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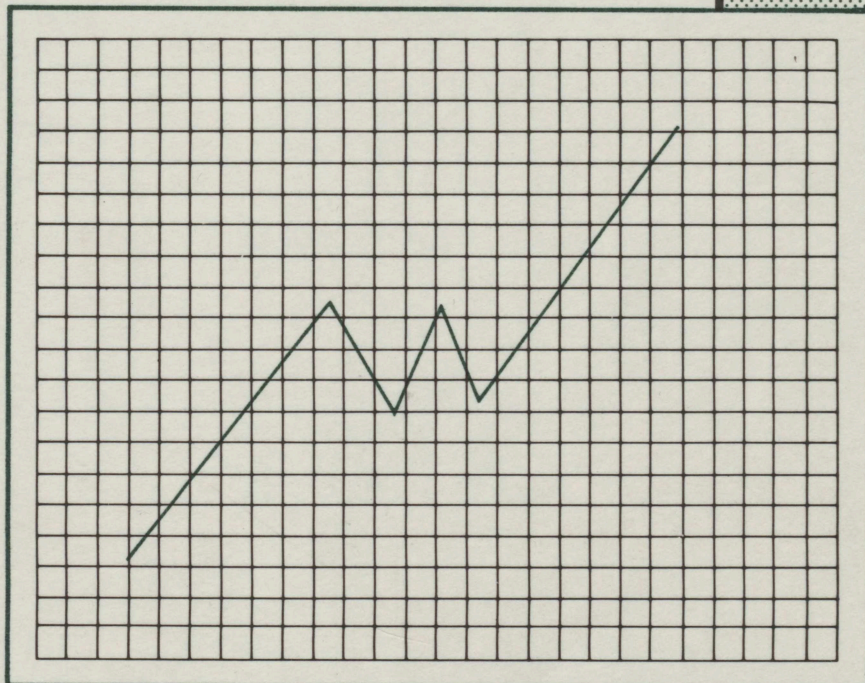
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# THE IMPLICATIONS OF FISCAL AND MONETARY POLICY ON MANAGEMENT IN AGRICULTURE

by C.J.F. HUMAN\*

The term "agriculture" is a very comprehensive one and refers not only to agricultural producers but also to the co-operative movement, manufacturers of agricultural implements and suppliers of inputs. On this occasion, however, attention is focused specifically on agricultural producers.

If we are to examine the implications of monetary and fiscal policy for individual agriculturists later on, it would be desirable to begin with a brief review of the conditions prevailing in agriculture.

It is widely recognised that agriculture is an indispensable sector of the economy, not only on account of its role as a supplier of food and fibre but also in view of the future requirements of a growing population and the uncertainties surrounding sanctions and boycotts.

In terms of its contribution to the GDP, agriculture is not the biggest sector in the national economy, but the forward and backward linkage which takes place, puts the real contribution of the agriculture to economic activities in perspective. To this it may be added that agriculture is potentially and in reality a major net earner of foreign exchange and is also the biggest employer in rural areas. Agriculture serves the national interest through the part it plays in the decentralisation of economic activities and the important social function it fulfils in that it provides accommodation and school buildings - largely at the expense of agriculturists - for farm workers and their dependants; this sector also makes a contribution to the maintenance of security on the country's borders, which depends on a stable agricultural industry and a relatively high occupation of farms and rural towns. Furthermore, agriculture serves as a primary point of departure for the development of backward rural areas, the development of which goes hand in hand with the stabilisation of the local economy and job opportunities. Although one cannot generalise about all agricultural regions and branches of farming, the business environment of agriculture has changed dramatically since 1975. There are numerous pointers to the fact that financial conditions in agriculture have deteriorated considerably. For instance, from 1975 to 1987 total agricultural debt increased from R2 billion to an estimated R13 billion. This means an average growth rate of 17,1 % per annum over the period. Even allowing for the influence of inflation, this increase in total debt remains disturbing. The proportion of total debt to agricultural assets increased from 11,8 % in 1975 to 27,7 % in 1987. At the same time the share of the total debt constituted

by short-term debt increased from 35 % to 52,4 %. The expression "short-term debt" refers to the source of credit supply. Credit from co-operatives and commercial banks is regarded as short-term for our purposes.

