



Costa Rica

WILL THE LIBERALIZATION OF RICE IMPORTS IMPROVE CONSUMER WELFARE IN COSTA RICA?

CONTEXT

In the recent years, there has been an ongoing discussion in Costa Rica about the trade policy regime for rice. Rice is an essential staple in the Costa Rican diet, particularly for the poorest segments of the population. Although it is produced in the country, local production does not reach the level necessary to satisfy domestic demand. In order to assist the rice industry, the government of Costa Rica has been implementing a complex mix of policies consisting of tariffs, a performance requirement for the importation of paddy rice – which links the right to import to an obligation to first purchase rice from domestic producers – and a price-fixing mechanism for all stages of the rice production chain.

These measures have resulted in an increase in domestic paddy rice prices to double that of international prices. Consumers in Costa Rica have therefore been paying a high price for a key commodity in their daily consumption basket. In addition to this adverse effect on consumers, the policies cited above

have not been successful in either increasing rice production or improving conditions for small rice-producing farmers. Instead, they have created significant rents for importers and rice millers who have been benefiting from the difference between low international prices and high domestic prices of rice.

Costa Rica is also in breach of its World Trade Organization (WTO) commitments. By providing a subsidy to producers in the form of a minimum price, the country has been exceeding the maximum level of authorized annual support to its agriculture. For these reasons, Costa Rica's rice sector policies are being redesigned. For instance,

the free trade agreement between Central America, the United States and the Dominican Republic (CAFTA-DR) will eliminate import quotas and provide unlimited duty-free access to imports from the United States – Costa Rica's main supplier of rice – by 2025.

A question therefore arises as to what will be the effects of the CAFTA-DR on rice-consuming Costa Rican households as a consequence of a reduction in rice prices due to cheaper imports. Will the CAFTA-DR be an opportunity to effectively reduce rice prices in the domestic market and thus improve the welfare of consumers?

METHODOLOGY AND DATA

To answer these questions, our research first simulates the evolution of consumer prices of rice as a result of the implementation of the CAFTA-DR. Then, following the theoretical approach in Deaton (1989), it analyses the welfare effect of those price changes on Costa Rican households.

The welfare effect is assessed at three different stages of the tariff phase-out process: in 2015, 2020 and 2025 (when the import tariff will be zero). According to the calculations, the estimated price change will be -12.1 per cent in 2025, -5.52 per cent in 2020, and -1.51 per cent in 2015 under the assumption of perfect pass-through of tariff reductions to domestic prices of rice.

Using these price changes, our study estimates the welfare effect on Costa Rican households as rice consumers. The results are disaggregated at the following levels: urban versus rural, by region, by education level of the household head, and by household size. It is assumed that, on average, households are net consumers of rice, and that the net effect of any price decrease of rice will consequently translate into an increase in welfare.

The analysis uses data from the most recent source available on household consumption in Costa Rica, the 2004 National Income and Expenditure Survey. The fact that the survey dates back to 2004 is not a limitation because neither the tariff conditions for rice nor the characteristics of the poorest households have changed much since then.

FINDINGS

Several results can be derived from the analysis. First, the welfare gains will be positive for all households, both urban and rural, as a result of tariff reductions during the phasing-out process. The poorest households, and in particular those in the urban areas, will benefit the most from a decrease in the price of rice. In 2025, when rice imports from the United States will be fully liberalized, the poorest urban households may record a welfare increase close to 1 per cent as compared with their consumption level in 2009–2012. The welfare gains for the richest households will be negligible because the share of rice in their budget is relatively small compared to

low-income households and because they can afford a more diversified diet, away from rice.

With regard to the welfare effects by region, the Chorotega, Huetar Atlántica, and Brunca Regions show, on average, the highest welfare increase for households, probably because they have consistently had high poverty levels. By 2025, the welfare of poor households in these regions will increase on average by at least 0.5 per cent as compared with the initial level.

However, the level of poverty is not the only explanation of differences in welfare effects among

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regions. For instance, poor households with the same per capita level of expenditure will benefit, on average, more from tariff reductions on rice in the Chorotega Region than in the Brunca or Central Regions. This may be due to the differences in the share of rice in household expenditure across regions because of differences in taste. For instance, households with the same per capita expenditure dedicate 3.6 per cent of their average budget to rice in the Chorotega Region, followed by the Huetar Atlántica (3.1 per cent), and the Brunca Region (2.9 per cent), while such households in the Central Region only spend, on average, 1.1 per cent of their budget on rice.

Consequently, the increase in welfare resulting from a rice price decrease is, on average, more pronounced for households in regions with a higher share of rice in total expenditure.

However, in addition to consumption, price changes can also influence household welfare through income. For example, the Chorotega Region is the largest producer of rice in Costa Rica, so a decrease in the price of rice may reduce the income of producer households in this region. As our analysis does not consider these income effects, the welfare gain of the region calculated here may be overestimated.

POLICY RECOMMENDATIONS

The results of our research show that poor households in Costa Rica will likely be the segment of the population that benefits most from a reduction in the price of rice. In this sense, the phasing-out process scheduled under the CAFTA-DR might serve as an automatic price-control mechanism, resulting in rice imports becoming progressively cheaper. For this to take place, the institutions in charge of defending the interests of consumers, as well as those that supervise the functioning of the domestic market, must develop an active stance towards surveillance of price behaviour for the imported product, especially after 2016. Liberalization of imports may also put additional pressure on local producers to reduce their prices to avoid losing market share.

Additionally, the phasing-out schedule under the CAFTA-DR will progressively reduce the relevance of the performance requirement for paddy rice imports from the United States, as well as the import quota, since the tariff for imports outside quotas will move closer to zero. This means that industries will not need to purchase domestic paddy rice in order to be able to import duty-free from the United States. Large producers, which are also millers, may have an incentive to import most of the paddy rice they will process, depending on how profitable producing locally or importing will become. If large producers have a better business opportunity by importing most of their rice and reducing their own production, this may require an active policy of stocks and safety nets to address international market price spikes.

With the CAFTA-DR, the local rice sector will face the challenge of improving its competitiveness, including: (a) productivity, which has decreased in recent years; (b) capacity-building for rice producers; (c) improved and cheaper access to inputs, a growing concern for the sector; and (d) strengthening of credit mechanisms, which is particularly crucial for small producers who may require this kind of assistance. In this sense, Decree 37699-MEIC defines a coordinated programme of work between the government and the rice sector to increase competitiveness, facilitate access to credit, and effectively reduce costs of inputs such as agrochemicals and seeds. The decree also aims to remove rice price regulation: the Costa Rican government, producers, and millers have agreed to work on an alternative mechanism that would substitute the existing price-fixing scheme.

Finally, Costa Rica has to continue its efforts to comply with its commitments to the WTO. A continuous dialogue needs to take place between producers, millers and the government in order to enhance productivity levels, avoid the need to apply trade-distorting policies, and prevent a loss in welfare for consumers. In addition, the possibility of fixing prices should not be politicized. Even if Article 5 of the Law for Promotion of Competition and Effective Consumer Protection (Law No. 7472) allows the government to regulate the prices of goods and services in exceptional situations, the need for such a measure has to be properly established and justified, and the measure should only be applied temporarily.

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