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Farming Today: Is It Viable?

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FARMING TODAY: IS IT VIABLE?

Farming today, is it viable? We all think we know what we mean when we use the term 'viable'. But I decided to go and check its meaning in common usage. Webster's Dictionary includes the definition "being able to live or exist in a particular climate".

Accordingly, we can reformulate the question you have asked me: farming today - is it able to live and grow in the current and likely future economic, political and social climate? To answer this question, many commentators examine particular features of agriculture.

Do profits ensure viability?

They may ask the question, for example, is agriculture profitable? Surely a profitable sector is viable while an unprofitable sector will wither away.

However, there is ample evidence from the past that profits can be a poor indicator of the long-term viability of a sector. The profitability of a sector may be inflated by subsidies and tariffs. This is still the case in parts of the manufacturing sector where tariff reform has been slow. Regulatory barriers, such as inappropriate occupational licensing, protect many service providers from competition. The growth of poorly conceived regulatory controls in the environmental, land, labour and product markets also chips away at competitiveness. Profitability may not ensure viability if the price signals farmers receive for their produce induce additional production over the medium term that cannot be profitably sold.

It is, therefore, not enough for farming to be profitable. The sector must match the performance of the fastest-growing, most innovative and dynamic sectors of the economy to keep up. Otherwise, farming will continue to face increasing pressure from a higher real exchange rate and the bidding of capital, labour and land away to fast-growing and more profitable sectors. Profitability must also be sustainable in the longer term.

Does increased production ensure viability?

Others are tempted to assess the viability of agriculture by looking at trends in total production.

I am often surprised at the extent to which total production is still used as a benchmark of performance when there is so much rhetoric about how the marketing of New Zealand farm output should be market- and not production-driven.

A few months ago, I gave a speech criticising the role of producer boards in agriculture and horticulture, particularly those that still exercise near-monopoly control of export marketing. Critics in the boards responded by pointing to the significant growth in primary production and exports over the last decade. In an article in *The Independent* of 1 March, Joe Pope pointed to what he saw as the sound performance of the pipfruit sector by noting the "staggering" 340 percent increase in the value of apple and pear exports in the last 10 years.

But this growth in production has not been matched by an increase in profitability - indeed quite the reverse has occurred. In 1995, profitability in the sector was all but wiped out. In 1995 growers supplying the board finished up with just \$11.89 per carton. This was down from \$16.70 the previous year and \$19.30 in 1992. Most growers reported trading losses for 1995.¹

Likewise, Sir Dryden Spring was eager to point to substantial increases in projected dairy revenue in an address to the 1996 dairy industry conferences. Dairy exports are projected to increase by 26 percent between 1996 and 2000. However, increases in production do not necessarily promise increases in profitability, or ensure the viability of the sector. I shall say more on this issue in the context of the dairy industry later.

Another commonly expressed view is that the primary sector will only be viable in the highly competitive world of international marketing if greater resources are devoted to adding value through branding and further processing. This is seen as a way of insulating producers from the vagaries of fluctuating prices in commodity markets. Inevitably, price premiums achieved by New Zealand producer and marketing boards relative to those of our competitors are pointed to as evidence of the success of this strategy.

However, what is ignored is that premiums are often due to restricting exports to a limited number of grades. Like is not compared with like. In kiwifruit, for example, higher per unit tray returns can be obtained by rejecting ever-increasing quantities of fruit. In addition, substantial investment in grading, processing and branding adds to costs. The big question is whether the additional price exceeds the extra marketing and production costs.

Evidence from other sectors indicates that supplying a narrow range of branded products of uniform specifications may not be the most appropriate strategy to secure profitability and viability. The tourism sector is an example where target markets range from tourists interested in low-cost 'backpacker' packages to those interested in luxury service. In all cases, the success of the sellers is determined by whether the expectations of purchasers are met or exceeded and whether the activity is profitable.

