

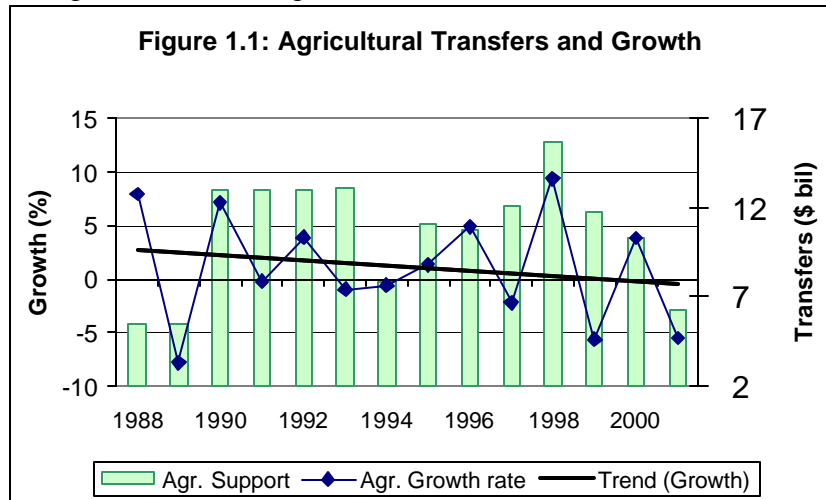
1. The Reform of Agricultural Sector Subsidization

A. The Context

1.1 Turkey is endowed with rich natural and human resources, but its full potential for rural growth went largely unrealized in the period between 1980 and 2002 because of increasingly inefficient rural development policies focused on two main objectives. The first was self-sufficiency in key individual products to be brought about by increasing yields and production levels through the subsidization of agricultural inputs and credit and through the expansion of cultivated land with heavy public investment on irrigation. The second was increasing agricultural incomes by emphasizing output price support policies and protective trade measures.

1.2 During the last four decades agricultural GDP grew about three times slower than the overall economy, resulting in a declining share of agriculture in GDP from 35 percent in 1960 to 15 percent in 2000 (Figure 1.1, using SIS and OECD data).

However, the share of agricultural labor in total labor force declined by much less, from 55 percent in 1960 to 44 percent in 1997. Although labor productivity in agriculture showed an upward trend over the period 1960-2000, growth rates declined steadily and turned negative in the mid-1990s, with the growth of land productivity showing a similar trend.



1.3 Agricultural subsidies generated significant and unsustainable fiscal costs, and high import tariff policies placed a heavy burden on low and middle income consumers. As input and price subsidies disproportionately benefited large farmers, this type of agricultural support contributed to income inequality and widening of absolute income differentials in rural areas.

B. Reforms Targeted Subsidies and Hard Budget Constraints

1.4 The non-sustainability (fiscal, economic, and social) of agricultural support policies prompted the Government of Turkey (GOT) to adjust them in 2000 in an effort to promote fiscal stabilization and allocative efficiency. These reforms were part of a larger fiscal stabilization program. The reformed agricultural subsidy policies focused on two broad themes. The first was the phasing out of subsidies for fertilizer, credit and price supports and the introduction of a national program of Direct Income Support (DIS) for farmers through a uniform per hectare payment (roughly \$90/ha) unlinked to the production of any specific crop. This was done to partially compensate for the removal of the old subsidy system and to continue to provide adequate income support to the rural sector, but in an incentive-neutral way.

1.5 The second main theme has been domestic price reforms through commercialization and privatization of national parastatal enterprises, including SEKER (Turkish Sugar Company) and TEKEL (Turkish Alcohol and Tobacco Company), and the restructuring of TMO (the Turkish Grain Board) as the support price mechanisms for these crops were reduced. Government has also been supporting the restructuring of the quasi-governmental Agricultural Sales Cooperative Unions (ASCUs), which in the past also intervened to support certain commodity prices. These are being made into sustainable, self-financing organizations dedicated to marketing and conducting primary processing (e.g., cotton ginning, olive curing) of as much of their farmer members' output as possible. These two efforts have reduced the state's direct role in agricultural production and processing considerably.

1.6 The changes to agricultural output subsidization have taken the form of greater market deregulation through reduction and phasing out of state-set prices, and reduced intervention purchases financed by the budget. For example, in the sugar sector, state set prices for sugarbeet were reduced by 21 percent (in real 2001 TL) over 1999-2001, and starting in 2002, these prices have been set on an annual basis under agreements reached directly between the operators of sugar factories and growers. Sugar sales prices are now freely set by the operators of the sugar factories, and in 2002 they fell by an additional 5 percent. Sugar quotas have been set for a five year period by the Sugar Agency (established in 2001), and sugar beet purchases agreed to by the factories have declined by 26 percent over 1999-2001.

