A new methodology for assessing the impact of water pricing scenarios: case study of small-scale irrigation schemes in South Africa

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Abstract

The growing water scarcity worldwide has increased the call for economic instruments to stimulate rational water use in agriculture. In developing countries where currently agricultural water use is often still heavily subsidised, there exists a tendency of introducing water pricing policies to achieve this goal. The exact impact of water pricing policies on irrigation water use or on the farmers' production system is however mostly unknown. This study introduces a new two-stage methodology that allows estimating at farm level the effects of introducing or raising a water price on the agricultural production process and water demand. In the first stage the technical efficiency frontier is constructed and the technical and allocative efficiency levels of each farm are calculated. This representation of the technology is in the second stage used in a profit maximization model. Applying the method to small-scale irrigators in South Africa, it is shown that water demand of farmers is quite responsive even to small changes in the water price. Furthermore, introduction of a water price is shown to significantly decrease farm profit. This appears to be mainly a problem for the poorer farmers.

Key words: water pricing, water savings, irrigation, data envelopment analysis, South Africa

1. Introduction

Irrigation systems are the main consumptive users of water at world level. Due to the growing water scarcity irrigators experience increasing pressure to release water for other uses and to find ways in which to improve performance (Perry, 2007; Malano et al., 2004). Efficient use of water resources is therefore considered a fundamental target for farmers and water management (Ortega et al, 2004; Tsur, 2004). In this respect, the apparent misuse and waste of irrigation water, in the context of low and subsidised water prices, causes many (Liao et al., 2007; Russell et al., 2007; Bar-Shira et al., 2006; Becker and Lavee, 2002; Perry, 2001) to advocate a more prominent role of economic incentives in encouraging efficient water use.

Irrigation water pricing is often regarded as a good tool to achieve efficient use (Singh, 2007). Increasing the price of irrigation water or simply introducing a price is believed to have two important positive effects. Firstly, it will make consumers aware of the scarcity, creating a new respect for water, which should improve management efficiency and secondly provide incentives to farmers to rethink crop choices, stimulating the shift to more profitable crops (Easter and Liu, 2007; He et al., 2006; Becker and Lavee, 2002). However, according to Tardieu and Prefol (2002) and Liao et al. (2007) rises in water prices are not without risk: They could lead to an overall reduction in a country's agricultural production, endangering the goal of securing food self-sufficiency; They could lead to higher prices for urban consumers resulting in increased import and loss of market share for local irrigating farmers; Finally they could lower agricultural income with negative effect on rural development. In addition, Abu-Zeid (2001) adds that increasing or introducing water charges in many parts of the world is a sensitive issue involving historical, social and even religious dimensions and that the effect of irrigation rates on efficiency might be insignificant if they represent too small a proportion of the total production costs. Yet another reason reported to expect only limited effects is the low elasticity of demand for irrigation water reported by Albiac et al. (2007), Gómez-Limón and Riesgo (2004) and Berbel and Gómez-Limón (2000). Taking into consideration these possible disadvantages and the limited effect water pricing scenarios might have on water saving, it is clear that methodologies that allow to estimate as accurately as possible, the effects on the agricultural production process and water demand are very important (Ortega et al, 2004). Due to the importance of the issues raised above, much research has been done in this area. For example Albiac et al. (2006), Manos et al. (2006), Gómez-Limón and Riesgo (2004), Doppler et al. (2002); Berbel and Gómez-Limón (2000) and Gómez-Limón and Berbel (2000) have used linear programming models to predict changes in cropping patterns resulting from different water pricing scenarios. From these changes they then deduced water use and use of other inputs. A disadvantage of these methods is that they use predetermined fixed ratios between inputs and outputs and work at aggregated level assuming all farmers are the same. Other authors like Moore et al. (1994), Bar-Shira et al. (2006) and Schoengold et al. (2006) use econometric approaches to study the impact of water pricing. Although they model individual decision they also neglect input substitution possibilities.

