MARCH 2008 Policy Brief

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Agricultural Policy Reform in Chile

Introduction

Chile has made important progress in raising incomes and reducing poverty. Real per capita incomes have more than doubled since the restoration of democracy in 1990, and the incidence of poverty (as measured by the cost of two basic food baskets) has fallen by nearly two-thirds, from 38.6% of the population in 1990 to 13.7% in 2006. Over the same period extreme poverty, as measured by the cost of one basic food basket, has been almost eradicated, falling from 12.5% to 3.2%. Income inequality remains among the most extreme in Latin America and indeed the world, although here too there has been some progress in recent years.

The key to Chile's strong economic performance has been sound macroeconomic management, institutional and structural reforms, trade openness, and the prudent management of mineral resources (principally copper). The economy has become progressively more open, with a ratio of exports plus imports to gross domestic product (GDP) of about 75% – higher than anywhere outside East Asia. Inflation has converged on the OECD average, even in the face of global and regional volatility and large swings in the copper price and real exchange rate, although it is poised to exceed the target ceiling of 4% in 2007, mainly as a result of higher food prices.

The agricultural sector, in conjunction with related downstream activities, has played a key role in Chile's economic success. Yet while the incomes of agricultural households have increased, small-scale farmers have seen little change in their farm incomes, with most of the gains coming from improved off-farm opportunities.

This *Policy Brief* considers how the agricultural sector has responded to economy-wide reforms and describes how agricultural policies have evolved. It describes the level and composition of support provided to Chilean agriculture and evaluates the effectiveness of current measures. Finally, it suggests some ways of further enhancing the effectiveness of policies and fostering more inclusive development. ■

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How has agriculture responded to reforms?

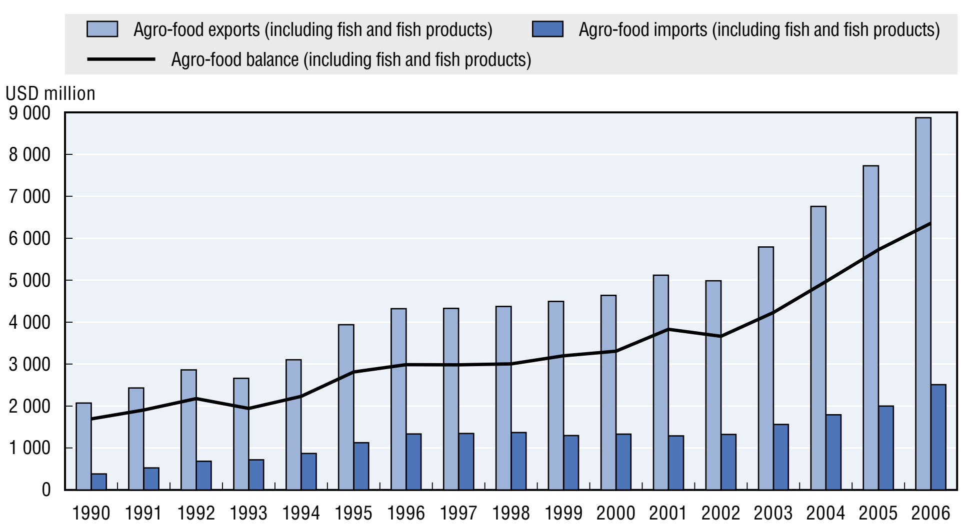
The agricultural sector, in conjunction with related downstream activities, has played a key role in Chile's economic success, both benefiting from stability and reforms, and making an important contribution, via rapid export growth. The sector is strategically more important than its 4% share of GDP would suggest. Chile's agricultural and agro-industrial sector has been extremely successful in adding value to the production of primary commodities, and processed products such as wine and fruits account for a similar share of GDP to agriculture itself.

