SENSE AND NONSENSE OF RICE PRICE CONTROLS IN SRI LANKA

OG Dayaratna-Banda, JMA Jayawickrama, MB Ranathilaka Department of Economics & Statistics University of Peradeniya



1. INTRODUCTION

This briefing note analyses some of the issues related to recent rise of rice prices and consequent policy responses. Questions posed here are:

- Whether the recent rise of rice prices was a permanent or temporary phenomenon?
- Why was the rice price unusually high since January 2008?
- Was the rice crisis market driven or policy driven?
- What are the economic consequences of rice price control?
- Are there alternative policy responses that the government might have contemplated?

2. RECENT TRENDS IN RICE PRICES

Rice prices in Sri Lanka rose rapidly in January 2008, a trend that originated in mid-2007.

Soaring Rice Prices: The price of Samba rice rose by 78% from Rs 46 per kg in December 2007 to Rs 82 per kg in January 2008. At the beginning of 2007, the price of Samba rice was Rs 44 per kg. The price of Kekulu rice also rose by 67.5% to Rs 67 in January 2008 from Rs 40 per kg in December 2007. In January 2007, the price of Kekulu rice was Rs 36 per kg. Similarly, price of Nadu rice also rose by 67% in January 2008 from about Rs 40 in December 2007 to Rs 67 in January 2008. At the beginning of 2007, the price of Nadu rice was about Rs 35 per kg.

Sri Lanka has never experienced such rapid increase of rice prices in the past few decades.

Movement of rice prices followed an interesting pattern over the years before 2008. Cyclical pattern of movement in rice prices implies that seasonal variations in rice prices dominated their time paths. Prices of each kind of rice followed its own seasonal variation, which have almost been the same every year.

Before January 2008, seasonal variation was such that rice prices started to rise in September in each year and reached a maximum in January and then experienced a declining trend. Prices of rice start to rise with the end of the Yala harvesting season. Since production in Yala is relatively low, price decline is small and last a brief period.

With the knowledge of supply shortages in the future, rice prices start to pick up thereafter. What this implies is that proper import policies should have been put in place to smoothen the demand in rice during periods of domestic supply shortfalls.

'POLICY BRIEF 10'

3. ROOTS OF THE RICE CRISIS WAS THERE A RICE SHORTAGE OR SCARCITY? IF SO WHAT WAS THE SOURCE?

According to the government statements one of the reasons for high rice prices is the loss of production due to floods in the last Maha harvesting season. However, our research findings indicate that soaring prices in January 2008 was not sudden but had a trend pattern since mid 2007.

The Central Bank of Sri Lanka predicted that the paddy output is likely to decline by about 3.9 % in the year 2008 due to various reasons (Central Bank of Sri Lanka 2007). By looking at total annual production figures, one may realize that paddy output in 2007 declined only by 6.4% compared to the total output in 2006. Per capita paddy production declined by 7% in 2007 compared to its previous year's figure. However, this drop in paddy production could not be a serious cause for recent high prices of rice. Since year 2000, paddy production in Sri Lanka has experienced severe fluctuations: large drops in some and large booms in other years. However, Sri Lanka has never before experienced such drastic price increases such as the one the country is experiencing at present. In the face of fluctuations in rice production people might have changed their consumption to imported rice or wheat flour.

Total rice availability in the economy comprise of domestic production and imports. While the average per capita rice availability has been about 106 kg over the period 2000-2008 the per capita consumption was about 102 kg.

Domestic production plus imported rice sufficed to meet the demand in the country prior to January 2008. But when the government imposed various restrictions on rice and wheat import, a shortage emerged.

RICE AND MIDDLEPERSONS

Speculative behavior (holding of undisclosed paddy or rice stocks)in the rice and paddy markets may have contributed for high prices to some extent, the effect could not last long as it is not financially viable to have rice or paddy stocks for a long time because of increasing cost of storing in terms of waste and loss of weight. In addition, hoarders normally sell their stocks when the prices rise above the average.

Speculative behavior in the paddy and rice markets was evident since price controls were removed in the late 1970s. If producers (or middlemen) perceive that rice prices may increase in the future they would withhold stocks. This is likely to create temporary shortfalls.

There are no specific reasons to believe that speculators behaved differently during the last five months.

Hoarding of rice because of speculations of future price increases would tend to raise prices.

However, the fact of the mater is that rice prices rose very rapidly until the government introduced price ceilings. If there were speculative stocks with the producers and middlepersons, they should have sold those stocks when prices were very high. It is naïve to think that producers and middlepersons would have kept stocks while rice prices have been soaring in the market.

