Drought Relief and Rural Adjustment Policy in Australia

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(The views expressed in this paper are those of the authors and may not represent the policies of the NSW Department of Agriculture or the NSW Government.)

INTRODUCTION

This paper presents an overview of government policy in relation to drought relief and rural adjustment assistance in Australia. The discussion on the role of government in this regard is based on economic efficiency and market failure principles. It is relevant, however, to note that this policy relates to an agriculture sector that is commercial, rather than subsistence, in nature, and that it is part of an economy that is underpinned by a general social welfare system.

BRIEF HISTORY OF RURAL ASSISTANCE IN AUSTRALIA

Government intervention in farm adjustment began in Australia with debt reconstruction and farm build-up schemes in the mid-1930's. During the 1950s and 1960s, assistance to agriculture was primarily concerned with increasing farm output through farm development assistance. Through the provision of commodity marketing schemes, governments aimed to provide a guaranteed price for the commodity, based on the cost of production and allowing for a margin for the farmer. These were designed to provide more stable returns so that farmers would have more confidence to invest in farm development and thus the agricultural sector would expand its contribution to the economy.

Toward the end of the 1960s, the focus of rural assistance moved away from the objectives of farm development towards stabilising the rural sector. Assistance was provided through concessional finance to enable "viable farmers to cope with short-term fluctuations in rural fortunes and to remain in farming" (Milham and Davenport 1997). This was followed in the 1970's with a number of specific reconstruction schemes for dairy, fruit growing, and beef as well as a generalised Rural Reconstruction Scheme (McColl *et al.* 1997), which focused at least in part on assisting exit from farming.

In 1977, the Rural Adjustment Scheme (RAS) was established to amalgamate the various schemes that were operating. In essence, the RAS operated as a lender of the last resort, providing cheap credit (Musgrave 1990). The RAS has since operated in various forms, with changes to the component programs following reviews in 1988 and 1992.

A further review, which commenced in 1996, concluded that the RAS would not effectively serve the needs of the farm sector into the next century, and recommended that it be replaced (McColl *et al.* 1997). In September 1997, the RAS was replaced by *Agriculture - Advancing Australia* (AAA), an integrated rural policy initiative jointly agreed by the State, Territory and Commonwealth Governments.

Another government policy designed to make government approaches to drought assistance more transparent and consistent across the nation was the National Drought Policy (NDP), which was established in 1992. This was an intergovernmental agreement on government responses to drought. The RAS was an integral component of the NDP, however, the fundamental philosophy of the NDP was self-reliance, namely that drought was one among many other risks faced by farm businesses and that farmers should implement strategies to deal with it in their own way. The NDP no longer exists in its own right, its component programs are now incorporated in the AAA package.

MICROECONOMIC REFORM

By the early 1990s many OECD countries were recognising that dynamic economic and social changes were rendering long-standing national regulatory institutions and regimes increasingly obsolete, and even harmful to national prosperity (Jacobs 1995). Australia boarded the deregulation bandwagon at a relatively early stage, with governments showing substantial bipartisan commitment to microeconomic and regulatory reform.

Major deregulatory moves in Australia have included relaxation of exchange rate controls and financial market deregulation in the early 1980s (Powell and Milham 1990), and on-going reform of industry assistance and protection, statutory marketing and price support arrangements throughout the 1980s and 1990s (Harris 1990; Industry Commission 1995; Mauldon 1990; Piggott 1990).

Perhaps the most significant step towards microeconomic reform since financial deregulation in the mid-1980s, was the endorsement by the members of the Council of Australian Governments (the leaders of the State, Territory and Commonwealth Governments) of the National Competition Policy in April 1995. This Policy, and the agreements under it, followed on from consideration by Government of the so-called Hilmer Report (Hilmer *et al.* 1993). The Commonwealth, State and Territory Governments are now committed to reform, by the year 2000, all legislation that unnecessarily restricts competitive market behaviour. The schedule for such reviews includes the various pieces of legislation which underpin agricultural adjustment and assistance policy.