Much of the increase in value-added has been in exportable commodities, with the consequence that agriculture and related products accounted for 29% of merchandise exports in 2002 and 2003, although this share has slipped back in recent years as a result of the boom in copper prices. Since the initiation of reforms, there has been a huge increase in the sector's export orientation (see Figure 1). The share of primary agricultural trade (*i.e.* exports plus imports) in agricultural GDP averaged 30% during the period of military government (between 1973 and 1990), reached 60% between 1990 and 1998, and has averaged more than 80% since 1999. Moreover, the growth of agricultural and agribusiness exports has accelerated in recent years, as new exports, such as pork, poultry and dairy products have added to earlier growth sectors such as wine and fresh fruit.

Chile has succeeded in diversifying the destinations of its agro-food exports. In the four years to 2005, 30% of agro-food exports went to the United States and Canada, 25% to Europe and 26% to Asian countries. Latin American markets are relatively less important, with a combined share of 18%.

Figure 1.

EVOLUTION OF CHILE'S AGRO-FOOD TRADE, 1990-2005



Source: UN Comtrade database, 2007.

Despite the growth in production and exports, agriculture's share of employment declined from 19% in 1990 to 12% in 2006, a share that remains about three times higher than the sector's share of GDP. The implied low productivity of labour employed in agriculture reflects the sector's duality, where a competitive export-oriented sector co-exists alongside an underdeveloped sector of semi-subsistence farmers. Over the long term, it is important to recognise that agriculture's share of GDP will not rise to match the sector's share of employment – in all OECD countries the tendency has been precisely the opposite. The incomes of households working in agriculture are on average about a third lower than those in other sectors, and a shift of labour out of the sector will be needed to close that gap. ■

How has agricultural policy evolved?

Since 1990, Chile's agricultural policies have centred around three main objectives: first, increasing competitiveness; second, achieving more balanced agricultural development by better integrating poorer less competitive farmers into commercial supply chains; and finally reconciling these objectives with goals related to conservation of the environment and the sustainable use of resources. While the specific articulation of objectives has changed from one government to the next, these broad areas have provided a common focus of policy concerns.

These objectives have been pursued in the context of a relatively open trade policy. Chile has a uniform most favoured nation (MFN) tariff of 6%, and the average effective tariff has been reduced to about 2% by the conclusion of a wide network of preferential trade agreements. With a few exceptions, notably wheat and sugar, for which a Price Band System (PBS) is operated, there has been little protection for agricultural products, although Chile's trade agreements have typically singled out agricultural sub-sectors for special treatment. Following a successful World Trade Organization (WTO) appeal by Argentina, the PBS was modified for wheat, wheat flour and sugar, and discontinued for vegetable oils. A second successful WTO challenge by Argentina means that the PBS for wheat and wheat flour will need to be further reformed. Over the past four years, however, domestic prices of these and other agricultural commodities have been on average no more than 2% above comparable prices in international trade.

Although Chile has relatively low trade protection, its agricultural policies are by no means laissez-faire. Indeed, government expenditures on agriculture have more than trebled in real terms over the past ten years. Spending by the Ministry of Agriculture (MINAGRI) has increasingly been complemented by the outlays of other ministries and associated agencies. The main categories of agricultural spending have been – in order of importance – irrigation; productivity improvement and skills development (including preferential credit); rural development; a soil recovery programme; R&D, training and extension; sanitary and phyto-sanitary standards; and marketing and promotion. About half of all expenditures are made at the sectoral level, while the other half comprises specific payments to farmers. A variety of agencies are responsible for these expenditures, with payments to small farmers, which account for about 30% of all outlays and half those of MINAGRI, made by a dedicated agency, the National Institute for Agricultural Development (INDAP). ■

How much support is provided to agriculture?

