CHAPTER NINE

SUPPLEMENTARY MINIMUM PRICES, STABILISATION SCHEMES AND FUTURE ASSISTANCE TO AGRICULTURE

Current Position on SMPs

It has been decided that SMPs will cease from the end of the respective 1983/84 seasons. The reasons for this decision were:

a SMPs prevented farmers from receiving the correct price signals as to what was happening in the international markets. The quantities produced of each commodity receiving SMPs in recent years have reflected relative SMP levels rather than international market prices. Relative prices at farm/orchard gate, and hence production levels, were further distorted by the fact that products other than the traditional pastoral ones did not receive SMPs;

b the method for calculating SMPs for each product differed. For wool a percentage supplement applied which at least reproduced price relativities for different types of wool—producers of the better class wool were rewarded. But for meat a flat cents/kg supplement, at the same rate for each grade of meat within a category, e.g. lamb, was paid. This acted to compress the market relativities and hence penalised the producers of better grades;

c when market prices were above producer board minima but still below SMP levels, there was no incentive for the boards or other parties in the industry to improve their performance. This was a particular problem for meat. For example, if the Meat Board lifted its performance and increased market returns for lamb this simply reduced the cost of SMPs to the Government but gave no greater return to the Board. In these circumstances there is also no pressure on meat processors to minimise increases in killing charges, as any increase is borne by the taxpayer and not by the producers;

d since both the producer board stabilisation schemes and SMPs were *intended* to be market related, and because of the mechanics of the SMP scheme, they interacted with each other to the detriment of the stabilisation schemes (this is explained later in this paper); and

e SMPs were attracting an increasing amount of adverse criticism internationally.

In order to fulfil the Government's commitment given in the 1983 Budget in respect of the 1984/85 season, it was agreed with the Meat and Wool Boards that they will be paid lump sums equal to the amount farmers would have received in 1984/85 by way of SMPs. While the Boards were given discretion as to the use of these funds they have indicated that they will be mainly replicating the SMP scheme, but some alterations to relative prices, especially for mutton, are likely to be introduced. As the basic milkfat price for the 1984/85 season has been set at 355c/kg, i.e. 30c/kg above the SMP for milkfat, no lump-sum payment to the Dairy Board will be required. The recent devaluation should totally remove the need for any lump sum payment in respect of wool and lamb and reduce the sum required for mutton.

As part of the agreement with the Meat Board the overdraft on the Meat Income Stabilisation Account at 30 September 1984 will be converted to a 30 year subordinated loan at 1 percent interest. There will be no interest or principal repayments for the first five of the thirty years. From 1 October 1984 new Meat Income Stabilisation sub-accounts will be established for the future stabilisation activities of the Meat Board. The sub-accounts will bear interest initially at 10 percent, as will the Wool Board's counterpart, the Minimum Wool Prices Funding Account.

As the third element of the packages agreed with the Boards, a commitment has been given to the Boards that the Government will immediately start a review intended to identify an internationally acceptable means of delivering assistance to the agricultural sector.

The issues involved in the above developments concerning the Boards' stabilisation schemes, assistance to agriculture, and the future course of action in these areas, are expanded upon in the following three sections of this report.

Stabilisation Schemes

The current stabilisation scheme for dairying has been in place for a long time and, subject to the interest rate problem discussed below, is generally considered to have functioned well. The schemes for meat and wool, which were revamped in the mid 1970s, have, however, suffered from a number of problems. Most of these have arisen, it would seem, from the adverse interaction of the stabilisation schemes with the SMP scheme. This interaction arose because both types of scheme were intended to be market related and because there was a tendency for the short-run price support costs inherent in stabilisation schemes to be pushed onto the SMP scheme through the conservative setting of board minimum prices. The cessation of SMPs should go some way to restoring the effectiveness of the meat and wool stabilisation schemes.

The other major problem experienced with the existing stabilisation schemes, including that of the Dairy Board, is that the 1 percent interest rate paid

/charged on credit/deficit balances in the reserve accounts has had detrimental effects. The Boards have been reluctant to accumulate reserves to carry them over adverse years when those reserves earned only 1 percent. Any reserves accumulated under those conditions quickly depreciated in real terms. Conversely, being charged only 1 percent interest on reserve account debit balances tends to encourage boards to seek or establish minimum prices higher than justified by the market outlook and/or the reserve account balance. The common results of these pressures are for the boards to minimise reserve account balances, allow greater fluctuations in minimum prices, use reserve account funds for other purposes, and put pressure on the Government for assistance when reserve account balances subsequently prove inadequate. The intensity of these various problems varies between the Boards. The Wool Board, for example has tended to operate a 'floor-price' operation rather than a 'price-smoothing' operation. It has also borrowed funds, put aside for price supplementation, for wool purchases. As already noted, the major cause, other than SMPs, of the undesirable aspects of the stabilisation schemes has been the low rate of interest on the stabilisation accounts. This led to the recent agreements with the Wool and Meat Boards that, from the beginning of the respective 1984/85 seasons, a commercial rate of interest, initially 10 percent, will apply to their reserve accounts. In respect of the Dairy Board the interest rate question has been deferred until later in the 1984/85 season.

