Selective underwriting v. a market share entitlement scheme for the Australian dairy industry

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Introduction

In June, 1978 the Australian Parliament passed a number of Acts to enable the implementation of Commonwealth Government proposals for the Selective Underwriting of certain manufactured dairy products from 1st July, 1978. In his second reading speech to one of these Acts the Commonwealth Minister for Primary Industry said:

> "The purpose of this Bill and the related Bills is to provide for the implementation of the Stage II marketing arrangements for the dairy industry from 1st July, 1978 through the introduction of a system of selective underwriting" (Sinclair, 1978).

The purpose of this note is to show that the Selective Underwriting scheme presented to the Commonwealth Parliament has nothing whatever to do with "Stage II" dairy industry marketing arrangements. It will be shown that Selective Underwriting is merely a modification of the existing scheme of compulsory equalization of domestic and export prices for certain manufactured dairy products. Indeed, it will also be shown that Selective Underwriting is *less* desirable than the currently-operating compulsory equalization scheme, and thus marks a move away from, not towards, a desirable marketing structure for the Australian dairy industry.

Stage II dairy industry marketing arrangements

In September, 1976 the Industries Assistance Commission (IAC) presented a report entitled *Dairy Industry Marketing Arrangements* (IAC, 1976). In that report, the IAC recommended a three-stage process of reform for the marketing system of Australian manufactured dairy products.

The three stages of the IAC's proposal can be summarized as:

> Stage I: in this Stage, the voluntary scheme for the equalization of domestic and export returns for certain dairy products, administered by the Commonwealth Dairy Produce Equalization Committee, was to be replaced by a compulsory system of domestic/export price equalization for prescribed dairy products. Compulsory equalization

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was to be effected through the Commonwealth's taxing powers and its power to pay bounties. This system commenced on July 1, 1977[1] with butter, casein, skim milk powder, cheddar and gouda cheese and wholemilk powder being the prescribed products.

Stage II: in this Stage, a market share entitlement scheme was to be introduced along similar lines to those suggested for the dairy industry since the early 1960s. The IAC's proposal envisaged that dairy farmers supplying milk for manufacture would be issued an entitlement reflecting recent production. Milk produced within entitlement would be paid for at a rate reflecting (higher) domestic market returns.[2] Milk produced in excess of entitlement would be paid for at a price reflecting average export returns.

Stage III: as in Stage II, milk production within entitlement would receive a return reflecting domestic market prices. However, returns for over-entitlement milk would not be averaged, and thus farmers would receive a return for this milk reflecting the actual prices received for their factories' sales.

The intended effect of the IAC's proposals was to improve the efficiency of milk production, processing and marketing. The major organizational change which would have arisen from the adoption of the IAC's recommendations would have been the phasing-out of the Equalization system. It had been shown that this system led to production of milk and manufactured dairy products in excess of what could be disposed of on profitable markets (*e.g.* Parish, 1962). The reason for this over-production was that the marginal return to the *industry* was actual export price whereas the marginal return to the *producer* was the average of domestic and export prices, and above the industry's marginal return. Thus the price received by farmers encouraged them to produce more milk than was efficient for the industry as a whole.

Stage II of the IAC's proposal was a working base for a market share entitlement scheme which would have encouraged the limitation of production to profitable markets. It should be noted that the IAC's objective was to limit *milk* production to profitable markets, since it was at the farm level that the dichotomy between industry and individual marginal returns created over-production.

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[1] The enabling legislation was the *Dairy Industry Stabilization Act 1977, Dairy Industry Stabilization Levy Act 1977, Dairy Industry Assistance Act 1977, Dairy Industry Assistance Levy Act 1977,* and the *Dairy Produce Amendment Act, 1977.*

[2] In its 1976 report, the IAC's concept of entitlements for "preferred markets" encompassed production for both domestic and worthwhile export markets. It proved impossible to specify worthwhile export markets and, in subsequent government deliberations, the "National Aggregate Entitlement" was specified as the domestic market plus some percentage (usually 40%) of that market. If this concept had been adopted, the return on entitlement would have been the premium from domestic and more highly priced export markets averaged over entitlement production (140% of domestic consumption).

Commonwealth's proposals for Selective Underwriting

Stage II marketing arrangements were intensively discussed by the Australian dairy industry, and Commonwealth and State governments, from the presentation of the IAC's report until early 1978. In January 1978, the Australian Agricultural Council[3] reached majority agreement for the introduction of Stage II arrangements as from July 1, 1978. In view of (mainly Victorian) opposition to the Stage II agreement, the Commonwealth Government consulted with the industry and the Australian Dairy Corporation to develop acceptable compromise proposals.