Therefore a novel methodology is proposed in this study that allows estimating the effect of water pricing at farm level and moreover takes into consideration possible substitutions between inputs. Comparison of the simulated level of water use with the current one offers an interesting insight in the water saving effect of the introduction of water charges. In addition environmental effects (use of fertilizers and pesticides) and socio-economic effects (labour use, effect on farm profit and total agricultural output) can also be assessed. The methodology is applied to a sample of 60 small-scale irrigators in North West Province, South Africa. This is a relevant case study because in South Africa the changes in the water law incorporate the principle of water as an economic good, thus levying charges on its use. For farmers at small-scale irrigation schemes this is a new challenge, because up to now their water use is entirely subsidized. These subsidies will gradually decrease and farmers will have to pay to ensure cost recovery (DWAF, 2004). As in most cases one of the expected benefits of this policy change is that water use efficiency will rise. The exact impact of this change on the irrigation water use or on the farmers' production system is unclear, but very important given the role these small-scale irrigation schemes play in providing a livelihood for rural households. Apart from employment opportunities, these schemes are believed to contribute to rural development by their potential to alleviate food insecurity and to generate additional income opportunities (Perret and Touchain, 2002; Perret, 2002).

2. Methodology

2.1. Measuring efficiency with DEA models

The first step in this study consists of determining the current technical and allocative efficiency levels of the farms in the sample using DEA. Input-oriented measures were chosen to reflect local reality, where a decrease in the use of water is an underlying objective. Technical efficiency (TE) is then defined as 'the ability of a farm to use minimum feasible amounts of inputs to produce a given level of output' (Coelli et al., 2002). Allocative efficiency (AE) on the other hand refers to the degree to which inputs are used in optimal proportions, given the observed input prices and the value of the outputs produced. Economic efficiency (EE) finally is the product of allocative and technical efficiency and captures performance in both measures.

DEA is a nonparametric systems approach in which the relationship between all inputs and outputs is taken into account. Economic and allocative efficiency can be calculated with only minor adjustments to the basic model for calculation of technical efficiency. In DEA simultaneously a production frontier is constructed and efficiency measures are obtained. This is done by solving a sequence of linear programming (LP) problems, one for each farm. In this way the frontier obtained is formed by actual observations and envelops the observed input and output data of all farms. In the second step of the analysis the frontier and efficiency measures will be used as a representation of the production technology. For a case with K inputs and M outputs for N farms the technical efficiency θ for each farm is searched as follows:

$$Min_{\theta\lambda}\theta,$$

subject to
$$\begin{aligned} &-y_i + Y\lambda \geq 0, \\ &\theta x_i - X\lambda \geq 0, \\ &\lambda \geq 0 \end{aligned}$$

where θ is a scalar and λ is an Nx1 vector of constants, x_i and y_i, are column vectors with the input and output data for the i-th farm. X is a K by N matrix and Y a M by N matrix with respectively all input and output data for all N farms in the sample. The value θ, a score always lying between zero and one, with a value of one indicating that the farm lies on the frontier and is efficient. An implicit assumption of the model described above is that returns to scale are constant and thus farms are operating at an optimal scale (Fraser and Cordina, 1999).

A second characteristic to capture is the farms' success in choosing the optimal set of inputs given the input prices. This is done by calculating the allocative efficiency. Based on the technical and economic efficiency the allocative efficiency can be determined residually as AE=EE/TE. Economic efficiency itself is calculated in two steps. First a cost-minimizing vector of input quantities given the input prices is determined using the model from eq. 2:

$$Min_{x_i^*\lambda} w' x_i^*, \qquad (2)$$

subject to
$$\begin{aligned} &-y_i + Y\lambda \geq 0, \\ &x_i^* - X\lambda \geq 0, \\ &\lambda \geq 0 \end{aligned}$$

where w_i is a vector of input prices for the i-th farm and x_i* (which is calculated by LP) is the cost-minimizing vector of input quantities for the i-th farm, given the input prices w_i and the output levels y_i. The other symbols are defined the same as in eq 1.

In the second step economic efficiency (EE) of the i-th farm is calculated as the ratio of the minimum cost to the observed cost (eq. 3)

$$CE= w'_i\, x_i^* / w'_i\, x_i \qquad (3)$$

With the allocative and technical efficiency of each farm calculated, a model to estimate the impact of changes in the water price can now be constructed.