Despite the deterioration in the position outlined above, the average debt burden is possibly not excessive, but the total debt burden is very unevenly divided. Whereas some agriculturists have relatively little debt, others, especially those in the summer rainfall cropping areas and in the stock-farming areas, have serious debt problems.

The other indicators paint a disquieting picture of agriculture. The rate of exchange in agriculture has deteriorated by an average of 2,6 % per annum since 1975. Farming profits expressed as average proceeds are still at a low level, despite the recent improvement in comparison with the level maintained from 1983 to 1986.

The causes of the relative deterioration in agriculture's financial position were given in the report by the State President's Economic Advisory Council on an Investigation into the Restructuring of Agriculture. According to this report inflation contributed 46,8 % to the farmer's increased debt burden in the period 1980 to 1985. On the other hand interest rates and the drought contributed 31,4 % and 21,8 % respectively.

After this brief review of the financial position of agriculture, we may proceed to discuss the State's monetary and fiscal policy and its implications for agriculturists. Before we can do so, however, there is an aspect of agriculture that needs to be highlighted, namely the role of agriculture as a supplier of raw materials and the ways in which the industry is different.

Since the mid seventies agriculture has been experiencing serious problems. The oil crises have helped to reduce the average economic growth rate in the industrialised countries of the Western world from 5 % per annum from 1960 to 1969 to 3,5 % per annum from 1970 to 1979 and to only 2,25 % per annum from 1980 to 1986.

These lower growth rates in industrialised countries have had a detrimental effect on all the countries that produce raw materials, including South Africa. During the period 1966 to 1975 the RSA's gross domestic product increased by an average of 4,8 % per annum whereas in the period 1975 to 1986 it increased by only 1,8 % per annum.

The problems facing agriculture that were outlined earlier should therefore be seen against the background of an economy that has experienced generally difficult times and is buying fewer raw materials. It is, however, necessary to emphasise that

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agriculture is unique in certain aspects. It could possibly even be claimed that it is more difficult for the agricultural industry than for other industries to adapt to a rapidly changing environment.

The different nature of the agricultural industry strongly influences the planning and management of farming enterprises. It necessitates a different kind of decision-making process from the kind found in a normal business.

On the basis of the report of the Economic Advisory Council on the Restructuring of Agriculture, the views expressed above may be briefly substantiated. Firstly, the demand for food-income is inelastic, as is the supply of food. These factors contribute to the fact that agriculture is inclined to overreact in comparison with other sectors of the economy when the economic cycle is high or low. When there is an economic downturn agriculture tends to experience a more serious collapse; the opposite holds true during an economic upturn.

Other factors that underline the difference between agriculture and other sectors of the economy are the limited alternative applications for agricultural land and the fact that the market value of land is frequently far higher than its agricultural value. Furthermore, the residence and the place of work of the agriculturist are usually on the same site. This means that if he wishes to discontinue his farming operations he usually has to give up his home as well.

In certain respects agriculturists have to shoulder a greater responsibility for social and related matters - greater, that is, than the responsibility certain other industries shoulder. Here one thinks of housing and recreation facilities for workers, schooling, community needs and transport. Agriculturists therefore have to take a broad spectrum of factors into account in each decision they make, in a field where Government policy and monetary and fiscal considerations undoubtedly play a part.

Agriculture's dependence on the climate is undoubtedly the most important characteristic that distinguishes it from other industries. The agriculturist starts the production process without any indication of what the weather conditions will be.

Here it may be said that agriculture is very vulnerable to rapid changes in the monetary policy. The increasing vulnerability of agriculture to monetary policy changes should be seen in relation to its almost unique characteristics and the nature of the financing it requires in consequence.