It is no more valid to assume that New Zealand exporters should sell, and overseas buyers be offered, produce of uniform quality and specifications than it is to assume that in-bound tourists should be offered only one type of holiday package. A strong and diverse agricultural sector would provide a range of products, of differing quality and price, depending on the needs of customers. So called 'commodity selling', often a term of detraction, would appropriately stand alongside the marketing of produce in more processed and branded forms.

The characteristics of a viable environment for farming

If industry profitability, production and the extent of value adding do not necessarily ensure the viability of farming, how do we answer the question - is farming viable? In a commercial sense - as a matter of picking winners and predicting the future size and configuration of the sector - the short answer is, I don't know. Nor do I know whether the future viability of farming lies in additional processing, new branding strategies or

¹ *The Independent*, 4 April 1996, p.28

changes to the organisation of production and marketing. But I would hasten to add that no other single person or organisation is likely to know either. In the real commercial world, it is impossible to be absolutely sure about the right answer, certainly when it comes to detail. People routinely make mistakes. The key issue is whether one particular view of what determines the viability of farming should prevail through legislative controls, or whether there should be scope for different ideas and strategies to evolve.

In competitive markets a variety of arrangements can be observed. This is the essence of markets - diversity is not a special characteristic of just some markets. Firms of differing sizes exist. In many sectors of the domestic economy (airlines and telecommunications to name just two) there appears to be significant duplication. Economies of scale might suggest that larger organisations would be more efficient. Why doesn't this occur? In a situation where people are free to combine their operations if they wish, presumably there are other offsetting costs they take into account. These costs include management costs which increase more than proportionately with the size of a firm, and information costs (staying agile in a continuously changing market).

This is of direct relevance to current debates among farmers. Are three or four super-dairy cooperatives better than fifteen smaller ones to ensure the future viability of the dairy sector?

There may well be some factors that point to economies of scale from larger organisations in the processing and marketing of dairy products. What is unknown is whether these benefits exceed offsetting costs. This could only be observed in a more competitive market than exists currently for dairy exports. If economies can be achieved by internalising within a group of producers the benefits of joint marketing and processing activity, larger enterprises would emerge in a more competitive environment.

These are some of the reasons why, in many industries, there are several large-scale enterprises. However, within most industries there are also smaller operators as well. The existence of multiple firms indicates that economies of scale are, at some point and in certain circumstances, offset by other costs, such as management and information costs. Otherwise single firm industries would emerge in every country. There are few examples of industries which comprise a single firm which do not owe their existence to government regulation.

The enormous amount of information that is processed in markets each day by a diverse range of buyers and sellers means that no one person or entity will know the commercial ingredients of a viable farming sector, both now and into the future. However, experience in New Zealand and elsewhere over the last decade points clearly to the ingredients of a climate in which farming, if it is competitive, will be viable. One commentator has noted that a common denominator of economic success stories in many countries:

... is that they have found their way to economic policies that use the marketplace, that use incentives, that emphasise enterprise, that have recognition in one way or another of private property, that are basically open to

the global economy, and that have managed to exercise reasonable budgetary and especially monetary discipline.²

What are the implications of these factors for the viability of farming today?

The importance of incentives

The first is that a climate which is conducive to a viable farming sector is one in which farmers, and the processors and marketers of their produce, are given clear and transparent signals about the mix and quality of products customers want to buy.

We all respond to incentives. Anyone who doubted this should be convinced by the results of the new format for the Super 12 rugby competition. In the space of a year, a cleverly designed system of bonus points has transformed the game. Teams that are comfortably in the lead face strong incentives to continue to play open, attacking rugby through bonus points for additional tries.

The farm-gate prices farmers face for their produce act in the same way. Like the experience with Super 12 rugby, there is plenty of evidence to suggest that farmers respond to the incentives created by the farm-gate prices they face. Unfortunately, there are too many situations in the primary sector where these price incentives have led to perverse results.

Many factors have contributed to the current plight of meat and wool farmers, including a significant drop in export prices. However, previous interventions such as price support mechanisms and subsidies in the 1980s have contributed to current problems. The sector is also still recovering from incentives created by the system for allocating access to quota-restricted markets. The share of the premium associated with New Zealand's privileged access to higher priced quota markets was (and still is) reflected in farm-gate prices. In addition, meat processors were allocated access on the basis of their production. This rewarded production-driven rather than market-led investment in processing capacity.