2.2. Simulating impact of different water prices

Several authors, listed in the introduction, have used linear programming models to estimate water demand. Based on one or more objective functions, these models predict changes in cropping activities and linked to this, changes in water use at different water price levels. This type of models however, typically uses a number of cropping alternatives in which the levels of input use and the output produced is fixed. As a consequence, substitutions between different inputs within an alternative are not captured at all, or only in a very static way by defining different input-output sets for the same crop as in Manos et al. (2006), Berbel and Gómez-Limón, (2000) or Gómez-Limón and Berbel (2000). Scheierling et al. (2006) and Cai et al. (2006) however report substitution between water and other agricultural inputs as an effect of increasing water prices.

Another shortcoming of most of these models is that they are based on average technology and implicitly make the assumption that all farms react in the same way. An improvement to this is the model by Gómez-Limón and Riesgo (2004) that classifies farms into different farm types and looks at the impact on each one of them. The combination of the use of average technologies and the simplified fixed resource constraints nevertheless leads to overly abrupt changes in the price response (Jonasson and Apland, 1997). Econometric models for studying impact of water pricing by Moore et al. (1994), Bar-Shira et al. (2006) and Schoengold et al. (2006) on the other hand have the advantage of modelling individual farmers' land allocation choices, but they also neglect the possibility of substitution between inputs.

The approach suggested in this paper uses the information from the efficiency analysis above in modelling the effect of water price changes at farm level. In this way the weaknesses of both types of approaches discussed above are overcome. In addition, by incorporating the occurrence of inefficiencies in the price responses simulations more closely reflect reality (Arnade and Trueblood, 2002). The rationale is similar to that of Jonasson and Apland (1997) when they incorporate frontier technology and inefficiencies in the mathematical programming of a sector model. By introducing the efficiency information, representation of the production technology is improved. Besides, the farm level accounting data to estimate the technology frontier are relatively easy to collect. An underlying assumption for this second step is that farmers will adjust their water use and input mix in response to the introduction of water charges, because relative prices have changed. It is assumed however that in the short run this will not have a direct effect on their overall levels of efficiency as they were defined above. A study by Maniadakis and Thanassoulis (2004) confirms this assumption. When they decomposed productivity changes in Greek hospitals between two time periods, they were able to clearly distinguish the effects of changes in allocative and technical efficiency, changes in the technology of production and changes caused by shifts in input prices. Thereby they showed that shifts in input prices cause changes in input use without changing allocative efficiency.

The simulation model of this study is presented in eq. 4 to eq. 18. In this model $w_{new}^{'}$ and w' are respectively the new and old price vector for each farm and $xsim_i^*$ and x_i^* the new and old cost-minimizing vector of input quantities for the i-th farm. $xsim_i$ is the simulated input vector, which maintains each farms' technical and allocative efficiency and x_i is the original input vector. For all these vectors subscripts "k1", "k2" indicate one of the non-water inputs, while subscript "wa" indicates water input. $ysim_i$ and y_i are the simulated and original outputs. λ_1 and λ_2 are vectors of constants. θ is the technical efficiency level and EE is the economic efficiency level which were determined in the first step for each farm. X_{fron} and Y_{fron} finally are parameters that are equal to the observed input vector and output vector of farms for which technical efficiency was found to be 1 in the first step

$$\underset{\lambda 1, \lambda 2, xsim_i, xsim_i^*, ysim_i}{Max} \; ysim_i - w'_{new} \, xsim_i, \qquad (4)$$

subject to

$$-ysim_i + Y_{fron}\lambda_1 \geq 0, \qquad (5)$$

$$xsim_i^* - X_{fron}\lambda_1 \geq 0, \qquad (6)$$

$$-ysim_i + Y_{fron}\lambda_2 \geq 0, \qquad (7)$$

$$\theta xsim_i - X_{fron}\lambda_2 \geq 0, \qquad (8)$$

$$\frac{w'_{new} x'^{*}_i}{w'_{new} xsim_i} = EE, \qquad (9)$$

$$ysim_i \leq y_i, \qquad (10)$$

$$xsim_{wa,i} \leq x_{wa,i} \qquad (11)$$

$$xsim_{k,i} \leq xsim^*_{k,i} \qquad \forall \text{k, if } x_{k,i} \leq x^*_{k,i} \qquad (12)$$