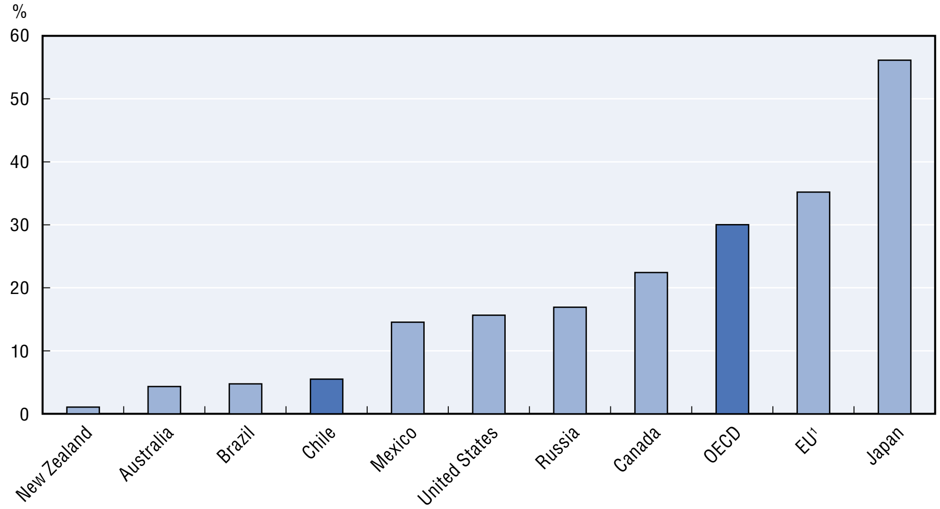
Support provided to producers is low compared with other OECD countries, with an average %PSE (producer support as a share of gross farm receipts) of 5% in 2004-2006 – a similar figure to the estimates for Australia and Brazil (Figure 2).

Market price support has fallen to very low levels, reflecting the limited use of tariffs and other trade restrictions. This has been counteracted by rising budgetary payments made specifically to farmers since the mid-1990s, with these payments dominating producer support in recent years. On balance, the PSE has trended downwards slightly since 1990 (Figure 3).

Agricultural policies that consist of payments to farmers are one component of total budgetary spending on the sector. Payments to the sector as a whole, but not specifically to farmers, included in the General Services Support Estimate (GSSE), have increased in parallel with those made to farmers. As a result, total support to agriculture, as measured by the Total Support Estimate (TSE), now splits fairly evenly between the three components: market price support and payments to farmers (which together comprise the PSE), and the GSSE. The division between payments to farmers and to the sector as a whole has been roughly half and half for the past 15 years. Spending on infrastructure dominates the GSSE while fixed capital formation dominates the budgetary component of the PSE. In a number of cases in Chile, GSSE

Figure 2.

PSE BY COUNTRY, EU AND OECD AVERAGE, 2003-2005



1. EU15 for 2003; EU25 for 2004-05.
Source: OECD, PSE/CSE *database*, 2007.

expenditures are the off farm equivalent of producer-oriented programmes (such as the provision of farm level infrastructure, irrigation and inspection services).

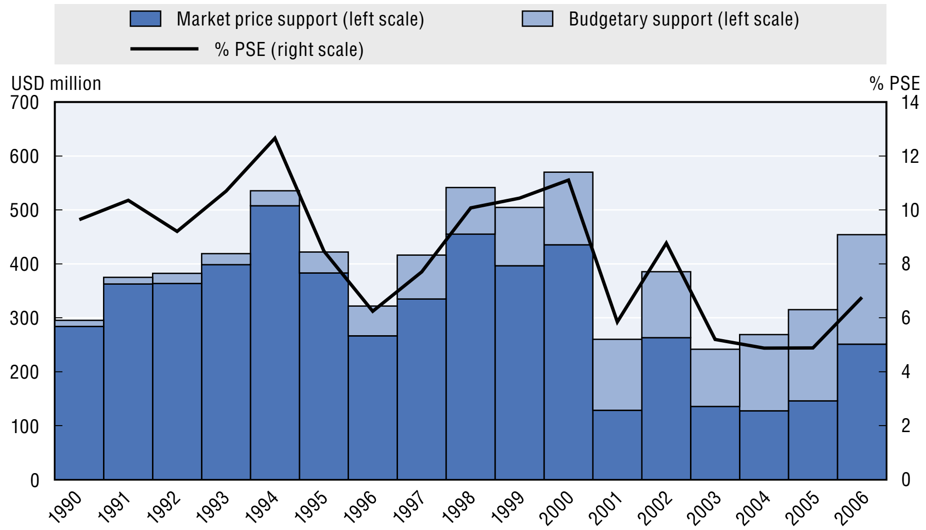
Although budgetary expenditures have risen rapidly, support to the agricultural sector imposes a much milder burden on the economy than in most OECD countries. The TSE accounted for 0.4% of GDP between 2003 and 2005, compared with an average share of 1.2% in OECD countries. The main reason for this difference is that market price support has declined to very low levels in Chile, whereas it still dominates producer support in most OECD countries. The share of the GSSE in total support was 26% over the same period, as compared with an average of 17% in OECD countries. Since the GSSE contains investments in areas that may be considered to be public goods, this suggests a more productive use of taxpayers' money than is the norm in OECD countries. However, the fact that money is spent on public goods that the market would under-provide does not itself guarantee that policies are effective. Indeed, given the large number of programmes that Chile has in place, there is a need for a more thorough evaluation of performance. ■