The mechanics of the sheepmeat price stabilisation scheme may need to be altered if the national pooling arrangements for sheepmeats come into operation as scheduled on 1 October 1984. Current indications are that the alterations would move the existing scheme closer to the principles of the Dairy Board scheme.

As noted above, a number of the recent problems with the stabilisation schemes arose from their interaction with the SMP scheme. This illustrates the dangers of trying to both deliver assistance and stabilise prices through one policy.

The other longer-term concern of officials with the stabilisation schemes of the Meat, Wool and Dairy Boards is in respect of their basic functions. The schemes at the farmer level are essentially a means of reducing risk of fluctuating incomes due mainly to varying prices. Like other groups of entrepreneurs, individual farmers have different attitudes to risk. Farmers also have other methods of reducing risk e.g. by their financial management, by product diversification, by stock management, by the government operated income equalisation scheme etc. Tax provisions concerning development expenditure also help farmers to even out their net incomes. Officials are therefore doubtful as to whether, from the farmer viewpoint, the compulsory stabilisation schemes operated by the producer boards are either necessary or the best way of stabilising farm prices. The indications from overseas analysis of commodity price stabilisation schemes are that the advantages to the producers as a whole are minimal. Treasury and MAF therefore intend over the coming year to further investigate the alternative methods for farmers to handle risk, and examine what impediments there are, if any, to individual farmers taking a greater role. A move away from compulsory stabilisation schemes could give farmers greater flexibility as business managers, with an improvement in resource use.

The other objective of the Boards' stabilisation schemes has been seen as evening out the effects of fluctuating export receipts from primary produce on the overall level of economic activity in New Zealand. The data in Chapter 1, indicate the likelihood of international primary product prices moving together, as they did in 1973/74, is somewhat less now than previously. Moreover, since the early 1970's the share of agriculture in Gross Domestic Product has fallen from around 12 percent to around 7 percent. The macroeconomic instruments available to the Government for handling such events are better suited to stabilising the economy than instruments such as stabilisation accounts. The stabilisation schemes have therefore a much reduced macroeconomic role and adjustments to the schemes to reflect this should be considered. A new scheme, more flexible than the current board schemes, and based on the existing income-equalisation scheme, could be considered at the farmer level as a means of evening out farmer incomes.

Specific Problem Areas

a *Dairy*

We have already noted the levels of assistance received by each of the pastoral industries with and without SMPs. The main conclusion is that if it were not for SMPs each of the pastoral industries, apart from sheepmeats, would be receiving broadly similar rates of assistance. With SMPs ceasing at the end of the 1983/84 seasons, and the transition arrangements for 1984/85, the existing problem of extremely large disparities between levels of assistance to the pastoral industries will be effectively removed at the end of the 1984/85 seasons. In respect of dairying for 1984/85, the Board has received an assurance that the Government, in conjunction with the Dairy Board, will "review later in the 1984/85 season the current situation and outlook for dairy product prices in the international market and the state of dairy industry's reserves with a view to providing positive assistance to the industry as appropriate in respect of 1984/85 and beyond".

The assurance to the Dairy Board was partly in response to the Dairy Board's claim that it had been unfairly treated in respect of SMPs. In regard to 1984/85 only, the Board's case for special treatment by the Government was based on the forecast that, for at least 1984/85 and 1985/86 the Board would incur large trading losses because of international dairy product surpluses. The effect of the 20 percent devaluation will be that the Dairy Board should return a surplus in 1984/85.

The situation in the dairy industry, and the determination of the appropriate Government response, are prime examples of the general policy issues concerning assistance and stabilisation schemes discussed above. The absence of a commercial rate of interest on the Dairy Industry Reserve Account has led to the Board over recent years pressing successfully for the freedom to transfer funds from the Reserve Account to the Capital Account for capital investment purposes. Thus, while in terms of the conditions covering the transfer, these funds are still available as reserves, they are in a non-liquid form just at the time when the industry expected to need them. The 1 percent interest rate currently earned by the industry on its reserves, and hence the depreciation of the reserves in real terms, was one of the factors leading to a higher basic price for 1984/85 than the market outlook then justified—i.e. the industry wanted to get some immediate benefit from its 'savings'.