1.7 In the tobacco sector, state set prices were reduced by a third over 1999-2001, and were abolished starting with the 2002 harvest. Over the same period tobacco purchases from farmers fell by 30 percent. Under the Tobacco Law of January 2002, there are provisions for purchasing tobacco produced by growers based only on written contracts or open auction. The price of tobacco produced under contract between the producers of tobacco products and the growers is set by mutual agreement. Tobacco produced by growers other than under written contracts is sold on an open auction method. In 2002, tobacco purchase prices fell by an additional 13 percent in real terms (compared to 2001).

1.8 In the grains sector, the Turkish Grain Board (TMO) reduced its volume of intervention purchases by over 45 percent from 1999-2001 to about 2.4 million tons. In 2002, these purchases were reduced further to about 800,000 tons. In 2002, TMO also ceased announcing minimum purchases, and wheat import tariffs were reduced substantially, though they remain at about 45 percent. The prices paid by TMO dropped by 13 percent over 1999-2001, and by an additional 10 percent in 2002. In the hazelnut market, the intervention purchases and announced support prices made by the parastatal Fiskobirlik (hazelnut ASCU) declined by about 25 and 40 percent, respectively, over 1999-2001.

1.9 A related initiative under the reform program provides grants to farmers who require assistance in switching out of crops that are no longer profitable. One-time payments are offered mainly to hazelnut and tobacco producers and are designed to help cover the transitional costs of switching to other crops. However, participation in these programs is not robust, as many farmers are not fully convinced that the GOT will continue to reduce its presence in agricultural marketing in the tobacco, sugar and hazelnut sectors. By completing the privatization of TEKEL and SEKER, ending hazelnut support purchases and facilitating the restructuring of Fiskobirlik, and selling off TMO's excess grain storage capacity, the GOT would ensure hardened budget

constraints on important large marketing enterprises in the sector and improve the efficiency of agricultural markets. This would also improve the outlook for sustained macro-economic stabilization.

1.10 In distinct contrast to the policy of reduction in agricultural subsidies, the GOT has maintained the level of agricultural sector investment outlays financed by the central budget at a fairly constant level during the reform period. These investments have been fairly steady at roughly 600 trillion 2001 real TL, averaging almost US \$600 million annually. This represents a 7-9 percent share of the total central budget investment expenditures and roughly 0.3 percent of GNP.

Table 1.1 - Agricultural Sector Investment Outlays By Turkish Central Budget, 1999-2003

	1999	2000	2001	2002	2003
Real 2001 Billion TL	567,918	616,541	503,060	566,124	664,876
US\$ Million	580	636	410	547	761
Share of Total Investment Budget	6.8%	6.7%	7.3%	8.4%	9.2%
Share of GNP	0.31%	0.32%	0.28%	0.29%	0.40%