This situation also applies to the farm-gate prices for milk. Dairy farmers have investments in the farming, processing and marketing sectors of the industry. These separate investments provide separate returns. In a normal commercial situation, the returns from different investments would be provided separately to owners, for example in the form of dividends paid on shares. This would be the case, for example, if a farmer held shares in an investment company earning its income from a wide range of sources. If the investment company has a good year and dividend payments increase, the farmer might use the dividends to have a holiday or buy farm equipment if such an investment is profitable in its own right. But there is no direct link between the investment return the farmer receives on his or her off-farm investments and on-farm production decisions.

In contrast to this normal commercial situation, payment to dairy farmers for milk is typically made up of three elements:

² Schultz (1995).

- a payment for the milk based on the amount that the market will pay for the product;
- a return to their shareholdings in the cooperatively-owned processing facilities and the assets of the board. The economic investment shareholders have made in the board for each supplier is around \$114,000.³ The market value of that investment is likely to be significantly higher and in 1992 was estimated to be between \$280,000 and \$500,000 per supplier.⁴ A recent study estimated that the average dividend component of the board's payout between 1989 and 1993 was 14.56 percent and ranged between 9 percent and 25 percent;⁵ and
- a share of the premium associated with New Zealand's privileged access to the higher priced UK butter market. This quota gives rise to 'economic rents' - that is, extra returns which the UK market offers over the next best alternative market. The value of this entitlement has been estimated to be around \$300 million.⁶

Receiving these separate returns as one payment for their milk means that producers are given a price signal that acts as an incentive for them to expand output. They are being told that the world markets are demanding extra output which can be sold profitably. What is not obvious to farmers is that the extra output will have to be sold at prices which may not cover the total costs of processing the product. In other words, extra resources such as land are attracted into dairy farming which are not going to be rewarded fully by the prices received on overseas markets. That is not a good use of our resources.

The issue is further complicated because cooperatives and the board are obliged to accept the extra output from suppliers. They are, therefore, required to expand their processing capacity and investment in marketing to support the additional production. With the current industry structure, additional off-farm investment can normally be funded only out of retained earnings or debt. In either case, the costs of financing the additional investment fall primarily on existing suppliers rather than those who increase their production. But existing suppliers will receive only a part of the returns on that additional investment. This is due to the averaging of returns across all suppliers, including new suppliers and those who have increased their production. In effect, by increasing their production, suppliers erode the value of the investment in the board of other stakeholders.

An inadequate return is provided to funders of the new investment and the result is that wealth is transferred from existing suppliers to those who increase their production. This underlies the strong incentives for all suppliers to increase their production to protect their equity position regardless of whether the additional production can be sold at a profit.

³ Based on the assessed value in 1994 of \$1.6 billion (Ireland and Wallace (1995)) and approximately 14,000 factory supply units.

⁴ Ireland and Wallace (1994).

⁵ Sullivan and Scrimgeour (1995).

⁶ Ireland and Wallace (1994).

Another effect of an inadequate return to funders of new investment is that it can be difficult to raise new equity or loans to finance new investment. This will be the case once existing stakeholders realise they bear the costs of the investment but share only part of the rewards.

The provisions of the Dairy Board Amendment Bill are intended to help the board cope with anticipated increases in dairy production over the next decade. Substantial increases in production will throw into stark relief the problems caused by bundling. However, the provisions of the Bill are half measures. They reward cooperative companies on the basis of their respective shares of total milk supplied. Companies that increase their share receive additional equity in the Dairy Board relative to those that lag behind.

As could be expected, the effects of these incentives are already being felt in the dairy sector. Under the heading "barbarians storm the farm gate", *The Independent* of 19 April 1996 carried as a front page story the expansion plans of Kiwi Dairy Cooperative. The article noted that Kiwi wants to boost its market share to retain shareholder equity under the proposed Dairy Board ownership changes. If amalgamation is driven by sound commercial imperatives, well and good. If it is driven by inadequate changes to the regulatory structure of the dairy industry, the viability of the sector will be compromised.

