

## Reforming Africa's cotton economies: A 'second best' approach

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**T**he challenges facing African agriculture are well known. Typical problems include stagnant or declining yields, untapped production potential, low returns and environmental degradation. The remedies, however, are less self-evident, and opinions on the subject continue to vary widely, especially when it comes to major commercial crops such as cotton.

Since the structural adjustment programmes of the 1980s, mainstream analysis has attributed poor agricultural performance in Africa to excessive government regulation, poor incentives for production and innovation, and the inefficiencies of the state-owned companies ('parastatals') that stand between producers and markets. Following the apparent logic of this diagnosis, the international financial institutions (IFIs) and other donors have continued to advocate market liberalisation and the privatisation of parastatals as key elements of any solution. However, these recommendations have been challenged on several fronts. It has been argued that market liberalisation can have seriously negative consequences, offsetting any gains from increased competition. This is seen as particularly true for commodity sectors such as cotton, which require considerable market coordination to function well.<sup>2</sup>

Today, these more nuanced perspectives on agricultural markets are becoming accepted more widely. Yet donor agencies and IFIs have had difficulty in translating them into alternative policy recommendations. This is a result, in great part, of the continuing influence of two particular notions. First, that state companies are wasteful and pay farmers lower-than-market prices, and, second, that greater efficiency can be achieved only by aligning actors' incentives with price signals. The consequence has been that the pressures to privatise agricultural parastatals and liberalise markets have hardly relented.

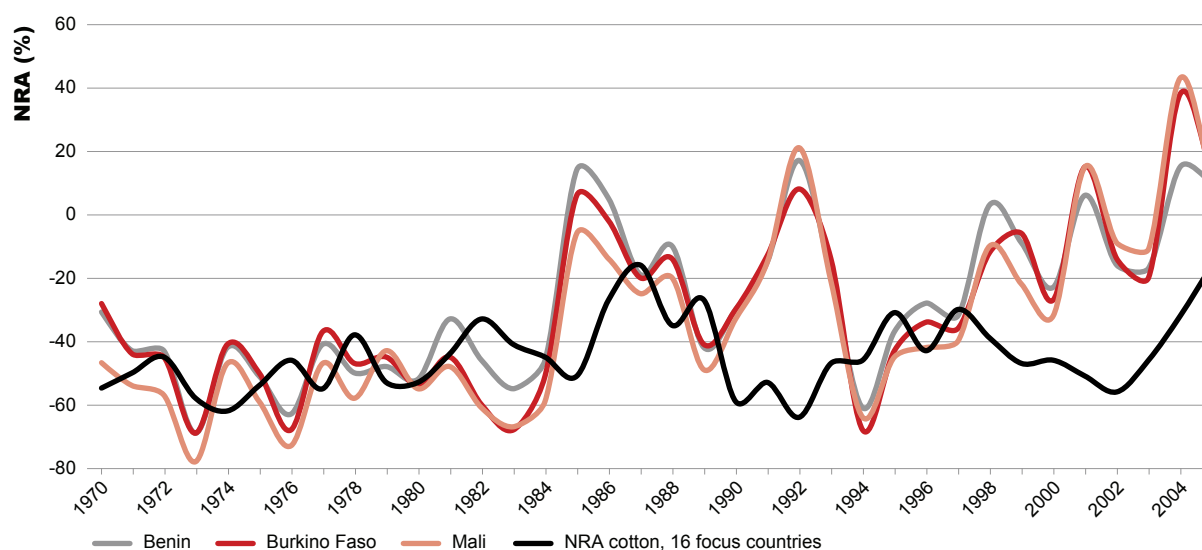


Cotton flower © Flickr / ep2media

The Africa Power and Politics (APPP) Cotton Sector Research Project has examined cotton sector reform experiences in Benin, Burkina Faso, Cameroon and Mali. It concludes that donor recommendations continue to be focused too narrowly on removing policy-induced market distortions in contexts where such policies are not appropriate, given the prevailing combination of market, institutional and policy failures. The insistence on such principles does not only generate strong and predictable resistance by domestic actors. It also leads to observed outcomes that are very different to those predicted. In addition to showing little appreciation of local realities, prevailing policy stances miss the opportunity to build on the many positives that existing agricultural systems already display. And opportunities are missed to leverage local resources to get around real constraints.

Analysis of the cotton sector in the four countries suggests the need for more adept handling of market, institutional and policy failures, with more emphasis on what works in specific country contexts, and less on the reduction of inefficiencies. The aim should be 'second best' strategies that work with, rather than against, the local grain.

**Figure 1: Natural Rate of Assistance to cotton sectors (1970-2005)**



Sources: J. Baffes, 'Distortions to Cotton Sector Incentives' in World Bank Research WP 50, 2007, and K. Anderson and W. Masters (eds.) *Distortions to Agricultural Incentives in Africa*, World Bank, 2009.