Source: SPO website – www.dpt.gov.tr/kamuyat

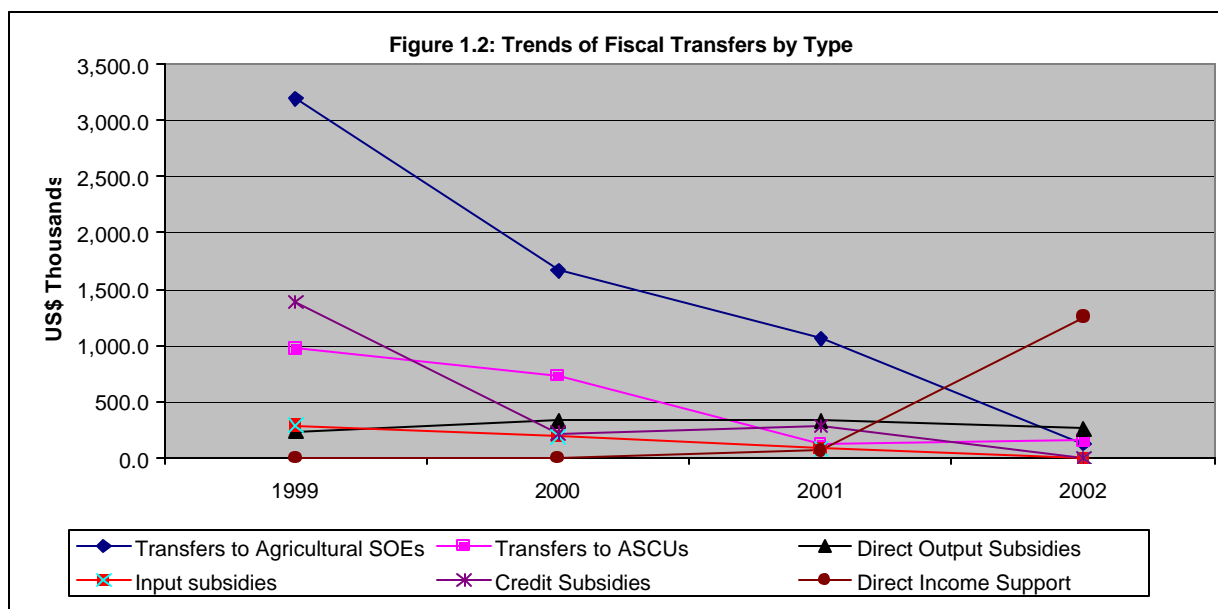
1.11 The next rural development policy challenge for Government is now to define the priorities where it can lead, and promote private sector development. However, before embarking on the formulation of these policies, it is necessary to examine the impact of the various reform policies of the 2000-2002 period so as to take stock of the starting point for the next phase of agricultural and rural sector reforms. The rest of Chapter One concerns itself with the scale of fiscal tightening achieved through subsidy reduction, while Chapter Two examines changes in agricultural terms of trade and Producer Subsidy Equivalents (PSEs) which have resulted from the subsidy reforms. Chapter Three focuses on how the reforms have affected the availability and use of agricultural inputs and credit, and Chapter Four examines resulting changes in agricultural output structure and foreign trade flows. In Chapter Five the Review examines the impact of the of subsidy reforms on agricultural sector productivity at the national and regional levels. Chapter Six presents the analysis of survey data (from 2002) regarding the welfare impact on farmers resulting from the interaction between subsidy reduction and the introduction of the Direct Income Support (DIS) program.

C. Achievements in Reducing Subsidies

1.12 By the end of 2002, the implementation of the main themes of the program had significantly reduced artificial incentives for inputs and particular crops and switched the main focus of agricultural policy to the DIS Program. Annual fiscal transfers have been reduced from US \$6.08 billion (3.06 percent of GDP) in 1999 to US \$1.79 billion or 0.67 percent of GDP in 2002. This has been effected largely through elimination of credit subsidies, and substantial reduction in crop price subsidies and state financed crop purchases. TMO grain purchases declined from 3.6 million tons in 2000 to less than 1 million in 2002, and budget-financed tobacco and hazelnut purchases decreased by half as well. Many ASCUs have initiated restructuring programs, returned to profitability, and begun to increase value added for their member farmers through improved and expanded marketing activities. At the same time, the DIS Program has expanded to become the main instrument of rural income support. In 2002, the

DIS Program covered approximately 75 percent of farmers and accounted for more than half (US \$1.25 billion) of the budget and other fiscal subsidies to the agricultural sector.

1.13 Between 2000 and 2002, subsidies to state owned enterprises (SOEs) witnessed the largest declines from US\$3.2 billion to US\$130 million (**Figure 1.2**). These subsidies include budget for support purchases (the largest share), “duty losses” (compensation for losses on exports or written-off tax arrears), and injections of equity into the SOEs. TMO and TEKEL were the largest recipients of these subsidies. As estimated US \$1.0 billion, 35% of the \$3.1 billion decline in subsidies to SOEs, was a loss of income for agricultural producers. The other 65% has been an efficiency gain, as these funds were formerly absorbed within the SOEs¹.



Source: Undersecretariat of Treasury and own calculations.

1.14 The second largest decline was in credit subsidies, which by 2002 had been phased out from their level of US \$1.4 billion in 1999. Since these credit subsidies were also administered by a state entity (Ziraat Bank, the state-owned Agricultural Bank) or quasi-state entities (the Agricultural Credit Cooperatives, ACCs), a significant share of these subsidy reductions did not fall fully on farmers, given ACC overstaffing, and high administrative costs. Since the incidence to farmers in the past for these credit subsidies was roughly 80 percent², they have lost roughly US \$1.1 billion as a result of reduced credit subsidies. The third largest area of subsidy reduction were transfers through ASCUs, which have been reduced by over 80 percent. Similar to output subsidy flows through SOEs, an estimated 40 percent of these subsidy reductions represent losses to farmers: roughly US \$320 million. Input subsidies declined by US \$300 million and have been borne entirely by farmers through higher input prices. As a result, the reduction in these three subsidy areas by the above amounts has meant that farmers lost roughly an additional US \$1.4 billion in fiscal transfers in 2002 compared to 1999.

