

New Zealand Strategic Management Society Leaders Breakfast

**Agriculture's Albatross:
Producer Boards in the 1990s**

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AGRICULTURE'S ALBATROSS : PRODUCER BOARDS IN THE 1990s

At a Wellington Chamber of Commerce breakfast late last year, David Henderson, Head of the Economics and Statistics Department of the OECD for eight years to 1992, was asked his opinion on priorities for ongoing economic reform in New Zealand. His answer was that reform of statutory marketing arrangements in agriculture would be at the top of his list.

Earlier last year the OECD itself highlighted the problems of this area of regulation in its most recent report on the New Zealand economy. It pointed out that:

Although New Zealand is one of the few OECD economies to have comprehensively liberalised its agricultural production, this is not the case for processing and marketing. The latter remain firmly controlled by a host of regulations including statutory export monopolies, restrictions on entry, and institutional control over marketing. Most of this regulation is implemented by Producer Boards, at present influencing approximately 80 percent of all agriculture and horticulture exports. The major marketing boards include the Apple and Pear, Dairy, Kiwifruit, Meat Producers, Wool, and Game Industry Boards, as well as the Horticultural Export Authority. Their functions fall into three main categories: regulatory (e.g. licensing exports, quality control and transportation organisation), commercial (e.g. processing, marketing and purchasing), and servicing (e.g. advisory services, research and development and marketing strategies). Although the extent of commercial activity varies amongst the Boards, they all invest in the marketing of their respective products.

Before looking at the justifications that continue to be advanced for this body of regulation and the problems associated with it, I want to look at some trends in the agricultural sector and how it is performing in the new economy. The story is a sobering one, and it is surprising that it is not receiving far more attention.

Essentially we are talking about a rapidly declining sector of the economy, at least in relative terms - other sectors are growing much faster.

Over the last 15 years, agriculture as a percentage of GDP has shrunk dramatically. From being over 10 percent of the economy in the late 1970s, it will fall to 4.8 percent this year according to MAF forecasts. Of course on-farm production gives rise to activity elsewhere in the economy but the same is true of other industries - tourism supports retailing, for example. There is no mistaking the reality of this trend.

The decline may be accelerating. Looking at employment figures we see that over the two years to September 1995 when the economy was growing strongly, 34,000 new jobs were created in manufacturing, 20,000 in construction and 38,000 in wholesale and retail trade. By contrast, agriculture actually lost 2,000 jobs.

According to the government's December Economic and Fiscal Update, farm incomes are likely to be down by 21 percent this year and a further 2.3 percent in 1996/97, and by 1998/99 both farm incomes and farm profits (operating surplus) are still expected to be below their levels of five years earlier.

A recent article by Warren Hughes of the University of Waikato looked at trends in major export industries for the six years to 1995. All the major agricultural industries recorded growth rates in export values below the annual average of 7 percent in this period, with dairying coming closest to the average and meat and wool trailing the field. If these rates were to hold for the future, the fishing industry would overtake the wool industry within two years. With respect to price realisations, Hughes found that four out of the eight major industry groups - meat, wool, dairy and fruit - experienced negative export price growth and commented that "One factor all four industries share is significant producer board/cooperative marketing arrangements."

Going forward, the projected export trends are even more striking. The December Update forecasts primary export volume growth in the five years to 1998/99 to average just under 1 percent a year. By contrast, non-commodity manufacturing is expected to grow by a total of 90 percent in that period and tourism by 77 percent.

What should we make of this fairly consistent set of indicators? My interpretation is that in the new economy the traditional agricultural industries are struggling. Of course some are in better shape than others - dairying has come back from its early 1990s trough and meat and wool will no doubt recover to some extent in due course. Land values have also risen, although this partly reflects the increased value of some alternative land uses. But the relative trends are clear. The traditional rural industries are turning out to be insufficiently profitable relative to alternatives and are having trouble retaining and attracting resources. A continuation of this trend is likely to see more plant closures, less public funding for agricultural research, and difficulties in maintaining services such as health, education and roading for rural communities.