## Is farmer 'taxation' really the problem?

It is well established that African governments impose double penalties on their agricultural sectors: directly, through export taxes, exchange rate controls, trade restrictions and parastatals' monopolies in commodity marketing; and indirectly, by subsidising manufacturing and other non-agricultural sectors. Despite the agricultural market liberalisation and privatisation measures undertaken under donor pressure since the mid-1980s, recent data from the Agricultural Distortions Project of the World Bank suggest that the degree of farmer 'taxation' remains high and 'larger than government investment or foreign aid targeted to agriculture'.<sup>3</sup> This finding, however, focuses on the average. Questions remain about the level of agricultural policy distortions in specific commodity sectors and countries, and which policies should be applied in those cases.

Using an indicator called the Natural Rate of Assistance (NRA),<sup>4</sup> the Distortions Project finds that cotton is one of the most heavily taxed commodities on the African continent. But this applies less to West African cotton economies than to other African countries. When considering three of the major cotton producers in our sample, Benin, Burkina Faso and Mali, their NRA for cotton was comparable to

the average for 16 other African countries only during the 1970s and 1980s. In most years, it was highly negative, implying taxation (Figure 1). Since 1998, however, it has edged towards zero, and has even achieved positive values in some years – implying state support.

This brief does not discuss the distinctive historical and institutional features of West and Central African (WCA) cotton sectors that are responsible for this divergence.<sup>5</sup> A key finding, however, is that the taxation of cotton sectors has fallen in recent times in the four countries studied.<sup>6</sup> The first part of our argument is, therefore, that the removal of trade and policy distortions in these cotton sectors may not have been the main priority, especially in recent times.

## A 'second best' perspective

There is another kind of problem with the prevailing focus on agricultural policy distortions. This relates to what economists know as the second-best theorem of welfare economics. This states that, if a market imperfection or distortion prevents the attainment of the first-best optimum outcome that is in theory possible in a competitive economy, then policy measures designed to provide other conditions for that optimum are in general no longer desirable. Such measures may simply create new distortions elsewhere in the economy.<sup>7</sup>

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The problem with orthodox recommendations on economic policy is that they completely disregard this theory, aiming to rectify as many policy distortions as possible even in contexts replete with market and institutional failures. The APPP study shows that this is the case for many donor-promoted cotton sector policies. By ignoring the multiple linkages between West and Central African (WCA) cotton sectors

and other parts of countries' economic, social and political systems, interventions that aim to 'fix' a given inefficiency risk creating counter-productive effects elsewhere. This is illustrated by two examples: privatisation and price liberalisation.

### **Privatisation**

The argument for parastatal privatisation is based on the apparently faultless belief that state companies are inefficient. But this argument loses weight when it runs up against the reality of other market and institutional failures. WCA governments have often used state cotton companies to deliver a wide variety of services to rural regions. These have covered agricultural extension services, not just for cotton but also for cereals, livestock and environmental conservation; roads and other infrastructural development; nutrition and health training; and literacy classes. Our qualitative evidence from interviews across Benin, Burkina Faso, Cameroon and Mali indicates that, for cotton farmers and their families, these services may operate on a scale that compensates them for lower cotton prices.

The traditional argument is that it is more efficient to provide farmers with fair market remuneration, and let them buy these services through markets, or fund through public good provision. That neglects the enormous costs and difficulties of switching from a known and proven system to a new one in countries where, typically, markets fail, where public goods provision is dismal and where stakeholders, including farmers, have little patience left for new experiments.

This kind of complexity in these cotton systems invalidates the idea of an optimum efficiency achieved by minimising market distortions. Such features may not be economically efficient, and it is true that resources could be reallocated in a way that delivers higher economic returns. But they may make sense in their specific context. The belief underpinning orthodox market reforms – that the current crisis in the cotton sector can be solved by removing distortions and establishing the 'right' incentives – demonstrates a misunderstanding of the realities on the ground. Added to a context of imperfect markets and institutions, the inter-dependencies between the multiple domains and actors involved in each country system make it highly likely that any policy intervention in one sphere will have unintended consequences elsewhere. A wise approach to cotton-sector policy reform would start by recognising this interconnectness.

### **Price liberalisation**

Price liberalisation is a standard element in the orthodox recipe for agricultural sector reform. This is based on the belief that state intervention and price regulation dampen farmers' incentives. In WCA cotton sectors, the tradition has been for price systems to set one producer price for the whole country (pan-territorial pricing), with that price announced at the beginning of the cotton-growing

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season. While this base price can be increased after harvest in response to higher international prices or greater than expected trading-company profits, it can rarely be decreased. This implies that parastatals bear the costs of any negative price fluctuations.