The importance of a stable and certain regulatory environment

The Dairy Board Amendment Bill brings me to another important characteristic of a climate that will promote the viability of farming. Farming will be more likely to prosper within a stable and certain policy and regulatory framework. Real progress has been made in the meat and wool sectors towards achieving such an environment, although the debate is still sometimes side-tracked on to dead-end debates about single-desk selling.

However, in other sectors the current range of statutory interventions creates too many winners and losers. The long, protracted process to achieve the modest gains (at best) of the Dairy Board Amendment Bill is an example. Another is the totally inappropriate arrangement for licensing exporters of apples vested in the Apple and Pear Marketing Board.

Existing statutory controls obscure responsibility. Processors, exporters, farmers and unions can each believe that, somehow, interventions into normal market processes will offset their own failings or that such controls can remedy a downturn in the market that is beyond anyone's control. Likewise, the political imperative to lobby to protect existing controls can tempt defenders of controls to point to their existence as a contributing factor to an improvement in the market which is, again, caused entirely by external factors.

The highly politicised nature of the process is driven home to me every time I appear before a select committee on a bill that affects the statutory rights of producer boards. During submissions, select committee rooms are generally full of industry politicians, with a fair sprinkling of other observers. By comparison, tax bills with potentially far-reaching effects on our national competitiveness receive a minimal response.

Existing statutory controls, particularly in the dairy sector, are inherently unstable. Under them, incentives for producers to increase their production beyond levels that maximise profits will increase, not reduce, for the foreseeable future. The property rights of existing and future producers will not be as secure as those of investors in other sectors. Significant impediments to the flow of capital necessary to finance profitable expansion will remain.

However, the ability of producer boards that monopolise export marketing to defy the forces of economic gravity can't be sustained indefinitely. As a consequence, significant amendments to existing statutory controls will be unavoidable well within the next ten years. A viable farming sector is one that can live independently of the current range of controls.

The importance of the wider economic environment

The climate that determines whether farming is viable also includes the wider economic environment. Over the last decade, the farming sector has been a major beneficiary of a wide range of reforms which freed up financial, labour and product markets. More appropriate regulations have been introduced in many areas, such as coastal shipping and tariffs, and other impediments were reduced. Major state sector reforms were implemented and fiscal and monetary discipline was reinforced by the Reserve Bank and Fiscal Responsibility Acts. In the last few years international

commentators have placed New Zealand high in the rankings of international competitiveness.

There are grounds for serious concern, however, that lack of competitive pressures in the state sector and the non-traded goods sector (such as the ACC and local government) are resulting in additional costs being imposed on exposed sectors, like farming.

The issue of international competitiveness is essentially a matter of the relative cost structures of the traded and non-traded sectors of the economy. Most of the government's commercial enterprises and most of its services are non-traded and are a major part of that sector. The efficiency of many of them would be improved by greater contestability and privatisation. Health, education, social welfare and accident compensation are heavily regulated and highly politicised, and outcomes continue to be unsatisfactory. The costs of ACC continue to balloon.

Cost increases emanating from the non-traded sectors of the economy that are not matched by productivity increases must be funded by reduced real incomes in other sectors, including farming. Typically monetary policy gets blamed - either for being too loose and letting inflation get away, or for high real interest rates and real exchange rates which can result if it is kept firm. Either way, the burden of an inefficient state sector can be readily shifted to exporters and to import-competing industries. This is partly why they are called 'exposed sectors'. But the blame is misplaced since monetary policy cannot address the fundamental problem of inefficiencies in the state sector and industries supplying domestic markets.

Tax reform would also contribute to a climate in which farming has its best opportunity to be viable. The combination of increased tax revenues and deregulation - which has made resources more mobile and responsive to prices in the last decade - has markedly increased the so-called deadweight burden of the tax system on the community. Meanwhile technological change and the integration of New Zealand with the rest of the world is putting our income tax system under pressure because of the distortions it is imposing on business decisions and the problems of enforcement.