There is an irony here. Farmers were to the fore in pressing for the economic reforms which have been implemented in New Zealand since the mid-1980s. They raised on-farm productivity significantly as subsidies were removed, and benefited greatly from things like lower input costs and port reform. World markets are opening up as the implementation of the Uruguay Round proceeds. Why then is the sector still in difficulty?

The answer, I believe, is that although agriculture is doing better, other less controlled foreign exchange-earning industries such as forestry, fishing, tourism, other export services and, increasingly, manufacturing are doing better still. These are no longer expanding from a low base. Agriculture is competing for resources - capital, labour, and in some cases land - with these profitable and fast-growing industries. The mechanisms through which agriculture is being squeezed include movements in the real exchange rate which other industries are able to sustain, higher wages and higher prices for land and other assets. All these are indicators of a healthy economy but they pose a challenge to lagging sectors. The process is similar to the impact of North Sea oil on British manufacturing in the early 1980s or the emergence of the mining sector in Australia which dragged resources away from other uses.

There may be a certain inevitability about a relative decline in the importance of agriculture in New Zealand in line with long-run trends in other countries, although we should not accept that fatalistically in a country with so many potential advantages in the sector: efficient producers can always outdo others. The long-run determinants of the profitability and growth of agriculture will be the rates of growth of productivity and innovation in the sector relative to the performance of other domestic industries that are competing for resources. We need to focus on all possible ways of removing barriers to productivity growth and innovation in the sector, in such forms

as new investment, new products, better processing techniques, adding value through branded and differentiated products, and new linkages with markets. Moreover, we should be doing so whether growth in the sector is weak or strong. This is where the issue of producer board regulation comes in.

No one would maintain that the current producer board structures are the only thing holding back the traditional agricultural industries, but their impact is nevertheless very powerful. It varies between the different industries but the relevant common features of the controls governing the single sellers - dairy, apples and pears and kiwifruit - and those affecting meat and wool are more important than the differences. All of these industries now stand out as more highly regulated than any other part of the commercial sector.

There is little debate today about the economic benefits of deregulation. There have to be very good reasons for governments to confer special regulatory privileges on any industry. Many industries in the past claimed they were special for one reason or another. Taken at face value, these claims would have suggested that about 85 percent of the economy needed to be subject to special rules. When the claims were scrutinised it was typically concluded that they did not stand up. A common framework of commercial, competition, taxation, resource management, employment and other law now applies to most industries.

The main arguments in the producer board debate have been canvassed at length and I shall summarise them only briefly. The basic premise underlying the producer boards is that unless farmers are forced to cooperate under a statutory framework they will be commercially exploited. The role of the boards according to this view is to ensure through compulsion that farmers maintain producer control of exporting and marketing while trying to maximise their returns. There are three main strands to this argument for enforced collective action: first that New Zealand is selling into distorted agricultural markets; second that regulation enables New Zealand to exercise market power and achieve higher prices; and third that it provides economies of scale.

The first argument is a variant of W B Sutch's argument for import protection: that New Zealand could not be "an island in a sea of controls". The conclusion in the import protection debate was that that view is fallacious, and the same holds for export controls. New Zealand can seek to influence other government's policies by persuasion or negotiation, but by and large it has to take the rest of the world as it finds it. It only compounds the problems of distorted external markets by imposing additional controls on imports or exports, and in the process becomes poorer than it would otherwise be. A small number of restricted markets such as the US beef market or the European Union market for butter may offer the scope for capturing quota rents and thus justify some mechanism for rationing supplies, but not the present raft of controls on exporting.

