

## Agriculture Modernization

*The major issue facing the agriculture sector is declining competitiveness relative to other countries in the region and the serious consequences this is having on farmer incomes and levels of private sector investment in the sector. This stems from an inappropriate policy environment, inadequate public sector support for core services, and weakened irrigation infrastructure. Running through all these is the lack of incentives for the private sector to invest in agriculture. A broad-based approach alongside a focused and strong political commitment to sustain a process of change are required to implement the necessary strategic solutions and actions.*

### A. Background

The domestic market for agricultural products is slowly becoming more sophisticated and trade liberalization under the World Trade Organization (WTO) is opening new opportunities. However, despite this, the country's competitive edge in its key commodities (rice, corn, sugar, and coconut) has been slipping, and few new agricultural products have emerged where the country can compete effectively in the world markets. As competitiveness has declined, the trade deficit in agriculture has increased by over 400 percent from \$199 million in 1995, to \$1.08 billion in 2002, reflecting a 21 percent decline in agriculture exports over this period to \$1.98 billion, and a 15 percent increase in imports to \$3.05 billion. Average rural family incomes have virtually stagnated at P73,319 (1997 National Statistical Coordination Board data), which is about 34.2 percent short of the poverty threshold. Furthermore, the sector's capacity to meet basic food needs has declined, the incidence of poverty in rural areas has only slightly declined, from 44.4 percent in 1997 to 41.4 percent in 2000 (National Statistics Office data), and investment programs designed to help small farmers are often unsustainable as the underlying issues have not been resolved.

This declining competitiveness vis-à-vis other countries in the region is in large part due to inconsistencies and failures in implementing public policy, which have reduced incentives for private investment and increased inefficiencies in the use of public resources for the sector. In common with many other sectors in the country, the analysis and diagnosis of the issues needing

attention have been well documented and often discussed. An extensive report on Philippine agricultural competitiveness<sup>1</sup> by the Department of Agriculture (DA) itself provides a thorough review of problems and suggested actions, though clearly, some much-needed actions are beyond its authority. Analysis shows, for example, that there has been inadequate research in high-value products and their post-harvest handling; market information systems are almost nonexistent for small farmers; quarantine, food, and bio-safety standards are poorly defined and inadequately enforced; and investments in rural infrastructure tend to be ad hoc and poorly maintained. In particular, the country's extensive irrigation network is in need of rehabilitation and modernization, and consistent implementation of effective management policies is lacking. Exacerbating the problem is the lack of transparency and poor enforcement of regulations, high agricultural input and transport costs, and the reluctance of banks to provide rural credit due to poor performance and failed policies in the past. Collectively, these deficiencies add enormously to the costs of doing business in the agriculture sector. As a consequence, the profitability of farming is marginal; agricultural, livestock, and fishery products have a hard time competing with cheaper and often higher-quality imports; and levels of private sector investment in the sector are low.

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<sup>1</sup> Philippine Agricultural Competitiveness and Benchmarking Study (2000). This comprehensive study identifies important areas that need to be addressed (including regulatory services) to lower transaction costs of doing business in the sector—the key factor in the decline in the competitiveness of Philippine agriculture.

While recognizing the need for a broad reform agenda, successive administrations have found it difficult to break away from a chronic “fire-fighting” mode of operation because of: (i) the need to respond to increasing clamors from farmers for trade protection and support, in the face of stiff competition from imports as trade is liberalized under the WTO; (ii) pressures for quick-return investments that respond to the very real concerns of farmers, but that have diverted DA’s operational budget away from core functions (e.g., support for market development, regulatory enforcement, and technology generation and dissemination); and (iii) a devolved system of resource allocation through special programs, which operate with limited management input and oversight, leading to a wide divergence between planning objectives of DA and its actual expenditures.

