercised to ensure that further disciplines on food aid do not interfere with its humanitarian role.

Developing country experiences of market reforms under structural adjustment have been highly variable: some countries have fully and consistently implemented reforms while others reformed in name only or reversed course unpredictably. Such stop-and-go policies can negate the potential benefits of agricultural and trade policy reforms.

The three so-called "pillars" of the AoA (domestic support, export competition and market access) are interlinked. Many developing countries continue to resist reducing their tariffs as long as their farmers have to compete with subsidized production from other countries.

*Chapter 4* surveys some of the most recent economic-modelling exercises that explore the potential economic gains at the national level resulting from serious reforms of the trade and agricultural policies of both developed and developing countries.

Policy-makers need good analytical results in order to understand the potential impacts of alternative policy choices and to devise appropriate measures to ensure that the most vulnerable groups are supported during the trade reform process. The quantitative studies discussed use a variety of modelling approaches and differ significantly in their details. Despite these differences, however, a few consistent conclusions, summarized in the paragraphs below, can be observed.

Agricultural trade reforms could produce important welfare gains at the global level for most, but not all, individual countries. Several recent studies suggest that the largest gains would be achieved under a comprehensive liberalization programme that addresses all economic sectors and all regions. Scenarios in which a single sector or group of countries liberalize would produce far smaller gains.

Industrial countries have the most to gain from agricultural trade liberalization, in



absolute terms, because their agriculture sectors are the most distorted by existing policies. Consumers in currently protected markets and producers in countries with low levels of domestic support would tend to gain the most.

The potential gains from agricultural trade liberalization for developing countries, although smaller in absolute terms, would be larger relative to gross domestic product (GDP) because agriculture constitutes a comparatively large share of their economies.

While developing countries as a group stand to benefit from liberalization, some groups could be hurt, at least in the short run. NFIDCs and recipients of preferential access to highly protected OECD markets are vulnerable in this regard.

The liberalization of domestic supports and export subsidies in the OECD countries could result in higher food prices. While producers would benefit from higher commodity prices, consumers would pay higher prices for food. For net food importers, the negative impact on consumers could outweigh the potential benefit to their producers.

Furthermore, developing countries that currently rely on preferential access to OECD countries for their exports could be harmed by reforms that reduce the value of these preferences, unless compensatory measures are put in place.

The net result for these vulnerable countries depends crucially on the policy response of the country itself and the ability of its people to adjust to the changing economic circumstances. This argues for a concerted programme of technical assistance and support for these countries before and during the reform process.

Some developing country exporters would gain as a result of OECD liberalization, but benefits for developing countries are also expected to come from the liberalization of trade among themselves. Indeed, between 70 and 85 percent of the potential benefits for developing countries would result from their own reform policies in agriculture.

Job creation and wage growth for the rural and urban poor constitute one of the main avenues through which trade liberalization can benefit developing countries. Moreover, a broad-based multilateral trade liberalization programme is more likely to benefit the poor than would

reforms that focus solely on agriculture and solely on OECD countries. Special attention should be given to labour markets to ensure that the poor are able to make good use of what may be their main asset – their labour.

*Chapter 5* takes the analysis from the macroeconomic level to the household level to examine the impact of agricultural trade on poverty.

The results confirm that the primary endowment of the poor is their labour, and that the impact of trade policy reforms on unskilled wages is central to the poverty story, underscoring the importance of domestic policy reforms aimed at improving the functioning of labour markets.

For many developing countries, the principal way in which trade generates positive impacts on poverty and food security is through non-agricultural incomes. Job creation and higher wages in non-agriculture sectors are the biggest promises of trade reform.

Poverty and hunger are also influenced by price changes arising from trade liberalization. The model-based studies discussed in *Chapter 4* suggest that net purchasers of agricultural commodities (most of the poor) would be hurt by the higher prices predicted in the wake of comprehensive trade reform.

Higher commodity prices may indeed hurt the poor in the short run, but, in the longer run even net purchasers can benefit if higher commodity prices translate into more jobs and higher wages. The cases reviewed in *Chapter 5* suggest that this is often the case. Safety nets and food distribution schemes can also help ensure that low-income consumers are not penalized by rises in the prices of food imports.

Another avenue through which trade reforms can promote pro-poor growth is by removing tariffs on agricultural inputs (machinery, fertilizers and pesticides) in developing countries. Many developing countries continue to penalize their agriculture sectors with these kinds of taxes. Their removal would improve the terms of trade for agriculture and help producers compete on both domestic and international markets.