$$xsim_{k,i} \geq xsim^*_{k,i} \qquad \forall \text{k, if } x_{k,i} \geq x^*_{k,i} \qquad (13)$$

$$w'_{new} xsim_{k1,i} \leq w'_{new} xsim_{k2,i} \qquad \forall \text{k, if } w' x_{k1,i} \leq w' x_{k2,i} \qquad (14)$$

$$w'_{new} xsim_{k1,i} \geq w'_{new} xsim_{k2,i} \qquad \forall \text{k, if } w' x_{k1,i} \geq w' x_{k2,i} \qquad (15)$$

$$\frac{xsim_{k,i}}{x_{k,i}} \geq \frac{xsim_{wa,i}}{x_{wa,i}} \qquad \forall \text{k} \qquad (16)$$

$$\lambda_1 \geq 0 \text{ and } \lambda_2 \geq 0 \qquad (17) \text{ and } (18)$$

The model maximizes the gross margin of the farmers (Eq.4). To reflect the situation that farmers start adjusting from an existing input mix, the original vectors x_i and y_i are used as starting values in the simulation. Equations 5 to 18 are the constraints in the model. Eq.5 to 9 and 17 and 18 of the model form the representation of the technology found in the first step and incorporate the inefficiency levels of the farmers. Eq. 9 in combination with 5 and 6 equals the economic efficiency given the new prices with the economic efficiency under the original prices, while eq. 7 and 8 make sure that the technical efficiency is maintained. Eq. 10, 11, 12, 13 and 16 are based on economic theory. For instance eq. 10 and 11 respectively introduce that a rise in the price of water will not lead to a rise of output or the use of water and eq. 16 adds to this that the relative use of the input will decrease. Eq. 14 and 15 finally assure that farmers' preferences for using certain inputs are maintained.

Figure 1 gives a graphical illustration of the method using a simple numerical example. In the starting situation Decision Making Units (DMUs) A-H use two inputs (X_1 and X_2) to produce a single output (Y). For simplicity it is assumed that all units face the same input prices (P_1 and P_2), which are equal to 3 for both inputs (cost boundary 1). The technical efficiency frontier is formed by DMUs A, B, C and D. Moreover at the original prices DMU A is allocative and economic efficient, with cost boundary 1 tangent to the technical efficiency frontier.

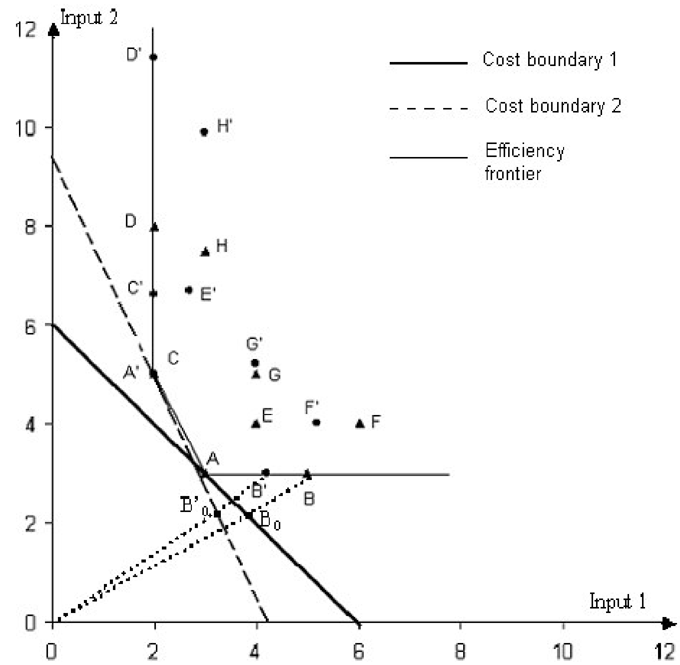

Figure 1: Simulating effect of relative price changes in a simple numerical example