Against this background, the Agriculture and Fisheries Modernization Act (AFMA) was approved in 1997. This comprehensive Act recognizes that, to meet the challenge of trade liberalization under the WTO, the sector has to become more competitive in terms of price, quality, and safety of its agricultural, livestock, and fishery products. Unfortunately, implementation of many of the goals of AFMA, especially reorientation and revamping of public sector support, has not taken place. While an annual budget of some P20 billion is envisaged under AFMA, actual releases have averaged around only P12 billion–15 billion over the past 6 years. Clearly increasing this level of funding is important, but, as outlined above, it is not the only problem. A number of institutional and policy reforms must be undertaken, as described later in this discussion brief.

## **B. Key Issues**

The fundamental issue for agriculture is its declining competitiveness relative to other countries in the region and the serious consequences this is having on farmer incomes and levels of private sector investment in the sector. This issue is now analyzed under the following headings.

### ***Inappropriate policy environment***

Farm incomes and incentives for improving quality, safety, and value-added of agricultural, fishery, and livestock products are severely constrained by ineffective policies and bureaucracy that lead to high transaction costs, high levels of risk, reduced profit margins, and, collectively, generate disincentives for investment in the sector. Numerous studies have been carried out in past years, identifying the major issues and offering recommendations in this area. Key issues relate to (i) distorted trade policies that raise the costs of agricultural inputs and send the wrong market signals to farmers; (ii) poor access to strategic market information and credit for most small farmers and fishers; (iii) inordinately high costs of transport, especially shipping; (iv) inconsistent enforcement of regulations, especially those dealing with safety and quality issues; and (v) inadequate public sector support for core services designed to facilitate market expansion and private sector-led development of the sector.

### ***Inadequate public sector support for core services***

Although DA is organized along functional lines, its core functions have not been funded sufficiently, transparently, or sustainably. The funding problem also stems from irregularity of budget releases, ineffective absorptive capacity of DA to fully utilize its budgetary allocations, and the lack of a cohesive planning and resource allocation framework. This makes work programming difficult and leads to resources being allocated according to pressing issues, at the time the limited resources become available. There is also a lack of oversight being exercised to ensure that core functions (e.g., data analysis and market information, regulatory enforcement, and analysis of technology development and dissemination) receive adequate funding and attention. Likewise, the system does not enable DA management to make strategic shifts in programming resources in line with emerging strategic issues, particularly as they relate to trade liberalization and the need for much greater attention to safety and quality requirements in both domestic and international markets. A review of DA resource allocation over the past 4

years shows that the bulk of funding has gone to production-related investments (59 percent), whereas the widely acknowledged problems facing the sector—relating mainly to how to improve the profitability of farming and fishing in the face of increasingly more competitive domestic and international markets—have not received adequate budgetary resources. For instance, market development services have received only 1 percent of the operational budget, and regulatory services only 9 percent. This has led to an impasse where DA staff and agencies are frustrated by their inability to consistently perform the tasks they know are needed, while farmers and fishers, as well as the private sector, have become frustrated with the bureaucracy and perceived lack of DA support for core public sector functions.

### ***Deteriorated irrigation infrastructure***

Irrigation is a key pillar of the country's agricultural production, and can be an effective instrument for addressing rural poverty. Closing the gap between irrigation service areas and actual irrigated areas offers the potential for increasing agricultural productivity with relatively low investment costs. The total irrigation service area in the Philippines is 1.5 million hectares (ha), but only 1 million ha are actually irrigated. The gap of half a million ha, for which infrastructure is available but full benefits cannot be delivered, is due to physical deterioration in aging irrigation systems, incomplete infrastructure, lack of secure water sources, flooding and droughts, and inefficient management of irrigation systems.<sup>2</sup> Two overriding issues are: (i) the need for better irrigation in light of increasing competition for water for urban and agricultural purposes (this includes improving the efficiency and cost-effectiveness of irrigation water delivery); and (ii) establishment of management and financial systems for sustaining irrigation systems.