There are anticompetitive activities in the rice import market which include creating artificial supply shortages by not importing enough rice at the right time and collusive dealings to raise prices. It is also possible that collusive dealings exist between importers and domestic rice dealers. Higher prices created by artificial shortages as a result of anticompetitive activities cannot be eliminated by imposing price ceilings. They could have been eliminated by using competition laws, which prevent anticompetitive activities in paddy and rice markets.

THE IMPACT OF RICE AND WHEAT IMPORT POLICY

Sri Lanka failed to import sufficient amounts of rice to meet the demand due mainly to higher import tariffs introduced in 2006.

Rice Import Tariff Hike: Until 2002, imports of rice were subjected to a 35 percent tariff rate, which was waived by the government when supply shortfalls occurred from time to time until 2002. This policy has worked well during supply shortfalls prior to 2005. This was replaced by a lump sum tariff of Rs 7000 per ton of rice in 2002, which was increased to Rs 9000 in 2005. But with the re-emergence of protectionist policies in 2005, the government increased the rice tariff to Rs 20,000 per ton in 2006. According to Rafeek and Samaratunga (2000), the level of trade restrictions on rice imports is higher in Sri Lanka in comparison to some other countries in the region

Trade barriers have contributed to intensifying temporary rice shortages and raising prices. The government has failed to provide tariff waivers for rice during periods of shortfalls since 2006. The recent rice crisis was mainly due to the weaknesses in the rice import policy.

Data reveals that wheat is a strong substitute for domestic rice. If prices are determined by market forces, high wheat prices dry up the demand for wheat and create additional demand pressure on rice thereby raising the price of domestic rice. In the year 2005, about 790000 metric tons of wheat was imported to Sri Lanka. Though, rice production increased from 2164000 metric tons in 2005 to 2228000 metric tons in 2006, wheat imports also increased to 1239000 metric tons in 2006. However, wheat importation in 2007 fell sharply to 952000 metric tons. There are trade restrictions to import wheat in Sri Lanka.

Wheat Import Tariff: Since 2006, the import duty on wheat flour imports has been 15%, in addition to 10% import surcharge, 3% of port and airport development levy (PAL) and a 1.5% of social responsibility levy (SRL). The government also removed wheat flour subsidy in 2007 which was a legitimate measure.

Severe restrictions on wheat imports without having increased rice and other food production in Sri Lanka have resulted in increasing consumption pressure on rice. The foregoing evidences suggest that government's restrictive import policy on wheat and rice appears to have significantly contributed to recent rise of rice prices in Sri Lanka. Given the lower paddy production (relative to paddy production in 2006), reduction in imports of wheat would have resulted in higher demand pressure on rice. The resulting lower consumption of wheat flour might have increased the demand for rice.

Removing Import Barriers in Other Countries: Sri Lanka continues to have higher import tariffs on wheat flour despite the fact that India removed a 36% import tariff on wheat flour, and Indonesia eliminated duties on wheat and soybeans, Peru removed tariffs on wheat and corn, Turkey reduced import taxes on wheat to 8% from 130% and on barley to zero from 100%, and Mongolia removed its value-added tax on imported wheat and flour (http://business.theage.com.au/). These countries adopted this policy to face the emerging food crisis.

4. ECONOMIC CONSEQUENCES OF PRICE CONTROLS

enforcement problem

It is important to note that competition between suppliers ensures that they cannot take advantage of consumers by setting prices that are out of line with their cost and fair margin of profit and ensures that rice is maid available to consumers who need it most. But price ceilings undermine this mechanism

Considerable amount of state funds and personnel along with a clear mechanism would be necessary to enforce rice price ceilings. There needs to be a monitoring mechanism in the country to oversee whether the traders comply with the price ceilings. There should also be a body to hear consumer and trader complains and resolve them. These activities will create a severe burden on the government as well as inefficiency in rice market in Sri Lanka

IMPACT ON SOCIAL WELFARE

The price control regimes tend to reduce social welfare. Market mechanisms generate efficient socially desirable outcomes, provided the government follows certain regulatory interventions

The stated objectives of rice price control regime are to: protect producers and consumers from middlepersons. The supply and demand elasticities of rice are relatively stable in Sri Lanka meaning that both producers and consumers equally gain from the market prices of rice. If the ceiling price is lower than the historical average, consumers tend to gain while producerslose (Ellis 1992).

As we have shown before, the ceiling prices of rice are higher than the recent average prices of rice meaning that consumers tend to lose rather than gain from ceiling prices. In this case, price ceilings tend to increase producer welfare marginally at the cost of long term consumer welfare provided that rice market is perfectly competitive. But since there are significant imperfections in the rice market in Sri Lanka, the ceiling prices which are higher than the normal market determined prices would in fact be beneficial to middlepersons rather than the producers.