In May 1978, the Commonwealth proposed a scheme of Selective Underwriting to be operative from July 1, 1978. As indicated in the quotation from the Minister for Primary Industry above, the Commonwealth interprets its Selective Underwriting proposal as being similar to the Stage II arrangements proposed by IAC.

The Commonwealth's Selective Underwriting proposal has the following features:

— the Commonwealth offered to share with each State on a \$2 Commonwealth: \$1 State basis, the total cost of underwriting all prescribed products — butter, skim milk powder, casein, cheese and wholemilk powder — at the equivalent of \$1.76 per kg butterfat at the farm gate for the 1978/79 season.

— where any State did not take up the Commonwealth's offer of joint underwriting,[4] the Commonwealth would meet the full cost of underwriting all prescribed products in that State to the equivalent of \$1.65 per kg butterfat at farm gate for 1978/79.

— as the Commonwealth saw the main dairy product in over-production being butter, it proposed a ceiling of 96,000 tonnes of butter which it would underwrite. *Pro rata* ceilings would apply on butter by-products — *viz.* skim milk powder and casein.[5] Production of butter, skim milk powder and casein in excess of underwriting ceilings would only receive average export return.

— as cheese and wholemilk powder production were judged to be in reasonable balance with market outlets, the Commonwealth decided

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[3] The Australian Agricultural Council comprises the Commonwealth Minister for Primary Industry and his State Government counterparts. It is a forum for the discussion of Australian agricultural policy issues.

[4] As of September, 1978, Western Australia, South Australia, Victoria, Tasmania and Queensland had declined to participate in the Commonwealth's Selective Underwriting proposal; N.S.W. had not, as then, announced a decision. Some of the States which had declined to participate were apparently considering State schemes of raising dairy farmer returns from \$1.65 per kg butterfat (as guaranteed by the Commonwealth in the absence of State participation) to \$1.76 per kg butterfat (the level proposed by the Commonwealth in joint underwriting).

[5] In August, 1978, the Commonwealth removed the previously announced underwriting ceilings on skim milk powder and casein. That is, the Commonwealth decided to underwrite the total 1978/79 production of these products.

that underwriting would apply to the total production of these two products for the 1978/79 season.

— underwriting, and the operation of underwriting ceilings, would operate through factories, and factories would be issued with quotas of butter and its by-products to which underwriting would apply.

— arrangements would be made for adjusting factories' underwriting quotas to cover special circumstances.

— transferability of underwriting quotas would be limited to quota transfer among branch factories of the same company.

In its original Selective Underwriting proposal, the Commonwealth offered to underwrite unconditionally the total 1978/79 production of wholemilk powder. The operation of underwriting ceilings on butter and its by-products could have led to a substantial increase in wholemilk powder production. Wholemilk powder, when packed under normal conditions for bulk storage, has a limited storage life — generally considered to be a maximum of about six months. After storage for this period, market outlets for wholemilk powder would be restricted to the stockfeed industry with consequent heavy price discounts. On realizing the implications this chain of events could have had on underwriting commitments, the Commonwealth subsequently limited its underwriting offer for wholemilk powder to that powder produced against "firm orders".

A form of joint Commonwealth-State underwriting similar to the above Selective Underwriting proposal was in operation for skim milk powder and casein from 1976 until the implementation of Selective Underwriting. The States were generally reluctant to participate in these arrangements.[6] It was argued that they represented the support of export markets which was seen primarily as a Commonwealth responsibility. Equally pertinent is the possibility that these arrangements could have been seen as a precedent for extending joint underwriting to other primary products where the monetary commitment could be significantly greater.

Selective Underwriting compared to Stage II Arrangements

Selective Underwriting differs from Stage II in a number of important aspects which are discussed below. In addition, we also comment on the effect of Selective Underwriting on the Equalization system which Selective Underwriting supplements.

(i) By abolishing the inequality between industry and individual marginal revenue caused by Equalization, Stage II was intended to impose an economic constraint on the "over-production" of both milk and manufactured products. Although gross industry revenue would fall, net revenue would rise if resources made redundant by the contraction of production were released into other enterprises. Further, if the contraction of milk production were accompanied by an adjustment in the number of dairy farmers, profitability in the milk producing sector would also rise.

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[6] N.S.W. participated temporarily in this joint underwriting during 1976; South Australia did not participate; the other States participated in this joint underwriting arrangement for its duration.

By contrast, Selective Underwriting only imposes a constraint on the production of arbitrarily *pre*-determined unprofitable products. The simultaneous, unlimited underwriting of cheese and wholemilk powder (with subsequent limitation of the latter) will merely lead to a diversion of at least the current level of milk production into the non-limited, underwritten products.