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<sup>2</sup> Reference documents: World Bank Country Water Resources Assistance Strategy for the Philippines; Policy Discussion Note with the National Irrigation Administration on Improving Participatory Irrigation Management.

### ***Weak incentives for private sector investment***

The combined impacts of these three main issues on reducing the profitability of agriculture and fisheries have contributed to the high fiscal burden on the Government due to their distorting effects on producer capacities to pay for services (e.g., water charges, improved genetic material), and have greatly reduced incentives for private investment in the sector. Implementing the necessary strategic solutions and actions to address these issues will require a broad-based approach, together with a focused and strong political commitment to sustain a process of change.

## **C. Suggested critical areas for action**

### ***Improving the policy environment***

Tackling a broad policy agenda is clearly difficult and implementation will require sustained and consistent action over several years. In the short to medium term, it is critical that the Government prioritize the initiation of concrete steps to address the above key issues, especially on (i) agreeing on and pursuing a consistent track with regard to a coherent agricultural trade policy reform agenda, which promotes a balance between efficiency and market development considerations; (ii) ensuring the provision of adequate funding for core services of government that are related to facilitating market expansion and private sector investment in agribusiness; (iii) enhancing capacities of relevant government agencies to more effectively provide marketing assistance to producers and traders, to collaborate in market promotion with the private sector, and to undertake analysis of emerging markets; (iv) revamping and strengthening the system of agricultural data analysis and delivery in order to provide comprehensive, timely, and accurate information to growers, traders, processors, and exporters on prices, volumes traded in major markets, product standards, regulatory policies, and procedures; and (v) streamlining and increasing transparency of the Government's safety and quality assurance systems and procedures.

### ***Implementing public sector expenditure reform***

DA should consistently pursue the alignment of its plans and budgets with its Major Final Outputs (MFOs), in line with the new Department of Budget and Management guidelines, which aim to rationalize budgetary allocations for core functions of DA prescribed under the AFMA. As such, DA should be supported toward (i) streamlining and improving its medium-term and annual planning and budget system; (ii) capacity building and training to orient staff to the new MFO-based budget and planning systems and procedures; and (iii) strengthening monitoring and evaluation in line with MFOs.

### ***Improving the cost-effectiveness of irrigation water delivery and utilization***

The solution to these issues requires different approaches, depending on whether the infrastructure is: (i) part of the national irrigation systems (NIS), accounting for 50 percent of the nation's irrigation service area and managed by the National Irrigation Administration (NIA); (ii) a communal irrigation system (CIS), accounting for 40 percent and managed by irrigation associations (IAs); or (iii) a private system (10%). The following are the proposed measures to address some of the core irrigation sector issues.

Collectively *national irrigation systems* occupy some 0.7 million hectares and constitute the largest systems in the country. AFMA mandates NIA to gradually transfer to IAs the management for secondary and below systems (in what is known as irrigation management transfer or IMT), as in other countries. This was started in an attempt to reduce, over time, the Government's budgetary burden, streamline NIA, and empower farmers for decentralized irrigation management. However, IMT has faced implementation problems, despite the willingness of most farmers/IAs to participate,<sup>3</sup> relating to the long-standing issue of NIA overstaffing. Irrigation issues in need of attention include:

- *Technical upgrading.* In a number of cases, rehabilitation per se will be insufficient to address underlying design and implementation flaws; rather, investment in modernization is needed. Emphasis needs to be given to investment for closing the gap in the provision of services for existing irrigated areas, rather than on expansion to new areas, in order to make optimal use of both financial and natural resources. Relating to this is the need to continue piloting the application of volumetric irrigation water charges in areas where water savings in agriculture could potentially benefit urban water use or availability in downstream areas;
- *Streamlining NIA.* This should be a priority for the Government, and IMT should go hand-in-hand with investments in improving physical systems. The levels of income from irrigation service fees and other sources are inadequate to meet NIA's operating costs, resulting in deteriorated infrastructure and inadequate services. The operating costs of NIA must be reduced through a phased streamlining process to help the agency get out of vicious cycles; and
- *Strengthening IAs/LGUs.* More attention needs to be given to building IA and LGU technical and financial capacity to take over responsibility for irrigation systems.