Added to this rich mix is the reversion to populist bidding wars in an election year.

While complaining about our supposedly poor savings record, several political groups promise to restrict access to imported capital and raise top marginal tax rates - measures hardly designed to promote savings or investment. There is talk again of special tax credits for favoured sectors and greater centralised controls.

Immigration is becoming a touchstone for poorly informed knee-jerk responses. It is a well-established fact that modern economic growth owes much to the application of better knowledge. This knowledge is often seemingly petty, practical know-how about production and marketing. An active immigration policy that attracts a larger and more diverse number of new citizens to New Zealand can make a crucial contribution to the pool of practical knowledge. Immigrants can also increase the economy's responsiveness to market opportunities through their close links with other countries.

While New Zealand will need to ration the number of immigrants it can accept, the tradition of rationing by arbitrary and frequently-changing administrative means is unlikely to be conducive to accelerated growth.

The importance of quality leadership

In the midst of rhetoric and uncertainty, it is important that key stakeholders keep their heads. Federated Farmers in the past has contributed significantly to an enhanced competitive environment. Your organisation has provided leadership in promoting policies that have sometimes been contrary to the short-term interests of its constituents in the firm belief that the pain would yield longer-term durable gains. Considerable credibility was earned as a result.

If I may say so, many of us have been missing the well-researched and broad perspectives which Federated Farmers brought to the tariff debate and other issues in the past.

I was surprised to see Federated Farmers' fulsome praise for last year's Budget when the surge in government spending which it revealed was bound to put pressure on the private sector. This would be intensified if the Federation's recent call to scrap the superannuation surcharge were heeded. We need tighter, not looser, means testing to encourage savings and cut tax burdens. Representations on tax have focused narrowly on stamp duty and more recently on the tax treatment of superannuation funds. A much broader approach to the issue is required, starting with government spending levels, the deadweight costs of taxation and the impact of top personal and company tax rates on investment and growth.

Examples of recent initiatives which have made my economist friends raise their eyebrows are the idea of giving the Reserve Bank the power to manipulate GST, the proposal to go back to fine tuning immigration policy according to the state of the economy, and the debate about the balance of payments statistics, an issue which was well understood by sophisticated investors and which had no market impact. Behind some of the recent commentary, such as statements headlined 'the markets are mad', has been the same failure to appreciate how market economies work which has plagued the producer board debate.

I suggest Federated Farmers needs to take care that it doesn't risk creating unrealistic hopes about the economic environment while upsetting confidence, public understanding and the 'political' market in New Zealand more generally. As it did with tariffs and the coastal shipping, it needs to address issues such as postal services, electricity, roading, education and health from the perspective of the wider economy, not just their impact on the rural sector. The indirect effects on farming of changes which would reduce costs or improve services in any of these areas might well swamp any adverse short-term effects on the sector.

The way ahead

Profitability and greater production do not ensure the viability of farming. In an environment in which farm-gate prices include returns to off-farm investment, greater off-farm profitability can compromise farming's long-term viability. Greater off-farm profitability is stimulating additional production which cannot be sold profitably in

some cases. Nor does more downstream processing and marketing investment necessarily ensure farming's viability. Money spent on branding and further processing must show an adequate return, like any other investment.

The best prospects for a strong and viable farming sector are the continual achievement of a regulatory and institutional environment in which:

- a variety of arrangements for the processing and marketing of farm produce can emerge;
- farmers, and the processors and marketers of their produce, are given clear and transparent signals about the mix and quality of products customers want;
- farming can live independently of the current range of marketing controls;
- the farming sector itself is not afraid to re-engineer the institutional arrangements that apply to its own sector; we need more leadership of the kind exercised by Federated Farmers in reviewing the meat and wool sectors;
- other sectors of the economy, including the state sector, face continuing competitive pressures to improve efficiency and responsiveness; and
- tax burdens are reduced by reductions in the overall government share in the economy.

A significant feature of this list is that many of the keys to unleashing the full potential of farming in New Zealand are in farmers' own hands.

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