The second strand to the argument, the idea that New Zealand can exercise market power, is illusory. Market prices are determined by supply and demand. To make any sense of this argument, it would have to be assumed that New Zealand can raise world prices by restricting its national production, and has the mechanisms to do so. From an aggregate supply and demand perspective, whether New Zealand exports its production through one marketer or many is irrelevant - it can have no effect on prices. New Zealand is competing in deep and highly competitive markets with domestic and third country suppliers, and against a whole range of substitute products to which consumers could turn if faced with higher prices. Far from having

a mechanism to restrict supplies, the reality is that the payout practices of the producer boards actually have the opposite effect - bundling will tend to cause over-production, depressing the world price if New Zealand really can influence it. It follows that any attempt at supply management by New Zealand would be highly unlikely to be effective. Moreover, if it really were the case that the boards could rig markets, they would rightly be subject to antitrust action in importing countries.

Achieving genuine market price premiums is another matter, but the price premiums New Zealand might achieve derive from factors such as quality, branding, reputation, and service. These are not due to market power and are best fostered by competitive marketing. A monopolist typically concentrates on a narrow range of commodity-type products, and the producer board structures militate against diversification into sophisticated and differentiated consumer brands.

The so-called 'weak seller' argument is the reverse side of the market power coin. Weak selling is the great bogey word used by the boards to kill intelligent discussion about alternative marketing options but, like the Loch Ness monster, confirmed sightings of the practice are rare. The term comes up mostly in connection with the export of sheepmeat and, in earlier times, kiwifruit. Both of these industries have been highly regulated, with a central authority determining grading and other key operational decisions. They were never models of free enterprise. I have yet to hear of anyone talking about the weak selling of logs or flowers - expanding industries which are not regulated by statutory boards. This strongly suggests that any exporter under-performance with sheepmeat and kiwifruit owed more to the regulations than to the commercial failings of exporters, who tried to maximise profitability in difficult circumstances. Exporters who do not maximise profitable selling opportunities - in other words who are weak sellers - will not survive long in competitive markets.

Thirdly, economies of scale may well be important in parts of the international food and fibre trade, but not in others. There is no need for central planning to determine what the structure of the exporting industry should be. Where size is important, large firms could be expected to emerge without government intervention as they have in forestry and fishing, while at the same time specialist firms can compete effectively with them and exploit market niches. Moreover, by denying New Zealand producers access to large multinational distributors of their products, the current controls may mean New Zealand is failing to exploit possible economies of scale in marketing.

A variety of other issues are sometimes raised which have no more validity than these core arguments.

Some of the exports in question are said to be 'special' because they are 'perishable'. But cut flowers, other fruits, electricity, airline seats and many other goods and services are also perishable - this attribute does not constitute an argument for regulation. The fact that some products are not storable further reduces any likelihood that the relevant exporters will be able to exercise market power.

It is sometimes argued that special controls are justified because of the 'commodity' nature of the products in question. Whether products can be differentiated or not is a commercial question, and turns not just on the physical attributes of the product but on factors such as quality, volume and the reliability of the supplier. But even in the case of a 'pure' commodity, there are no sound economic grounds for regulation. Pure commodities like gold, nickel, zinc and copper are traded around the world by firms

subject to normal commercial regulation and market disciplines, not by producer boards.

Another claim, which is really a variant of the market power argument, is that competing New Zealand exporters would be 'played off' by foreign buyers such as large supermarket chains, and producers would be disadvantaged. Of course buyers will seek good deals, but they have to have suppliers - otherwise they will not be in business. If the buyer doesn't offer profitable terms to a supplier, the supplier will go broke or switch to someone else. Either way the buyer loses out. This claim simply reveals a naive understanding of how competitive markets work. Successful firms in today's international markets are not looking for opportunistic bargains but are seeking to build mutually advantageous long-term relationships. In order to compete and build markets they often want to develop distinctive supply and distribution arrangements; they don't want to be forced to deal with the same source of supply. Indeed a single supplier can prove inflexible, irritate competitive buyers, and attract the attention of regulators.