¹ This estimate is based on examination of the past administrative cost margins, trading losses, and interest penalties of a sample of SOE's and ASCU's.

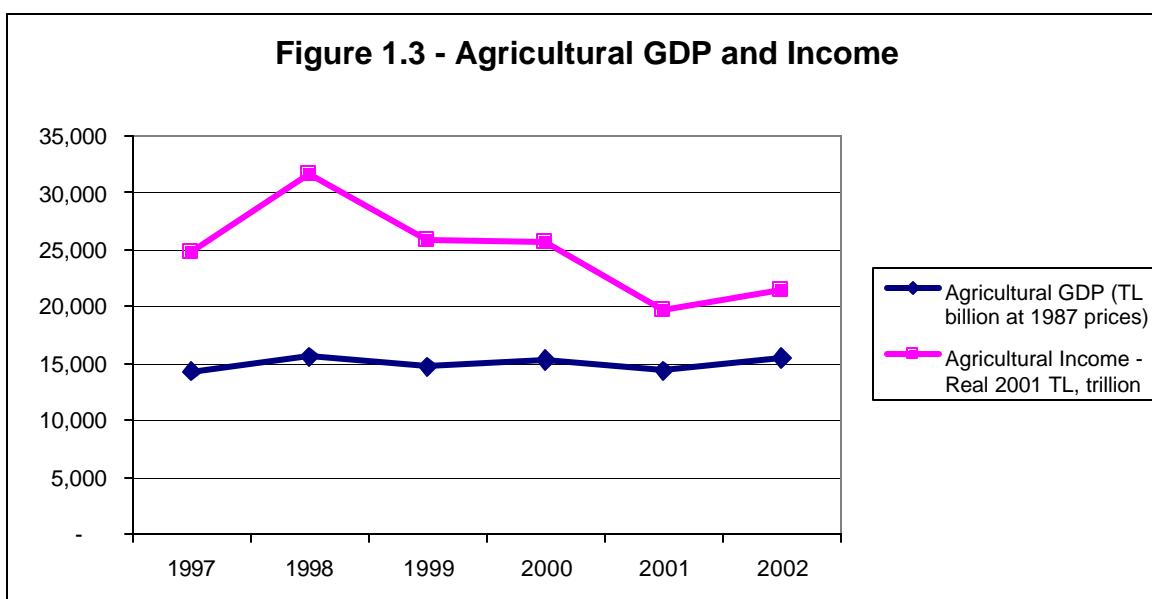
² This estimate is based on examination of ACCs and Ziraat Bank's past administrative margins and the timing of past debt write-offs.

Table 1.2 – Scope and Incidence of Agricultural Subsidy Phase Out, 2002 compared to 1999

Million US \$	Decline in Fiscal Cost	Change in Agricultural Transfers to Farmers	Efficiency Gain
Transfers to SOEs	3,063.0	-1,026.0	2,037.0
Transfers to ASCUs	814.2	-325.7	488.5
Direct Output Subsidies	-23.6	23.6	0.0
Input subsidies	290.2	-290.2	0.0
Credit Subsidies	1,387.6	-1,110.1	277.5
Sub - Total	5,531.5	-2,728.4	2,803.0
Direct Income Support	-1,246.7	1,246.7	0.0
Total	4,284.8	-1,481.8	2,803.0

Source: Undersecretariat of Treasury and own calculations

1.15 The overall impact on farmers of the fiscal subsidy reductions was roughly US \$2.7 billion when comparing 2002 to 1999 (**Table 1.2**). By factoring in the US \$1.25 billion given back to farmers as compensation through the DIS Program, one can estimate that the farming sector's interaction with the budget has deteriorated by about US \$1.45 billion. This is the equal to roughly half of the magnitude of the observed decline in agricultural income from 1999 to 2002 (shown in Figure 1.3). The other main factor responsible for the reduction in agricultural income, reduced flows from consumers to farmers which have resulted from less market intervention by the state, is examined in Chapter Two in the measurement of changes in Consumer Subsidy Estimates in the agricultural and food sector.



Source: SIS and own calculations.