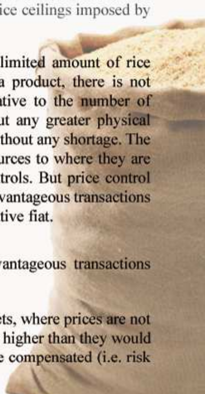
There is also a deadweight efficiency lost due to ceiling prices. These theoretical results suggest that dismantling of price controls rather than imposing them tends to improve consumer welfare. It has also been shown that marginal interventions by the government in the paddy market through assisting to develop the infrastructure of the private marketing system tends to stabilize market prices compared to price ceilings. For example, Indonesia achieved this for many years by state procurement of 5 per cent or less of production and by using imports to help balance the domestic market (Ellis 1992).

SHORTAGES AND BLACK MARKETS

To understand the effects of price controls, it is necessary to understand how prices rise and fall in a free market. There is nothing esoteric about it, but it is important to be very clear about what happens. Prices rise because the amount demanded exceeds the amount supplied at existing prices. Prices fall because the amount supplied exceeds the amount demanded at existing prices. The first case is called a shortage and the second is called a surplus - but both depend on existing prices

But if the markets are allowed to function fully independently prices will adjust so that the shortages or surpluses will disappear and an equilibrium price achieved.

There is little likelihood of market forces creating shortages in the rice market. Rice shortages will actually be created by price ceilings imposed by government.



The areas with less rice production will receive a limited amount of rice creating a shortage. When there is a shortage of a product, there is not necessarily any less of it, either absolutely or relative to the number of consumers. Just as there can be a shortage without any greater physical scarcity, so there can be a greater physical scarcity without any shortage. The usual function of prices in directing goods and resources to where they are most in demand no longer operates under price controls. But price control prevents buyers and sellers from making mutually advantageous transactions on terms different from those specified by administrative fiat.

Risk taking buyers and sellers make mutually advantageous transactions outside the price ceilings.

Price controls almost invariably produce black markets, where prices are not only higher than the permitted prices by fiat, but also higher than they would be in a free market, since the legal risks must also be compensated (i.e. risk preminum).

While small-scale black markets may function clandestinely, large-scale black markets usually require bribes to officials to look the other way. In a fragile democracy like ours, it is futile to think that state bureaucracy and politicians would be benevolent. There is a significant space for rent seeking activity.

One cannot rule out the fact that middlepersons collude with government officials and politicians to get mutually advantageous price ceilings to both parties.

QUALITY DETERIORATION

Price control regimes tend to lead to quality deterioration which has been common with many other products and services whose prices have been kept artificially low by government fiat. One of the fundamental problems of price control is defining just what it is whose price is being controlled.

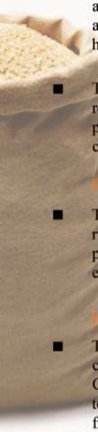
There are no pre-set standards for rice when fixing prices. The ceiling prices have been imposed on three names, Samba, Kekulu and Nadu. But the government has set unique price levels for three different types of rice disregarding the fact that there are different types of Samba, Kekulu (Red) and Nadu. In addition, there is little incentive to maintain high quality when everything will sell anyway during a shortage at the fixed price.

The priorities that prices automatically cause individuals to consider are among the first casualties of price controls.

There is no incentive in a control regime to maintain or improve the quality of rice. The final outcome would be that consumers to buy lower quality rice at higher than normal prices.

5. POLICY RECOMMENDATIONS

The recent episode of rapid rise of rice prices was a temporary phenomenon rather than a permanent phenomenon. We identified several factors that contributed to the recent rise of rice prices.



- The first and foremost is the failure to smooth rice supply to eliminate temporary rice shortfalls by importing rice due mainly to flawed import policy. While private sector has failed to respond to future market needs by importing rice, large increases of rice tariff in 2006 have seriously hampered rice imports. Increase of wheat tariff has also aggravated the rice crisis. Protectionist propaganda of the government might also have partly contributed to this.

- Second, government pressure to reduce wheat flour consumption has had a substitution effect on increasing rice consumption. Though removal of the wheat subsidy is legitimate, higher tariff for wheat flour was a main impediment.

- Third, both domestic and import rice markets are characterized by anti-competitive activities. These activities created artificial shortages and raised prices of rice. Finally, flood and other related issues might have also marginally contributed to the recent rise of rice prices.

- Therefore, we argued that rice crisis in Sri Lanka cannot be effectively resoled by imposing price ceilings. In this context, we attempt to provide some policy recommendations that would help resolve the rice crisis.