The weakness of the range of arguments for intervention in agricultural marketing suggests that in most cases it is unlikely to benefit the economy as a whole. On the other hand, it is clear that intervention carries a range of costs. As the OECD report correctly noted, these fall into two broad categories: the losses associated with restrictions on competition and the distorting effect on price signals to producers.

The first problem typically associated with restrictions on competition is cost-padding and a lack of innovation on the part of incumbent producers. Granted a quiet life, producer boards could be expected to engage in wasteful capital expenditure, pay excessive salaries relative to the performance of staff, fail to take entrepreneurial risks, stay at the commodity end of the business rather than concentrate on value-added and consumer products, and the like.

The boards are particularly sensitive to this criticism, although potentially it is not the most important of the objections to the present arrangements. Their attempts to rebut it, however, should be viewed sceptically. Last year a Dairy Board study found that cooperatives and corporates can both succeed in competitive markets - a finding that tells us nothing about the performance of cooperatives that are monopolies. Another Dairy Board study found that dairying was a profitable land use - a conclusion that might have little to do with the board's performance. On the other hand a University of Waikato study of the performance of the Dairy Board in adding value found that:

... the average dividend component in the milkfat payout was 14.56 percent over the years 1989 to 1993, which is considerably less than the 27 percent required for comparable efficiency with Nestle at adding value. Therefore it appears the current structure of the board has retarded the industry, with less innovation and value added than in a comparable investor owned firm.

A study commissioned by the Apple and Pear Marketing Board simply asked its customers what they thought of the Board. What would you expect them to say, given that no other New Zealand source of supply is available to them? And what about other would-be buyers of New Zealand apples, and potential suppliers and customers that have not even thought about entering the business because opportunities are foreclosed?

The statutory performance reviews of the boards are also weak mechanisms for assessing performance. Comparing performance in relation to a rather arbitrary and unweighted set of international benchmarks tells us little about what really matters, the overall profitability of the boards' operations. If such exercises were considered useful by, say, large institutional investors in listed companies we would expect them to be a regular feature of their monitoring activities, but they aren't. The reality is that no one, including farmers, has any way of knowing how well the monopoly sellers are performing in a commercial sense - the information available for that purpose in other commercial settings simply doesn't exist. It is theoretically possible that these monopoly organisations are performing at maximum efficiency, but this is unlikely. The monitoring and incentive problems associated with the boards' structures create significant opportunities for inefficient behaviour. We have yet to find a monopoly business in any other New Zealand industry that was not revealed to be highly inefficient and was not forced to raise its game substantially after being exposed to competition. In the sector we are discussing, the New Zealand Lamb Company, which had a monopoly in the United States for 25 years, has dramatically improved its performance since its monopoly status was terminated a few years ago.

However, the case for deregulation does not primarily turn on the issue of the operational efficiency of the boards. Indeed if the boards are doing as good a job as they say they are, they would have nothing to fear from competition. The benefits of deregulation would be that that claim would be tested; that they would be forced to maintain a high performance over time or face a loss of business; and, most importantly, that other players would have the opportunity on a continuous basis of searching for new product, processing or market opportunities. The most important problem with monopoly is that it forecloses such opportunities, which are likely to be crucial to the development of linkages with new and expanding markets in Asia and elsewhere, and to the ability of these industries to hold their own with dynamic domestic industries competing for resources. Simply allowing constrained opportunities to obtain licences to export in competition with the boards is unlikely to unleash such entrepreneurial activity.

The second category of problem associated with the current structures is the distorted prices faced by producers. One set of distortions arises from the pooling of returns across regions or varieties; this problem has been reduced but not eliminated in the case of apples, but is still serious in the case of kiwifruit. The more pervasive problem is associated with the bundling of the returns from farm production and the investment in off-farm assets in the payments to producers. This applies in all the traditional industries but is most acute in the case of the single-desk sellers, and particularly dairying. The Ireland Wallace study estimated that between a quarter and a third of the farmgate milk price is not derived from the proceeds of the milk delivered by farmers. This is a huge distortion. Its consequences include over-production of milk, artificially-induced conversions of farms into dairy production and a loss of information on which to base separate investment decisions in marketing and farm production. As Malcolm Bailey, chairman of the dairy section of Federated Farmers, has put it:

Trying to make investment decisions with bundled returns can be likened to a dairy farmer trying to make selective breeding and culling decisions from the analysis of a whole-herd bulk milk sample.