Most agricultural industries have relatively long production cycles, with the result that the rate of turnover of operating capital is far slower than in the case of many other industries. In respect of agriculture's fixed capital structure, where land and fixed improvements frequently represent over three-quarters of total capital investment, this industry differs from most other enterprises in the industrial sector (with the exception of capital-intensive industries).

The financing of capital formation in agriculture has undergone drastic changes over the past few years. Prior to 1982 about 70 to 80 % of capital formation was financed from own funds and only 20 to 30 % from external sources. In the period 1982 to 1985 internal financing declined to about 40 % whereas external financing rose to about 60 %. This swing left agriculture far more vulnerable than before to the effects of changes in monetary policy.

At the same time there was the increase in the debt burden of agriculture described above, which naturally increased the impact of changes in interest rates on agriculture. The relative share of short-term debt in respect of agriculture's total debt has increased in the manner already indicated. The immediate impact of monetary policy is far more perceptible in the financial market than in the capital market: monetary policy is first reflected in short-term interest rates, which naturally include the prime bank overdraft rate. Since agricultural debt is assuming rather more of a short-term character, monetary policy is having an increasing impact on agriculture.

When a higher interest rate structure was introduced in 1981 as a result of a policy change, it was a real blow to agriculture, more so than to other sectors. The reason was that in agriculture the adjustment had to start from a lower level than in other sectors of the economy. The higher interest rates required a rapid adjustment in agricultural activities - an adjustment that agriculture was hardly in a position to make rapidly, for reasons already mentioned.

A shift in emphasis has occurred in economic policy over the past decade. There has been a move away from direct control of the economy in favour of more indirect control. This does not mean that the government is following a "laissez-faire" free market policy, but that the role of the free market is receiving greater recognition in the application of economic policy. This approach is embodied in the Preamble to the Constitution, which expresses a preference for private initiative and effective competition. In the Long-Term Economic Strategy the Government also accepted a market-oriented approach to economic policy.

As a result of the change in policy, direct control over interest rates was abandoned in favour of more market-related rates. At the same time our exchange rate policy changed to one of controlled floating. Interest rates and the international value of the rand are now more volatile than in the past. The recovery of the economy since last year has exerted considerable pressure on the current account of the balance of payments and on the gold and foreign exchange reserves. To prevent total expenditure, including imports, from rising higher than the economy could afford, monetary policy assumed a less accommodative stance during the course of the year. In the process, the bank rate was increased from the level of 9,5 % at the beginning of the year to the current level of 12,5 %.

Short-term interest rates have also moved upwards and the bank prime overdraft rate is once again at 16 % after falling as low as 12 % in 1986.

This underlines a point already made, namely that agriculture will have to adapt to more frequent interest rate changes than was the case a number of years ago.

The increasing agricultural debt burden and the increasingly short-term nature of the total debt, together with fluctuating rates of interest, imply that higher demands will be made on the financial management skills of farmers.

In conjunction with a more market-oriented monetary policy and the accompanying movements in interest rates, it must be accepted that the floating exchange rate, with its uncertainties, is here to stay. One of the effects of the exchange rate is that it determines the price of an export product, overriding the domestic production costs or the supply situation.

The De Kock Commission of Inquiry into Monetary Policy (Commission of Inquiry into the Monetary System and Monetary Policy in South Africa) found that the pattern of agricultural financing entailed undesirable consequences for the implementation of monetary policy. In this context, specific reference was made to the practice of treating instruments of credit as liquid assets in the portfolios of banks.

As a result of this, Land Bank debentures and bank advances to the Land Bank have not been considered liquid assets since 1 August 1988, whereas Land Bank bills qualify as liquid assets under more restrictive conditions. The change in the status of these instruments will mean that certain sources of Land Bank financing will be more expensive than in the past. This adjustment will be reflected in the financing costs which will ultimately have to be borne by the individual farmer.

Fiscal policy deals with every aspect of government finance. It includes the extent and composition of government spending and also the financing of that expenditure by means of taxation and loans. This is too broad a subject to deal with in the course of my address. I shall only refer to certain facets which have direct implications for agricultural management.