Ironically, the diversion of milk into cheese production could increase the underwriting commitment. For example, if the anticipated increase in cheese production is sold on low-priced export markets, the rate of underwriting in the cheese pool may rise substantially as the average market return for the cheese pool falls.[7]

(ii) Further, by guaranteeing the farmer's marginal return substantially above the average market return (the Commonwealth estimated initially that the total financial commitment to the joint Selective Underwriting scheme for 1978/79 would be about $30 m),[8] Selective Underwriting will increase the marginal return to individual producers without affecting the industry's marginal return. Thus, far from reducing the "over-production" of milk which was the principal objective of Stage II, this over-production will be increased and the resource misallocation costs of Equalization will also be increased.

(iii) Stage II arrangements were designed to have no direct effect on manufacturers' product mix decisions. By imposing an arbitrary underwriting ceiling on butter production for individual factories, the Commonwealth's Selective Underwriting scheme has taken short-term product mix decisions away from the commercial control of individual factories, and probably decreased their efficiency.

(iv) Under the Selective Underwriting proposals, the prices of individual products in each product mix will be underwritten such that all farmers supplying factories with average manufacturing costs will receive the same return ($1.76 or $1.65 per kg butterfat) for milk used in prescribed products. This ignores trends in the relative returns of each product mix and, if maintained into the future, may only exacerbate the over-production of "problem" products unless the "correct" underwriting ceilings for these products are "set".

(v) The Selective Underwriting proposal is at best a very short-term answer to dairy industry problems. Being announced less than six months prior to the 1978/79 season, it follows rather than precedes cow mating (and thus production) decisions for the 1978/79 season, and could be expected to have only a limited effect on total milk production. Further, the Commonwealth's announced intention to review Selective Underwriting "towards the end of the 1978/79 season" means that mating decisions will be largely effected prior to the announcement of Selective Underwriting details for the 1979/80 season.

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[7] It has also been suggested that marginal cheese markets may be less profitable than the marginal butter markets to which supplies will be restricted by the effect of underwriting ceilings.

[8] Current estimates place the total cost of Selective Underwriting at about $20m for 1978/9.

(vi) There is reason to suspect that insufficient thought has been given to the administrative complexities of Selective Underwriting. Only after 18 months of intensive discussion was a broadly acceptable administrative framework for implementing the IAC's Stage II arrangements provisionally agreed to; and, even then, some details — particularly the size of Victoria's State Entitlement — were continuing to prove stumbling blocks to final agreement. Further, the announcement of limitations to the underwriting of wholemilk powder *after* the initial scheme had been announced, suggests that the Commonwealth only belatedly discovered the implications of placing underwriting ceilings on a relatively long-life dairy product but not placing similar ceilings on relatively short-life products (cheese and wholemilk powder).

(vii) It would appear that a main objective of Selective Underwriting is to increase farm gate returns for manufacturing milk producers whereas Stage II arrangements were not concerned with increased social support for the dairy industry. The underwriting values in Selective Underwriting have been chosen to provide equivalent returns to farmers irrespective of the product mix of the factories they supply. This ignores the fact that many factories use only a small proportion of their suppliers' milk in the production of prescribed products (butter *etc.*). By linking the subsidy element implied by Selective Underwriting to *products* rather than milk production, manufacturing milk producers will be subsidised differentially according to the product mix of their respective factories. Those factories which previously switched from making now-underwritten products (butter *etc.*) to those providing a greater return, will be penalised for making decisions that were (and still are) commercially sound.

Conclusion

We have previously suggested (Godden and Drane, 1978) that the Stage II arrangements as proposed by the IAC in 1976 and subsequent modifications had serious hidden costs. We suggested that some forms of Equalization, even if the resource misallocation effects of that scheme were maintained, might be preferable. Our major concern was with the *administrative* costs of any system of Government control in marketing. This view is apparently widely held:

> "The marketing arrangements which have operated for years for manufactured dairy products [*i.e.* Equalization] have tended to operate against product innovation and the development of effective marketing techniques.
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> "The selective underwriting arrangements will place greater responsibility on the production decisions to be taken by manufacturers and thus should help to stimulate greater initiative in the production and marketing fields" (Sinclair, 1978).

However, it is impossible to share the sentiments of the Minister's second paragraph — we have shown above that the likely effects of the Commonwealth's Selective Underwriting proposal will be to increase, not diminish, the allocative, technical, managerial and marketing inefficiencies of the Equalization system.

If the Commonwealth were to use its Selective Underwriting scheme to phase-in some more desirable marketing scheme for manufactured dairy products, it would be possible to defend its short-run deficiencies on the basis of the potential for long-run gains. However, we are inclined to suspect that all that is planned is a mere tinkering with the present Equalization system and this will lead to continued, and probably increased, inefficiencies in the production and marketing of Australian manufactured dairy products.

References

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