In general, the Competition Principles Agreement requires that legislation should not restrict competition unless it can be demonstrated that the benefits to the community as a whole outweigh the costs and, further, that achievement of the objectives of the legislation requires that competition be restricted.

The GATT agreement on agriculture is also providing impetus for globally coordinated domestic reforms to government intervention in the rural sector (see, for example, Andrews *et al*. 1996 and Thomson 1996). The final agreement reflected a broad commitment to reducing domestic support measures. While assistance measures which have a minimal impact on trade are allowed under the agreement - including disaster relief, research, disease control, infrastructure, environmental protection and food security (Thomson 1996) - it seems likely that more general programs, such as primary producer taxation concessions will be subject to increasing international scrutiny and criticism.

THE ROLE OF GOVERNMENT IN RURAL ASSISTANCE

The increasing focus on economic considerations has highlighted an anomaly in agricultural assistance in that traditionally the regime of programs in Australia has concurrently included elements intended to hold farmers in agriculture and others intended to encourage exit. In addition, the dichotomy between measures which assist farm businesses and those which support farm families has become evident.

The major rural assistance programs in Australia have and still involve intervention by governments in the operation of farm businesses (eg., price support, concessional credit, interest subsidies, training etc.). There is a strong case, however, that in an open market-based economy, justification for policy measures which attempt to directly alter business decisions (i.e., allocation and utilisation of land, labour and capital resources) can only be found in the existence of market failures which impede efficient resource allocation or create undesirable social or environmental outcomes.

Policy economists recognise that in a competitive market economy, government resources are most appropriately targeted towards correcting instances of market failure, where market failure is defined as the situation where freely operating markets do not provide the most desirable outcome for society as a whole (i.e., where private decisions lead to an inefficient or inequitable allocation of the community's resources). Thus, government intervention which does not explicitly target and ameliorate market failure can be expected to *cause* rather then reduce inefficiency, and impair rather then improve national well-being. There is a large body of theoretical and applied research literature to support this view (see, for example, Edwards 1971 and Thompson *et al.* 1996) and acceptance of it by governments in Australia and elsewhere around the world is inherent in the commitment to the microeconomic reform process.

Furthermore, it is a tenet of policy economics that as a general rule the first-best approach to redressing an instance of market failure is not to provide offsetting assistance to a particular business sector. This approach addresses only the symptoms of the market failure and then only for the particular sector or sectors targeted. Rather, the most effective, efficient and equitable approach is to intervene to correct the underlying problem. That is, a genuine market impediment should first be identified and then a policy instrument be developed to rectify the problem on an economy-wide basis.

Australian society is generally concerned with the alleviation of poverty. The relevant market failure in this case is the concern that freely operating markets will not provide a socially optimal level of welfare to all citizens. The appropriate response of government is therefore the provision of welfare assistance to persons who are unable to generate sufficient income to attain a certain minimum standard of living (Milham and Davenport 1995).

It follows from the points above that farm family welfare concerns are most appropriately addressed by providing support directly to the individuals and households who are in poverty, rather than through assistance to the farm business. The Australian social security system has not, however, been designed so as to adequately cater for self-employed persons (such as farmers) who become impoverished, with the major barriers to access being the assets and work activity test arrangements (Milham and Davenport 1995). Farmers have therefore experienced difficulty in accessing general welfare measures. Perhaps mainly on the grounds of political expediency, rather than seeking to make the eligibility criteria more generally applicable (thereby correcting the underlying problem), special welfare arrangements have gradually been introduced to alleviate farm poverty (Milham and Davenport 1995; Musgrave 1990).

While explicit farm welfare programs have been established, other rural assistance programs which supposedly focus on maintaining farm business profitability and/or promoting farm adjustment also have significant implications for the economic well-being of farm families. In practice it appears that in times of crisis, the farm sector in Australia has come to rely on business support programs as thinly disguised welfare measures.