In the years since the Second World War the macro-economic impact of fiscal policy has led to an increased awareness of the potential role of fiscal policy as an element of short-term policy. Through purposeful changes in government expenditure, taxes and the financing of deficits, the authorities are able to exercise a significant influence on the level of economic activity.

Since agriculture is part of the economy, it is inevitable that macro-economic application of fiscal policy will have an impact on agriculture and on the farmer as a decision-maker. Even if the supply of and demand for agricultural products are relatively inelastic with regard to changes in total income, there is, nonetheless, a link between economic cycles and agriculture.

Here I should like to emphasise the micro-economic issues of fiscal policy in which the extent and composition of government finances are of great importance.

It can hardly be denied that in South Africa, as in many other countries, the Government has always been particularly well-disposed towards agriculture. According to informed estimates, the support measures to bolster agricultural prices in the USA, the EEC and Japan cost close to R110 billion in 1987. Throughout the world farmers are under financial pressure because of over-production. However, there is a tendency of late to find methods of phasing out price support programmes.

The policy attitude of the Government towards agriculture in the RSA is clearly apparent from the amount of R1,2 billion which was allocated in the 1987/88 financial year to support agriculture. Among the most important items were:

subsidies to various agricultural sectors	R545 million;
assistance to co-operatives	R 40 million;
assistance schemes	R331 million.

The latter amount includes interest subsidies on residual debt, production credit and consolidated agricultural debts. An amount of R298 million was also approved as a fuel subsidy.

The Economic Advisory Council analysed several fundamental short and long-term problems in its Report on Agriculture. The Government responded positively and as far as short-term measures are concerned, several schemes have been implemented to relieve the worst financial burdens of certain farmers. The Government was prepared to allocate R400 million in June 1987 to save farmers from sequestration.

As far as long-term measures are concerned, good progress is being made with the land conversion scheme designed to convert agricultural land in summer rainfall areas from grain production to animal production. Other measures for the promotion of agriculture are the following:

- The establishment of agricultural advice centres to give the farmer technical and financial management support;
- the development of a financial strategy that will make agricultural financing more dependent on the productive value of land and the repayment ability of the farmer;
- a more market-oriented approach to price policies, particularly with a view to achieving a better balance between the supply of and demand for agricultural products and to limiting export losses.

However, the individual farmer would be wise to take note of a slight shift in emphasis which has become noticeable in Government financial policy in the recent past. Greater discipline in respect of Government expenditure is emerging. In 1984 the State President's Committee on National Priorities was established to determine priorities in the utilisation of resources. This Committee is particularly well placed to play a consensus-seeking role concerning the acquisition of funds and resources and their allocation to the overall functions of general and own affairs.

The establishment and functions of this Committee are indicative of a deep-seated realisation

that discipline is of the greatest importance in Government finance.

This approach was confirmed in the Government's Long-Term Economic Strategy. The reduction of the share of Government spending in the gross domestic product and the reduction of the public sector's claim to capital and manpower resources are among the goals set. In his address at the opening of Parliament this year, the State President reaffirmed the Government's intention to restore the extent and composition of the budget to affordable limits within sound fiscal relationships.

On the basis of an allocation system based on priorities, the State President expressed the Government's intention to:

- re-evaluate all existing services;
- review standards of service in terms of affordability;
- bring prices and tariffs more in line with actual costs;
- grant aid and support increasingly on the basis of individual needs instead of on the basis of blanket needs.

There is no doubt that the Government will remain as involved with agriculture and as concerned about it as always, but it has to be expected that financial assistance will be less readily available and that where it is granted, this will be done under more stringent conditions than in the past.

Given the absence of disasters, it should be clear, therefore, that farmers will have to rely increasingly on their own management skills and that the State will not make good ill-considered or even erroneous decisions by the farming community.