We can now apply the model described above to estimate the effect of a price change of one of the inputs. Assume now that the price of input 1 increases to 7 for all units. This change in relative prices of inputs 1 and 2 causes the slope of the cost boundary to alter (cost boundary 2). As a result technical efficient DMUs will move on the efficiency frontier maintaining their level of economic efficiency, which reflects an inherent characteristic of these DMUs namely the way they perceive prices. DMU A for instance moves from point A to the point A', where the new cost boundary is tangent to the frontier. DMU B moves from point B to point B' and the preservation of the economic inefficiency here can be graphically shown as 0B/ 0B0 = 0B'/0B'0. Summarizing, technical efficient DMUs move along the frontier, maintaining their economic inefficiency level, but changing the input mix. Similar to the DMUs on the frontier, DMUs with a TE smaller than 1, stay at the same technical and economic efficiency level.

2.3.Data collection

Data was collected from small-scale irrigation schemes situated in Zeerust Municipality (North-West Province, South Africa) from July to September 2005. Farmers in these schemes mainly produce vegetables. Questionnaires were used to collect data, with a total of 60 farmers interviewed, spread over 13 small-scale irrigation schemes. Random sampling was applied to select schemes and individual farmers, but representativeness was maintained by matching the number of respondents from each scheme with the number of farmers operational within them.

During the interviews information was gathered on quantities and costs of inputs used in production, quantities and values of outputs and the quantity of water consumed. Because the farmers in the study area do not keep records of their farming activities, data gathered during interviews was based on recollections of farmers. Therefore expert knowledge of extension staff was used as a supplement to the recollections of the farmers, something that was particularly helpful for the estimation of the water use and the prices of their produce. Using the quantities and corresponding prices of the different outputs a monetary value for the total output was calculated. The inputs considered in the efficiency analysis include land, irrigation, labour, fertilizers and pesticides (table 1). Although the sample is relatively small, this case study reflects the typical situation of many rural areas in South Africa and thus provides interesting insights. Moreover the sample suffices to demonstrate the possibilities of the methodology adopted.

Table 1 Descriptive statistics on outputs and inputs used in efficiency analysis.

	Unit	Average	St. dev.	Minimum	Maximum
Output	rand[1]	2816	11348	150	87200
Inputs					
Land	ha	0.16	0.40	0.01	2.8
Water	m³	1287	3299	82.9	2215
Labour	man days	29	76	5.6	599
Expenditure on pesticides	rand	72	82	0	360
Expenditure on fertilizers	rand	64	91	0	487

3. Results and discussion

First the three efficiency measures described above (technical, economic and allocative efficiency) are calculated. The average technical efficiency is 0.51, indicating that substantial inefficiencies occur in farming operations of the sample farm households. Allocative and economic efficiency are even lower, with an average value of 0.26 and 0.14 respectively. These scores show that farmers could considerably reduce costs by taking more notice of relative input prices when selecting input quantities. In South Africa these low values can be linked to the reported poor economic performance of the small-scale irrigation schemes in general (Perret, 2002).

The simulation model described in section 2 is now applied to the South African farm budget dataset. The original situation, where water is a free input, is changed by introducing different water price scenarios (0.025R/m³, 0.05R/m³, 0.1R/m³, 0.2R/m³, 0.3R/m³, 0.5R/m³, 1R/m³). In figure 2 the water savings per farm are put in different classes and for each water pricing scenario the share of farmers in each class is presented. It is clear that already at low prices farms considerably save water. Such results were also found by Moore et al. (1994) and Schoengold et al. (2006). By allowing substitution between inputs in the model, water demand is clearly much more elastic then found by Albiac et al. (2006), Manos et al. (2006) or Gómez-Limón and Riesgo (2004). The result is furthermore not surprising given the low water use subvector efficiency found in a previous study. At higher water prices water saving also increases because some farms that are not profitable anymore will stop producing. The finding of Gómez-Limón and Riesgo (2004) that farmers' response can be very different depending on the elasticity of their demand is also confirmed here.