Following promulgation of the Local Government Code (LGC), responsibilities for *Communal irrigation systems* (CIS) have devolved to LGUs. However, there has not been an accompanying transfer of NIA staff working on CIS to LGUs, contributing to the financial difficulties confronting NIA and the lack of technical capacity in LGUs. As a result, many community irrigation schemes are deteriorating. Compounding the problem is the fact that CIS loan repayments go to NIA. While these repayments are an important source of revenue for NIA, this approach is inconsistent with the need to establish sustainable financing mechanisms for CIS. The resolution of this issue would imply finding an alternative and sustainable funding source for CIS and needs to be addressed as part of the NIA streamlining package for reducing operating costs.

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<sup>3</sup> Results from an ongoing nationwide IMT performance survey and in-depth review study.

### ***Promoting private sector investment***

The issues related to improving the policy environment and to public sector support outlined above, will of themselves be insufficient for revamping the sector without the private sector playing a larger role, not just in terms of investment, but in delivery of services, and development of forward and backward linkages between producers, traders, processors and exporters. While DA reforms already under way are designed to improve the enabling environment for encouraging broader private sector investment in the sector, there are several areas of public policy that will need particular attention if significant impact is to be achieved. Summarized below are the opportunities for promoting private sector investments in the agriculture sector:

- *Reform pricing policies for DA services that discourage private investment.* Opportunities for greater private sector involvement exist in areas such as market information analysis and dissemination, laboratory analysis and certification, and certified seed and vegetative material production and distribution. At issue, however, is the public sector provision of such services and products at rates that do not reflect the true cost. It is suggested that DA (i) review areas where opportunities exist for greater private sector engagement, (ii) adopt a policy of pricing its own services in such areas along commercial lines and through a consultative process, and (iii) seek ways to encourage greater private sector participation while simultaneously ensuring that DA's capacity is strengthened in areas of regulatory monitoring and enforcement.
- *Enhance technology dissemination through private outlets.* The Philippines has traditionally been a source of agricultural technology across Asia, as a result of its active research programs pursued in academic, public, and international agencies. Of concern, however, is the relatively poor dissemination of this technology to the country's own farmers and fishers, in contrast to its more effective dissemination to

other countries. Several factors are at play that public policy needs to address, namely, (i) ineffective implementation of intellectual property laws; (ii) rent-seeking behavior on the part of researchers and agencies leading them to limit or withhold dissemination of improved genetic material; and (iii) disincentives for agencies or units to engage more actively in disseminating technology (and delivery of services), since revenues cannot be retained. It is suggested that DA actively explore ways to overcome the inherent disincentives for technology dissemination and adopt a transparent policy to encourage such actions.

*Balance regulatory responsibilities with facilitation.* The current widespread frustration with regulations in the agriculture sector stems mainly from the lack of transparency, cumbersome procedures, and their inconsistent application, rather than from the regulations themselves. These factors collectively add significantly to the costs of doing business for the private sector, and have led to practices of avoidance as an easier solution than compliance. While clearly much needs to be done to achieve more effective implementation of regulations under the authority of DA, e.g., capacity building, improving transparency and streamlining procedures, enhancing strategic facilities and equipment, etc., it is important that DA regulatory agencies and their staff see their role as facilitating safe and sound growth in the sector, balanced with strategic trade expansion, rather than focusing on "policing actions" that tend to inhibit private sector initiative and overall sector development. Accordingly, it is suggested that DA strategy for strengthening its regulatory services focus particularly on ways to streamline procedures for ensuring product safety, meeting quality standards and protocols of trading partners, increasing public awareness of food quality issues, and ensuring that sanitary and phytosanitary procedures are in place and implemented for the safe and sustained development of the sector