When the time comes to unscramble the bundling distortions that have influenced decisions in the industry - in terms of production levels, product mix, plant location

etc. - the adjustment could be an immensely painful process, comparable to the agony of the meat industry in the last 10 years as it has struggled to recover from the legacy of SMPs, and other government and meat board meddling.

Standing back from these fundamental arguments, we can note a number of other features of the structures of these industries which underline how archaic they are in today's commercial world. Typically, far from being able to restrict quantity to raise the world price, the single-sellers are obliged to accept whatever quantity of acceptable product is offered to them: what other profit-maximising industry operates today on such a producer-driven rather than market-led basis? With only minor qualifications, the kiwifruit and apple and pear boards are essentially forced to deal only in their own products and in products of New Zealand origin: what other international fruit marketer faces such artificial restrictions on its business? At a time when the rest of the commercial sector has been largely liberated from having to deal with politicians and bureaucrats and is getting on with business, the amount of time spent by the boards in lobbying constituents and politicians is extraordinary. Just like formerly protected manufacturers, they naturally claim that they should not have to be diverted into such activities, but the price of privilege is always endless investment to uphold it. Sooner or later the boards will have to make a choice between a political destiny and a commercial destiny.

It is also extraordinary that at a time when the New Zealand economy is performing strongly and attracting investment from around the world, outside investment in industries in which New Zealand has natural advantages is so strongly discouraged. In the case of meat and wool, uncertainty about the use of regulatory powers is a major deterrent; in the case of the single sellers there is a virtual prohibition. Australia, by contrast, is attracting massive amounts of outside capital into its primary industries, both through greater openness to corporate involvement through companies such as Wesfarmers and through foreign investment. Recent dairy investments include \$500 million by Nestlé, \$150 million by Bonlac and a \$44 million joint venture between the Murray Goulburn Co-operative, Meiji Milk Products and Mitsubishi. Dairy farmers in Australia do not seem averse to exploiting these opportunities, production is at record levels - one third up on average levels in the 1980s - and, with progressive deregulation of the industry, exports are growing strongly.

New Zealand producers can now touch and feel successful examples of competitive exporting around the world and see the ubiquitous benefits of deregulation in New Zealand. The recent World Competitiveness Report notes that ownership of the value chain is no longer a priority for international marketing success; outsourcing or alliances are emphasised at every point of the chain. It is therefore extraordinary that so many in New Zealand continue to cling to outmoded arrangements for a narrow range of industries that are in no way special. Most dairy farmers don't appear to have a problem about Heinz coming into New Zealand and Waikato increasing massively the sales of ice-cream to Japan but they seem terrified of Kraft and Nestlé. We export more fresh and frozen vegetables than kiwifruit yet no one seems to want a producer board for those industries. Fish, wine and cut flowers are all comparable and thriving industries based on competitive marketing. Farmers were able to see that monopoly unionism actually exploited its supposed beneficiaries - workers - who were denied any choice of bargaining services, but they fail to see that having no choice of marketing services puts them in exactly the same position in relation to the monopoly boards. But neither these obvious analogies nor logical arguments seem to do more than slowly influence deep-seated rural beliefs.

The boards seem to have fallen back on a variety of lame and emotional responses. They tell producers that deregulation would open the industry up to corporate predators when in fact some of the first movers in the dairy industry would probably be existing dairy companies. They tell us that at least the present arrangements 'work'. Given that what happens is that the single-seller boards take all that is offered to them, sell it for whatever they can get, deduct costs and return what is left to producers, it is hard to see how they could not 'work' in that sense. Everything 'works' by sufficiently low standards. Such statements are not arguments; they are tactics in lieu of arguments, and they tell us nothing about the merits of current arrangements.