[1] At the time of the data collection the exchange rate was 1 Rand = 0.1504 US$

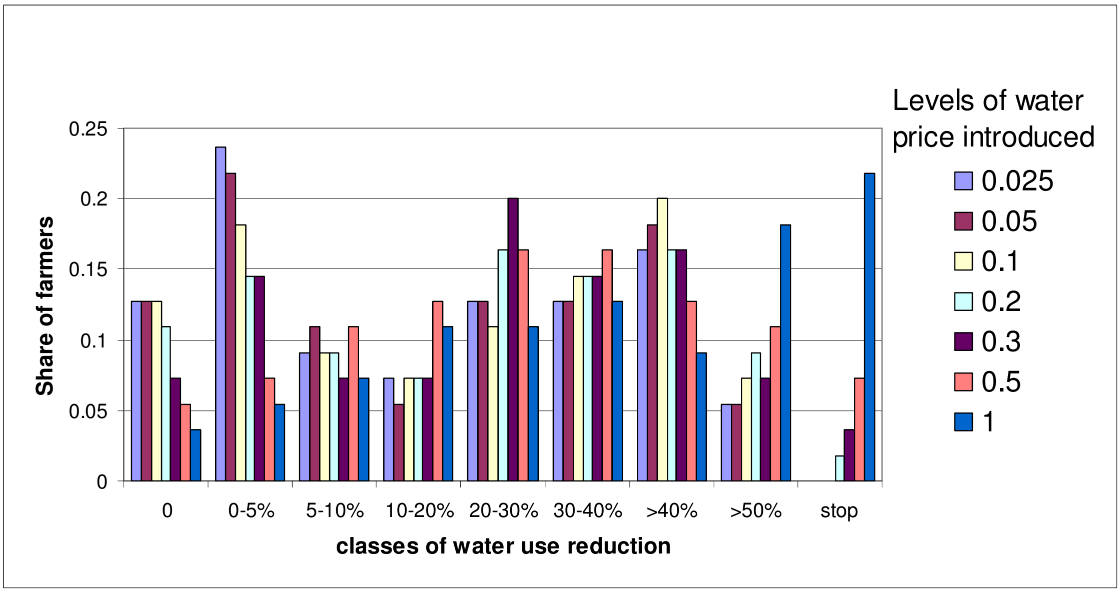

Figure 2. Classification of the reduction in water use under different water pricing scenarios

Figure 3 shows the effect of the different water pricing scenarios on the overall-use of the different inputs. Although not all farms react in the same way, at the lower price levels, there is a tendency of substitution between labour and water. This was also reported by Scheierling et al. (2006). The overall use of other inputs on the other hand decreases together with the water use, a result found in most studies. Relative use of the non-water inputs however increases. At higher water prices an additional factor for the decreases in the use of all inputs is the farms that go out of production.