All the above points in respect of the dairy industry have led us to the conclusion that:

- the assistance and stabilisation functions of government intervention in the dairy industry must be separated;
- for the dairy industry stabilisation scheme to work as intended, a commercial rate of interest must apply to the Dairy Industry Reserve Account;
- SMPs, underwriting schemes and any other assistance measures which are based on perceived deficiencies in market returns (i.e. "needs") are in conflict with the objective of making the most efficient use of New Zealand's resources; and
- assistance to the dairy industry after 1984/85 should be treated no differently than that for the other land-based industries, and this is best achieved, as already agreed, by including the dairy industry, along with the other land-based industries, within the scope of the forthcoming review of assistance. An acceleration of the decrease in assistance to other sectors, which acts as a "tax" on the land-based industries, would also give considerable benefit to the dairy industry.

b *Meat Marketing*

As a result of the deliberations of the Meat Industry Task Force and the endorsement, with some amendments, of the Task Forces' recommendations a new system of marketing sheep meats is to come into force on 1 October 1984. These national pooling arrangements will formalise the total control of sheep meat marketing exercised by the Meat Board since 1 October 1982. The Meat Board has not yet finalised how the pooling arrangements will work in detail. Critical issues yet to be determined are those relating to access to pooled meat by private exporters, and the determination of the prices to be paid to the pool by those private exporters. How the Meat Board's minimum price arrangements will work after 1 October 1984 has also yet to be decided. If the decisions are to be implemented legislation on both these aspects will need to be introduced once the Board has decided these matters.

The economic issues considered in the debate on the Meat Industry Task Force's report are the same as those summarised above in the post-election briefing paper on marketing (Part Two, Chapter 15). Generally, it is Treasury's conclusion that the solutions adopted for the perceived marketing problem for sheepmeats were not supported by adequate analysis and would reduce national welfare. We are most concerned with present marketing arrangements and proposals for this major industry and consider that any early opportunity to review the situation should be taken.

Legislation would also need to be introduced to provide a statutory base for the Meat Industry Council. If national pooling of sheepmeats proceeds, then Treasury would see the Meat Industry Council having a vital role in ensuring that the future structure of meat marketing evolves to match changing circumstances. The terms of reference agreed for the Council give it the wide investigating and reporting powers that allow for further consideration of the basic issues of marketing in the light of experience with national pooling and Meat Board control.

Future Assistance to Agriculture

In Chapter 2 of this paper we stressed the need to even out the levels of assistance among the land-based industries, and between these industries as a whole and other sectors of the economy, if the most efficient use is to be made of New Zealand's resources. We also noted the need to remove current forms of assistance which are particularly distortionary and/or involve other impediments to change. Levels of assistance to the pastoral industries over recent years, with and without SMPs, were given. The effective rates of assistance to horticulture and cropping were also given. The effect of devaluation has been to reduce the effective rate of assistance on most land-based products, particularly those receiving SMPs.

The main conclusion is that without SMPs the extremely large disparities in rates of assistance among the land-based industries are significantly reduced. What does remain, however, are the disparity in assistance levels between the land-based industries as a whole and the average levels for other sectors of the economy, and the unsatisfactory nature of the remaining forms of assistance to agriculture.

Rather than increase the overall level of assistance to agriculture, our strong preference is for an acceleration of protection reform which would obviate the need for alternative compensatory assistance. This would then allow discussion to concentrate on the unsatisfactory forms in which assistance is presently delivered to the agricultural sector. Making adjustments elsewhere in the economy at a faster rate than currently envisaged would remove the pressure for increased fiscal outlays on agriculture, horticulture, etc.

In conjunction with assistance reforms in other sectors, and action to maintain our international competitiveness through monetary policy and a market-determined exchange rate, the broad process of agricultural assistance reform could involve the following steps. First, the announced process of ending SMPs should stand. Secondly, the other most distorting interventions should be removed. These include the interest rate and some tax concessions, irrigation subsidies, and free meat inspection services. The fertiliser subsidies and some of the minor but administratively costly forms of interventions could also be removed. If progress elsewhere is fast enough there would be no need to consider alternative, compensatory, forms of assistance. Then less distortive interventions could be removed or reduced—these would include some of MAF's services (for which charges could be introduced). With the cessation of concessional interest rates, it would be appropriate to arrange for the producer boards' stabilisation accounts to be transferred from the Reserve Bank to private sector institutions.