In the short term -

- Temporary rice shortages should have been eliminated by importing rice and wheat (the closest substitute for rice) rather than imposing price ceilings. Existing trade barriers for importing rice need to be effectively reduced.

In the medium term -

- The government should eliminate market imperfections and increase competition in the rice market by enforcing competition laws. Competition laws should be enforced in domestic and import markets to eliminate anticompetitive activities. Antitrust law prohibits sellers from explicitly colluding to impose higher prices. Retailers are prohibited from taking exclusionary actions that would create monopoly power.

The Problem of Middlepersons: While taking measures to reduce pressure on rice, the government can address the issue of middlepersons. Anticompetitive activities in the domestic and importing rice markets cannot be eliminated by establishing a government monopoly in the name of Paddy Marketing Board or by imposing price ceilings. The ceiling prices would not be effective in resolving the problems that are said to be created by the behavior of middlemen.

- Government should also identify efficient forms of competition and promote them.

In the long run:

The demand for rice should be reduced considerably

This is required for increasing food security and promoting healthy food consumption. Government can take various actions for this.

- It needs to create incentives to reduce pressure on rice consumption by promoting alternative food/s.

- One would argue that higher than normal prices for rice might contribute to reducing demand pressure on rice and increasing consumption of alternative food. So that rising prices of rice would help increase food security in the longer term.

- The private sector should be promoted to make alternative food available by making them more consumable and nutritious. These would require agro-processing activities.

Reducing Pressure on Rice in Other Countries: Countries such as Japan, Indonesia, Philippines, and Thailand have succeeded in diversifying food consumption and thereby reducing the pressure on rice consumption through carefully executed public policies (Sidik 2004).

- Moreover, as countries such as Japan did, diversification of the meal would also be necessary to reduce pressure on rice consumption. By reducing rice consumption and increasing alternative food consumption, Sri Lanka will be able to become a rice exporter rather than a net importer in the long term. This would significantly help improve the welfare of the farmers in Sri Lanka.

Diversification of Food Consumption in Japan: Rice consumption policy in Japan provides very useful insights for Sri Lanka. There has been a marked decline in demand for rice over the years in Japan because of plethora of socioeconomic changes. This has resulted in comparative changes in food consumption structure. Grain (including rice), potato, and soybean consumption have declined while consumption of all other foods (meat, eggs, milk fats and oil) has increased. Japan has been very successful in reducing the demand pressure on rice by diversification of consumption, which has resulted in improved food security.

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The Contributors …

This Policy brief is based on an analytical paper prepared by Dr. O G Dayaratne Banda, Dr Ananda Jayawickrama and Dr. M B Ranathilaka and presented at a public Sanvada (Dialogue) held recently.

Dr. O G Dayaratne – Banda

Is a Senior Lecturer in Economics at the University of Peradeniya. He is a visiting Research Professor of University of Waterloo and the Center for International Governance Innovation, Ontario, Canada. His teaching expertise lies in Macroeconomics, Microeconomics, International Finance and Investment, Development Finance, Principles of Economics. His research interests are International Capital Flows and Economic Growth, Development Macroeconomics, Empirical Topics in Economic Growth and Convergence, Trade Openness, Free Trade Agreements, Empirical Topics in Macroeconomics

Dr. Ananda Jayawickrama

Is a Senior Lecturer in Economics at the University of Peradeniya. Dr. Jayawickrama earned a Doctor of Philosophy degree in Economics from the National University of Singapore in 2007 for the research on "Tax Smoothing and Fiscal Sustainability, and Fiscal Policy Simulation Experiments for Sri Lanka". His research interests are issues in public finance, government and economic growth, trade in services and service economy.

Dr. M B Ranathilaka

Dr. Ranathilaka is a Senior Lecturer in Economics at the Peradeniya University. He obtained his M.Sc. and Ph.D. from the Saga University of Japan. Dr. Ranathilake teaching areas include Rural Development, Statistics and Marketing. His research interests cove, rural development and agriculture marketing and poverty alleviation.

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This is the tenth in the series of Sanvada policy briefs and analyses 'Price Controls on Rice.' The detailed analytical paper which was the basis of this note can be viewed at www.sanvada.org. The views and opinions expressed in this brief do not necessarily reflect the views of the Pathfinder Foundation. We cordially invite your constructive criticisms and/or the feedback on the findings in here.

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Pathfinder Foundation

Telephone No	2596281
Facsimile No	2595894
E-mail	info@pathfinderfoundation.org
website	www.sanvada.org

Editorial Assistance Ms. Ameera Careem, Project Manager