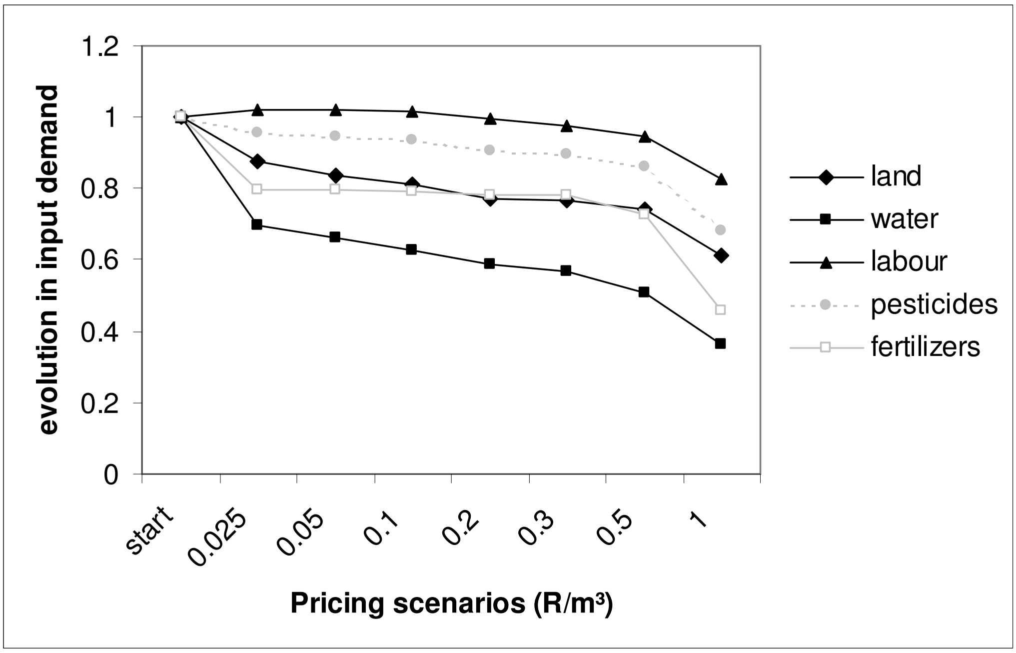

Figure 3. Evolution of overall input demand at different water price levels

Looking at the evolution of total output in monetary terms and at the total profit in terms of gross margins, these appear to be quite stable at the lower prices levels (figure 4). At these levels irrigation water forms only a small part of the costs and as a consequence has only limited effect on gross margins. Notwithstanding the fact that quite some farms stop producing as shown above, the effect on the reduction in total output, even at higher water prices, seems limited. This can be explained by the fact that it are mainly less profitable farms, that produce less output that go out of business. The more profitable farms that produce more output and thus have more weight in total output, reduce output only a bit. This explication is confirmed by figure 5. Here the cumulative distribution functions for the loss in profit at each price are presented. By comparing figure 4 and 5 it can be seen that at each level of price introduced the loss in profit in percentage for most of the farms is higher than the total percentage of figure 4. In other words looking at the total profit of the sector distorts the effect of a water price a bit. Similar to Gómez-Limón and Berbel (2000) and Yang et al. (2003) loss of farm income for many farms appears to be significant.

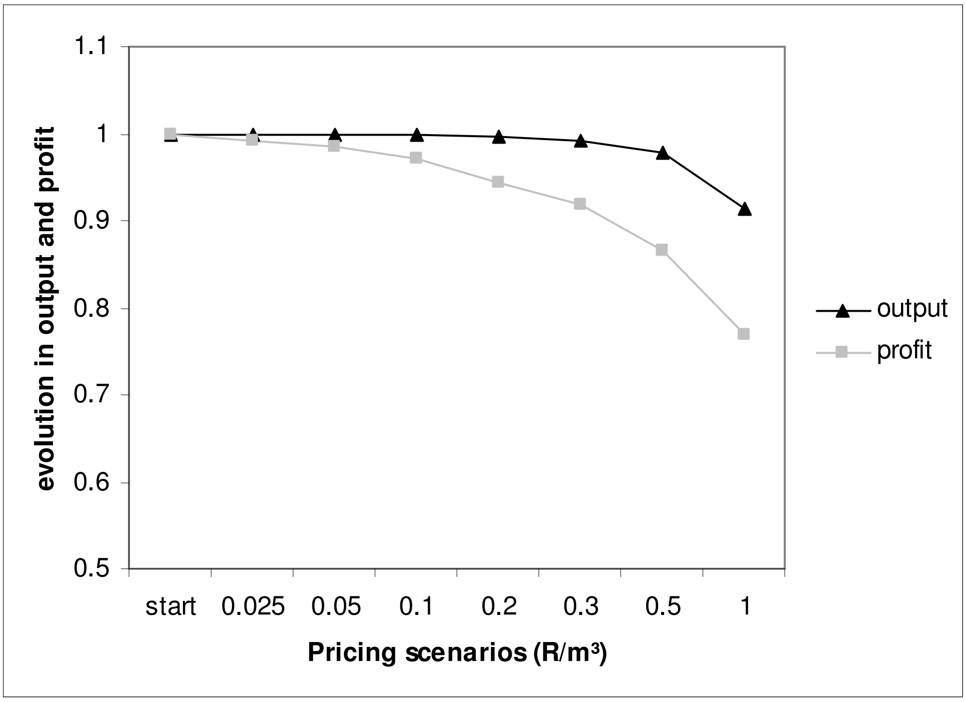

Figure 4 Evolution of total output (monetary terms) and profit (gross margin) at different water prices