How can Chile foster more inclusive agricultural development?

The half of government spending on agriculture that is made directly to farmers is focused on smallholders. According to the 1997 Agricultural Census, there were 278 000 smallholders in Chile (corresponding to a definition that determines eligibility for support), of which 102 000 were subsistence farmers and 176 000 were market-orientated. These smallholders accounted for 84% of the farms in Chile, but only about 30% of the value of production. The remaining medium-and large-scale farms do not receive any

Figure 3.

LEVEL AND DECOMPOSITION OF THE PSE, 1990-2006



Source: OECD, *PSE/CSE database*, 2007.

direct support from the government. The strategic objective is to integrate smallholders systematically into commercial structures.

Although operationally some programmes target market-orientated producers, there is no explicit targeting on the basis of potential competitiveness. The reach of INDAP – the government agency with responsibility for smallholder development – is limited to 40% of the eligible smallholder constituency, and INDAP is legally constrained in the size of operations that it can lend to, with an upper limit that rules out supporting some potentially competitive medium-sized operations.

Payments to improve small-scale farmers' commercial viability need to be based on a realistic assessment of who is potentially competitive within the sector, and to target that constituency. That group is likely to be a minority of smallholders. For the majority, the main requirements are for non-agricultural policies that help them diversify their incomes and find better paid jobs outside the sector. Recently introduced smallholder credit policies that focus on correcting underlying market failures represent a more productive use of resources than traditional credit subsidies.

Two thirds of households that depend on agriculture for their livelihoods are in fact headed by salaried farm workers, and these households have similar incomes to the poorest farm households. While salaried farm workers may benefit from the increased employment opportunities offered by agricultural growth, the long-term priority is similarly to help them get better paid (skilled) work, within the agribusiness sector or elsewhere.

Agricultural policies therefore need to be framed within an economy-wide context, and consistent with other policies, such as regional initiatives and social safety nets. As agricultural spending by the Ministry of Agriculture is increasingly complemented by the outlays of other ministries and agencies, the need for close cooperation across branches of government becomes ever more essential. ■

What about the future?

Chile has made important progress in raising incomes and reducing poverty, and more recently in narrowing income inequality too. Those benefits have extended to agricultural and rural families, although improved farm incomes have not been the main driver. Chile has eschewed trade protection in its attempts to improve competitiveness and draw smallholders into commercial structures, and producer support is low in comparison with most OECD countries. Instead, the main emphasis has been on matching policy instruments to objectives and providing the investments (many of which are public goods) that farmers need.

As a further refinement, there is a case for a more explicit targeting of farm policies to potentially competitive famers, with non-agricultural policies being used to help other farmers and agriculture-dependent households diversify their incomes or exit the sector, and social welfare programmes providing safety nets for households that do not have the potential to adjust to structural changes in agricultural markets. In this way, agricultural policies could be more effectively integrated into Chile's broader strategy for balanced economic development. ■

For further information

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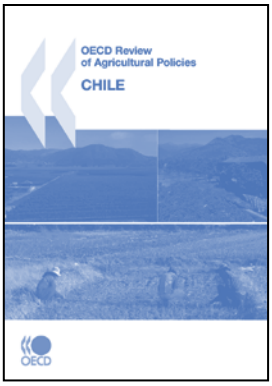

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