Critics of this system, especially within the IFIs, say that, according to the principle of comparative advantage, farmers closer to the ginning plant should be paid a higher price. Similarly, prices for farmers should be allowed to fall below the price set at the start of season when international prices fall below a given threshold. If the point of a pan-territorial price is to subsidise remote farmers who are poorer, they argue, this is an inefficient way to reduce poverty. A better strategy would be to pay farmers a price that reflects market principles, and then support vulnerable or remote farmers through targeted interventions.<sup>8</sup>

However, these arguments discount some important realities. First, governments may find it difficult to implement recommended targeted anti-poverty interventions because of weak administrative capacities and limited funds. Under these conditions, seemingly inefficient but feasible initiatives, such as the traditional price policy described above, can represent the next-best alternative. This applies especially if a sizeable percentage of cotton farmers are poor.

Second, economic theory supports another policy principle: since poorer individuals are more risk averse, it is more efficient for the less risk-averse party (the cotton company in this case) to bear most of the market risks (from price fluctuations). Therefore, and in line with the second-best theorem, the call for the liberalisation of prices can be counter-productive. With the uncertain promise of fixing one price distortion, it can create serious problems elsewhere, including increased poverty among cotton farmers and a reduction of their production incentives.

### **Going with the grain**

The reforms recommended by donors to reform the cotton economies of West Africa are often resisted and seldom implemented in full.<sup>9</sup> A common interpretation sees this as the result of a lack of government capacity or perverse incentives generated by current political

systems that deter rational policy-makers from following sound advice. The APPP research suggests an additional reason: problems with the policies themselves, in that they are first-best options that are advisable only under ideal conditions that are far from the reality. The economic, social and political conditions in the countries studied are not those that are required for a first-best approach to lead to an optimal outcome, even in theory.

The recent history of cotton-sector reforms in West Africa includes examples of countries' resisting donor recommendations (Mali) or transforming them (Burkina Faso), and of countries adhering to them at first, but then thwarting them during implementation (Benin). Close analysis of these contrasting experiences has shown that they are, at least in part, the result of actors' not responding to incentives in the way predicted by the recommended policy because of the market, institutional and policy constraints that pervade the environment in which they make decisions.

In Benin, for example, privatisation of parastatals did not force 'market discipline' on companies, nor did price liberalisation lead to a higher producer price (after an initial hike). The shedding of non-cotton functions by the cotton parastatal in Mali, and the introduction of a more stringent price system, did not lead to cost reduction. Nor did it increase farmer productivity. On the other hand, the unconventional privatisation of the parastatal in Burkina Faso, in which only producer associations were allowed to buy company shares, was relatively successful. So was the 'zoning' approach, under which the cotton companies were allowed local monopolies rather than required to compete. These features improved managerial performance, as the new system provided appropriate incentives to bureaucrats, using their solid alliance with rural elites for leverage.

## Policy implications

Reform policies for African productive sectors need to become much better at addressing the implications of widespread market, institutional and policy failures. At least where cotton is concerned, donor advice should reconsider its preoccupation with reducing inefficiencies at all costs. It is clear that orthodox economic policies have been counter-productive at times, diverting resources and attention from those very things that cotton systems are quite good at in the four countries studied – delivering high quality services to farmers, providing safety nets to poor farmers and bringing infrastructure to rural areas – in exchange for the unfulfilled promise of more rational incentives and more effective management.

A better approach to agricultural sectors would refrain from the mechanical adoption of theoretically questionable principles of market efficiency and optimisation. Rather than regarding actual interventions as falling short of some unattainable efficiency standard, it would work within, and attempt to learn from, specific country contexts. This would mean making more serious efforts to understand the inner logics of particular agricultural systems and, on that basis, suggesting context-specific ways to deal with the prevailing market, institutional and policy failures. Donors following this 'second best' strategy would immediately recognise the superiority of unconventional policy approaches such as the zoning model adopted in place of full liberalisation in Burkina Faso. Surely, they would no longer insist on imposing unwanted recommendations, as in Benin and Mali, that generate needless conflict among domestic stakeholders and waste already scarce resources and energy.

## References

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2. Johann Kirsten et al. (eds.) *Institutional Economics Perspectives on African Agricultural Development*, IFPRI, 2009.
3. Kym Anderson and William Masters (eds.) *Distortions to Agricultural Incentives in Africa*, World Bank, 2009, p. 35.
4. The NRA is defined as 'the percentage by which government policies have raised gross returns to farmers above what they would have been without government interventions' (ibid., p.11). Negative values for NRA, therefore, indicate taxation rather than support.
5. But see APPP Working Paper 24.
6. As evident from the data compiled by Anderson and Masters (2009), the rate of taxation for Cameroon, though typically lower than in Benin, Burkina Faso, Cameroon and Mali, has followed a very similar pattern since 1994.
7. R.G. Lipsey and K. Lancaster, 'The General Theory of Second-best', *Review of Economic Studies* 24(1), 1956.
8. Ilhem Baghdadli et al., *Strategies for Cotton in West and Central Africa*, WP 108, World Bank, 2007.
9. The foregoing discussion leaves out the case of Cameroon where donor pressure for reform was lower, and reform implementation quite limited – see APPP WP 23.



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