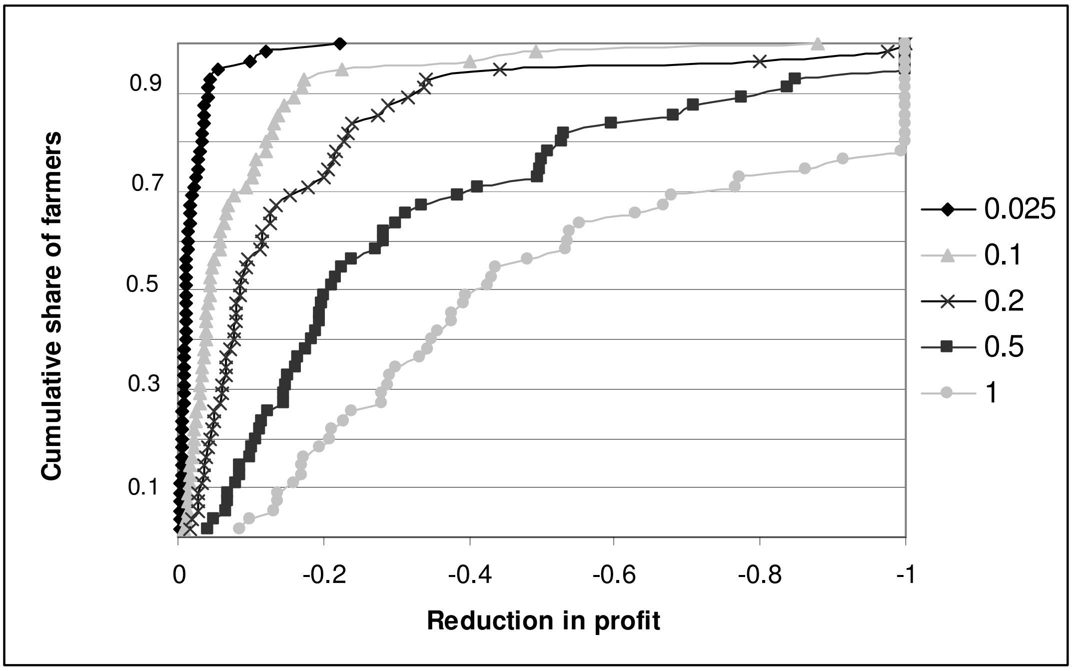

Figure5 Cumulative distribution of reduction in profit for different water pricing scenarios

4. Conclusions

Water pricing is often seen as an important tool to improve efficiency of water use. Several authors however have warned of the limited effect in terms of water saving and the even negative economic and social side effects of this policy. Given the increasing pressure to release water for other uses and to find ways in which to improve irrigation performance, there is an urgent need for methodologies that allow estimating the effects of different water pricing scenarios. This study proposes a novel method to simulate the effect of changes in water price. First a simple numerical example shows that the results of the simulation model are in line with classical economic theory, with a price change causing a change in the ratio between the inputs. When applied to South Africa, an important finding is that farmers are quite responsive to even small changes in water price. This can be explained by the low water use subvector efficiencies reported in an earlier study and by the possibility of input substitution incorporated in the model. Another key finding which was also reported by other studies is the magnitude of the adverse effect on farm profitability. From a development perspective it is worrying that it appear to be the smaller farms in terms of output (mostly the poorer farmers), which are affected most and which at higher water prices even stop producing.

Regarding the methodology, from the above it is clear that the use of observed technology frontiers in simulation models can clearly improve estimation of price change effects. Changes are less abrupt and by incorporating the occurrence of inefficiencies at farm level, simulations more closely reflect reality. Further research could focus on developing a model that works with frontiers on crop instead of on farm level. In this way changes between crops could also be explicitly predicted.

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