From a best-practice policy perspective it is not appropriate that this should be the case. Valid concerns over farm family welfare should not be regarded as providing grounds for publicly funded business assistance. It has been demonstrated that if it is desired to supplement to a given degree the incomes of persons receiving low incomes in agriculture, this can be done for a much smaller transfer payment (and a smaller cost in terms of real national income) if payments are related closely to a measure of need for this type of assistance (eg., Edwards 1971). In other words, to minimise collateral damage to resource allocation, welfare assistance should be based on welfare measures and be provided directly, and not through indirect means such as commodity programs or farm adjustment assistance.

MAIN FORMS OF RURAL ASSISTANCE - EXAMINATION OF THE RATIONALE

Subsidised credit (eg., interest subsidy assistance)

Implicit in this form of assistance is the notion of credit market failure. That is, it must be presumed that for some reason credit providers do not properly assess farm loan proposals and therefore either do not supply enough credit to the rural sector, or price it too high. In order to avoid resource misallocation costs, before implementing subsidised credit schemes it is important to establish whether this is indeed the case.

Theoretically, it is possible that there may be degrees of information failure in the Australian credit market, whereby lenders do not have full information about the credit worthiness of individual borrowers. For example, lenders may not have full information about the impact of certain production conditions or systems on the long term productivity of individual farm businesses, leading to the imposition of credit constraints or inappropriate risk margins. Clearly, however, the first-best response by government to this problem would be research and dissemination of information on the environmental impact and long-term sustainability of farming systems, rather than simply subsidising the cost of credit. Critical here is acceptance that while government responsibility extends to defining the institutional setting in which farms operate, it does not extend to 'operating the business'.

There now seems to be reasonable consensus amongst objective and informed commentators that (in Australia) subsidising farm credit does not address any form of market failure. Credit subsidies are hence of questionable validity as a use of public funds and are open to criticism on the grounds that:

- since they do not have a positive impact on efficiency, they represent a substantial amount of public funding that could be otherwise more beneficially employed in addressing actual instances of market failure that are detracting from the long term sustainability of the sector;

- they are likely to be impeding rather than facilitating farm adjustment; and

- interest subsidies during drought are likely to encourage farmers to maintain higher levels of production at a time when the natural resource base is most vulnerable.

Other concerns include:

- they are capitalised into asset values and thereby indirectly penalise non-assisted farmers wishing to purchase capital inputs;

- they act as a disincentive to effective risk management by discouraging the implementation by farmers of private strategies to build-up financial (or other) reserves, and thereby increase demand for government assistance in periods of downturn; and

- they disassociate recipients from the realities of the market place, resulting in delayed adjustment responses and unnecessary equity erosion prior to adjustment decisions being taken.

It has been found that interest subsidies on debt encourage farmers to invest surplus funds in debt-financed projects and fixed capital inputs and discourage the setting aside of funds for periods of reduced income. Consequently, in times of downturn, with few liquid assets, farmers can be poorly placed to service debt and to meet basic business and family expenses (Kaine *et al.* 1993; Milham and Davenport 1995; Thompson *et al.* 1996).

Transaction-based Subsidies

Transaction-based drought subsidies primarily include subsidised cartage on water, fodder and livestock (to and from agistment) in drought-affected areas.

In Australia, these subsidies have been found to be highly suspect both as an assistance measure and in terms of their effectiveness in meeting Government policy objectives (Synapse Consulting 1992): they do not provide a significant financial benefit to many farm businesses; they actively discourage the adoption of private risk management strategies; and they appear to encourage high stocking rates and late destocking during the onset of drought.

Farmer Education and Skills Development

For many years, a form of assistance available to farmers in Australia has been assistance towards the cost of education and training to improve farm management skills. Funding for diagnostic studies to assess the financial position of the farm business has also been available.

It could be expected that general purpose training, education and diagnostic studies result in private benefits through improvements in productivity and profitability. It follows that such services would be most efficiently provided if the cost was met by the beneficiaries. This would ensure that the supply of these services closely matched industry demand. In contrast to interest subsidies, however, they enable the unique problems of individual farms to be identified and addressed accordingly, rather than accepting the assumption that the solution to all farm problems is the same. Thus, while their justification on market failure grounds is equally questionable, they probably give rise to less efficiency costs than interest subsidies.