The evidence presented in this chapter suggests that the trade-growth linkage can be an important vehicle for poverty reduction. However, its potential in this

respect depends crucially on effective investments in infrastructure, institutions, education and health.

*Chapter 6* examines the significance of trade reform for food security. Food insecurity and poverty are closely interlinked but distinct phenomena. While food insecurity is often a result of poverty, it is also a leading cause of poverty. Hunger and malnutrition can permanently stunt the developmental capacity of children, making it more difficult for them to grow and learn. Hunger has longer-term economic implications because it reduces people's capacity to work and fight disease.

Agricultural trade and trade policy affect food security in many ways. For many policy-makers, tariffs on basic food commodities represent an ongoing dilemma. The justification for such tariffs is often that they offer protection for domestic producers from imports of subsidized commodities; however, they also raise the cost of food, thus taxing the people who can least afford it. This effect has immediate humanitarian implications, of course, because 852 million people in the world lack the ability to grow or buy enough food for their needs.

Trade's contribution to food security involves aspects other than market access in agriculture. It means better trading conditions for non-agricultural products as well, which improves access by the poor and food-insecure to jobs, income, assets and food.

This chapter presents a recent assessment of 15 country case studies undertaken by FAO, examining country experiences of the effects of trade and economic reforms on food security. Although these experiences were highly variable, some general policy lessons can be identified.

First, a country's pre-existing economic structure and policy environment have a strong influence on the results of policy reforms. The existence and functioning of market institutions are particularly important in this regard. In countries where reforms involved the dismantling of state agricultural institutions, finding mechanisms to encourage and assist the private sector to fill these gaps was vital.

Second, countries that implemented targeted transitional measures to protect and

compensate vulnerable population groups were more successful in ensuring positive food-security outcomes. Many countries experienced difficulties in implementing safety net programmes effectively.

In addition to safety nets, complementary policies aimed at improving the productivity and competitiveness of the agriculture sector were also essential to positive food-security outcomes. Creating a policy environment to support productive investments by small farmers made it much more likely that they could respond to price incentives and take advantage of the opportunities offered by reform. Improving rural infrastructure was important in most countries, but it was particularly needed in low-income areas.

In countries with a large proportion of low-income and resource-poor people living in rural areas and dependent on agriculture, reforms aimed at raising productivity, creating non-agricultural employment and facilitating the transition out of agriculture were essential for enhancing food security in the medium-to-long term.

However, because such policies may take some time to yield results, they should be set in motion before enacting trade or agricultural policy reforms that may impinge on low-income, food-insecure households. The sequencing of reforms requires special and ongoing attention.

*Chapter 7* outlines a twin-track approach to ensuring that the poor and food-insecure are able to capture the potential benefits of agricultural trade and further trade reform. It asks whether the necessary investments are being made to ensure that the poor and hungry are able to share in the gains from trade. Finally, it draws some overall conclusions to the report.

Trade policy reform can offer opportunities to the poor and food-insecure, but the adjustment process must be managed carefully and adequate protection of the vulnerable and food-insecure must be ensured.

Trade liberalization can be a key component for promoting and sustaining agricultural growth. Expanding markets overseas provide farmers with opportunities to supply richer markets and develop brands and qualities that enable them to increase their returns from sales. Liberalization can

also create conditions for faster income growth through better access to ideas, technology, goods, services and capital, and by promoting a more efficient use of resources through specialization and the scope for economies of scale. Such growth can also benefit domestic agriculture.

However, the benefits from trade liberalization do not come automatically. Many developing countries need companion policies and programmes that help increase agricultural productivity and product quality if they are to raise their competitiveness in domestic and international markets.

Examples of companion policies include institutional and market reforms, investments in roads, market information systems and related service industries, and policy measures to promote appropriate technological innovations. Above all, countries need to ensure that vulnerable

individuals, households and groups that may be disadvantaged by the initial impacts of trade reforms are identified and cushioned through well-designed measures and safety nets.

These policies are described more fully in FAO's twin-track approach, which focuses on (i) creating opportunities for the hungry to improve their livelihoods and (ii) ensuring access to food for the most needy through safety nets and other direct assistance.

Trade policy reforms, like any other potential shock to an economy, entail adjustment costs and not everyone necessarily benefits. Governments in developed countries and developing countries alike have a responsibility to ensure that the reform process is managed in a way that minimizes the risk to vulnerable groups and maximizes their opportunities to share in the gains.