What should be done? Practically all independent reviewers of these industries - ACIL in its report for the Business Roundtable, MAF, the Treasury, the OECD and others - have come to the same conclusions. The boards should not be dismantled but their statutory powers should be removed and their commercial activities should be corporatised and opened up to competition. Research and development could be undertaken on a voluntary basis or under the Commodity Levies Act 1990, and matters like grading and promotion could be left to individual firms or voluntary cooperation within the industries. Voluntary industry associations could invest in trade policy initiatives and other activities if their members wished. Generally speaking there should be no need for any more statutory apparatus for these industries than is the case with forestry, mining and other primary sector activities.

What are the prospects of reforms along these lines? In the short term they seem limited. Federated Farmers has done a good job in promoting reform in the meat and wool industries and getting some debate underway on dairying, but the debate in wider farming circles has got sidetracked on to absurdities such as the idea of a single seller for the meat industry. There seems little awareness within the agriculture sector of the economic factors that are now affecting it and how to respond to them.

Even though no one wants to turn the clock back on the abolition of the wheat and poultry boards and the deregulation of the local milk and apple markets, further progress is painfully slow. We seem to be stalemated at a point where the meat and wool boards are accepting a degree of reform; a largely ineffectual export licensing system is in place for apple and pears but not even that has been introduced for kiwifruit; and some tinkering with the Dairy Board's ownership structures, which will not solve the basic problems in that industry, may go through parliament this year.

None of this, I believe, will arrest the relative decline of the main agricultural industries that I spoke of earlier. Yet the government seems content to proceed at the speed of the slowest camel. Just as former National governments were not prepared to stand up to protected manufacturers, so too the minister of agriculture seems unprepared to put the national interest first in the face of entrenched interests in the boards.

We can see this in the government's standard pronouncement that its policies for specific agricultural industries are determined by whatever a majority of producers in the industry want. This is the same position that National governments previously took with manufacturers over import licensing policies: they told governments to jump and the usual response was "how high?". The problem with this position is that it neglects the interests of the entrepreneurial minority and the wider community. It even neglects the interests of other industries within the agricultural sector: the

capitalisation of off-farm dairy returns into land prices, for example, is seriously affecting the profitability of meat and wool production in some parts of the country. Southland meat producers whose farms might have been profitable at, say, \$40 a lamb might now need to get \$50 a lamb to break even. It would be unthinkable for a government today to argue that the union movement should have compulsory unionism if a majority of workers wanted it or that coastal shipping operators could determine their own rules about competition, yet these are the criteria for policy making that are being applied in agriculture.

The basic point is that seeking views in these industries through political processes - referenda and like - makes no sense whatsoever as a way of deciding the commercial rules that should apply to them. The only point of principle that should concern policy makers is whether there is any reason to deny individuals or firms whose business doesn't interfere with anyone else's the normal commercial freedom to sell what they produce to buyers of their choice, including overseas buyers. In any free enterprise system, numbers shouldn't even enter the picture.

Does any of this matter? With other export industries forging ahead and the traditional primary industries absorbing a relatively smaller share of scarce resources, the answer is 'less and less'. Farmers are increasingly becoming land use managers, and can continue to move away from the regulated industries into things like non-traditional agriculture, forestry and tourism.

But the traditional industries are still too important to the economy for us to be happy about this scenario. Opportunities for better performance in what should be areas of comparative advantage for New Zealand are being squandered. They will continue to be squandered until the existing regulatory albatrosses are removed from around agriculture's neck. In the longer run I believe it is inevitable that the force of logic and the pressures of global competition will bring this about. Some commentators are suggesting that the process will be speeded up with MMP, as the boards will almost certainly lose some of their enormous political clout with the new political arrangements and the retirement of some of their long-time supporters. In the interests of agriculture and the economy, we must hope that this will be the case.