Two sets of circumstances might justify government support for training and education. The first is where these activities are clearly targeted at overcoming ‘information failure’ associated with the adoption of sustainable production systems. The second is compensation-based and involves targeting subsidised training, for a limited period, to assist farmers adapt to a changed policy environment. It should be ensured, however, that subsidised training schemes not only address the various financial, environmental and non-economic risks relevant to farm families, but also explicitly target the use of market-based strategies.

It is essential therefore when considering this form of assistance:

- to identify and support only those specific forms of training and education that generate public benefits thereby warranting government assistance;

- that any subsidised farmer training and education programs should emphasise self-reliance and the adoption of market-based strategies; and

- to identify whether they are most effectively delivered through general programs, through more targeted programs delivered by other public agencies, or by commercial providers.

Re-establishment Assistance

Edwards (1971) argued that unless factors which slow the rate of adjustment - such as lifestyle considerations - are also genuine impediments to efficient resource allocation, they do not provide an economic justification for government intervention to facilitate adjustment. ‘One cannot argue that the consideration by a person of factors other than those which influence national income gives rise to a need for action by policy makers in order to achieve the most efficient rate of movement of farmers out of agriculture’ (p13). In fact, ‘…a measure introduced in an impediment-free economy to offset the effect of such factors on changes in resource use would in itself constitute a genuine impediment to efficient allocation’ (p12).

In other words, exit and re-establishment assistance can only be justified if a market failure which impedes farmers leaving their farms can be identified. (This argument can be generalised to include all adjustment assistance and not just reestablishment grants.) Edwards’ argument indicates that if reestablishment assistance were to be provided in the absence of such an impediment, efficiency losses would eventuate.

The weight of evidence suggests that there is little if anything in the way of genuine market failures which might impede farm exit and re-establishment in Australia (eg., Gow 1994; Musgrave 1990). A significant concern, however, is that interest subsidies or other forms of government assistance may have either encouraged excessive debt commitments or delayed adjustment decisions (and thereby eroded private equity in the farm business) to the extent that re-establishment grants become attractive.

A possible source of market failure warranting government intervention relates to the apparent aversion of rural credit providers to taking enforcement action on non-performing farm debts. While empirical data on this specific issue are not readily available, given the series of ‘crises’ that have afflicted Australian agriculture during the 1980s and 1990s, commonsense would suggest that many thousands of farmers would have been unable to continuously service their debts. While it is indisputable that the banks took enforcement action against many and even foreclosed on some, it is also evident that this did not happen to all or even most. Whatever the range of reasons for the banks adopting this policy, it would have reduced the market-based pressure for adjustment and it is likely that as a result the rate of adjustment was less than it might otherwise have been. Perhaps in recognition of these factors, the exit and reestablishment assistance program under the new AAA policy are only temporary.

Taking the above together, there seem to be grounds to expect that re-establishment grants do little to encourage farm families to leave agriculture. They may in fact impede structural adjustment by encouraging farm families to remain in agriculture even though equity is eroding. Less distortionary and effective assistance may be to intervene earlier to:

- increase the awareness of farm families of their financial situation;

- encourage the provision of debt mediation services such as government funding for the preparation of mediation cases and the employment of a mediator; and

- provide career counselling and re-training and include counselling targeted at non-economic or social barriers to farm families leaving the farm.

CONCLUSION

Australian governments have a long history of providing various forms of drought relief and adjustment assistance to the rural sector. Contemporary policy in this area now recognises the distinction between, and the differing roles of government in, assistance to farm businesses as compared to welfare relief to farm families.

Thus rural assistance policy in Australia now has two explicitly different elements:

(i) an emphasis on self-reliance by farm businesses in managing the risks they face, including drought, with assistance measures focusing on information and training; and

(ii) provision of an appropriate welfare safety net for farm families who are unable to support themselves above a defined minimum standard of living.

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