With regard to broader economic policy and the determination of priorities, one has to take into account the development of the Third World element of our society. In agriculture, specifically, this means the establishment and development of individual agriculturists. The best way to assist underdeveloped areas is to stimulate agricultural development. Agriculturists living under First World conditions will have to bear this in mind. Such stimulation comprises not only a diversion of funds and expertise in that direction but also the development of independent small-scale agriculturists. In order to avoid distortion these new entrants to the profession will have to be absorbed into the existing agricultural structure in many ways. Established agriculturists will have to make adjustments. Agriculturists will have to be aware that more and more funds will in future be channelled towards the development of agriculture in underdeveloped areas.

Lastly, a few words about the other side of State finance, namely taxation. As we all know, the RSA is on the eve of implementing a new tax system. Agriculture in general and agriculturists in particular will have to become reconciled to the goals of equity, neutrality and more efficient administration at which the new system is aimed.

This amendment implies among other things that the tax system should not be the primary motivation for decisions affecting farming operations. Agricultural activities should be geared to economic

viability, with tax considerations taking second place.

A practical consequence of this approach finds expression in the recommendation accepted in the White Paper on the report of the Margo Commission, namely that expenditure on agricultural development and improvements and the cost of agricultural machinery and equipment should be written off over three years on a sliding scale.

In addition to a few other recommendations specifically directed at agriculture and especially at part-time agriculturists, it should be noted that the Margo Commission is generally opposed to the use of tax expenses as a method of providing incentives for certain sectors of the economy. The following quotation from the report of the Margo Commission emphasises this viewpoint: "the Commission is of the opinion that subsidisation through tax incentives should be reduced to the minimum. Furthermore, only those activities that are likely to qualify for support on a permanent basis should be considered for subsidisation through tax incentives. It is therefore proposed that within the foreseeable future as many as possible of the tax expenditures still to be found in the South African system be phased out and the tax base broadened."<sup>1</sup>

To the extent that these ideas are reflected in practice one should be under no illusion that one sector, like agriculture, will be favoured in future with regard to taxation. Both monetary and fiscal policy will pose greater challenges to agriculture in future and the industry will have to operate on a different basis than in the past. Despite the unique problems it faces, agriculture will have to be more business-oriented than it has frequently been in the past. A structural adjustment as recommended by the Economic Advisory Council in its report on the Reconstruction of Agriculture is essential, but it will also bring agriculture face to face with new challenges in the short term with regard to monetary and fiscal policy.

Financial management in particular will play a major part in successfully countering the challenges facing agriculture. Cash flow planning and the judicious use of borrowed funds, careful consideration having been given to repayment ability and provision for risks, will be of decisive importance to every agriculturist. This is especially true in highly inflationary conditions.

Financial management in general requires a high degree of technical knowledge. In my opinion commercial banks, the agricultural co-operatives and organised agriculture have an important part to play in supplementing and developing the individual agriculturist's financial management skills.

Apart from the emphasis on financial management, the agriculturist of the future will also have to expand his knowledge of marketing and develop further initiatives as a marketer. The RSA is dependent for the sale of its products firstly on the domestic market and secondly on the international market. Original thought and planning are necessary, especially in respect of product innovation and presentation. The expansion of markets may lead to

a reduction in unit costs, greater profitability and improved cash flow.

The development and use of marketing points in the self-governing territories and the TBVC-countries in order to utilise the increased buying power of these areas and develop sales points is equally important. Concerted marketing action is essential.

Agriculture's contribution to foreign exchange earnings remains extremely important, but it must be made on a cost-effective basis. The agriculturist has a part to play here, not only in respect of cost effectiveness, but also in an orchestrated export drive, especially within an African context. This comprises the active development of marketing

channels and thorough planning in order to establish a long-term export strategy.

The agriculturist will have to attempt, through more effective management, to counter the implications of a change in monetary and fiscal policy, as well as socio-economic policy. This will have to take place in a spirit of positive acceptance of new challenges by the agriculturist.

#### NOTE

1. Report of the Commission for Inquiry into the tax structure of the Republic of South Africa. Government Printer, RP 34/1987 p. 65