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## **A Tale Of Two States: Deregulation Of The Dairy Industry In Nsw And Victoria**

**Geoff Edwards**

**La Trobe University**

### **BACKGROUND**

Under competitive conditions there would be strong tendencies for the price of all Australian milk, whether used for table purposes or for manufacturing into butter, cheese, milk powders etc, to be equated to the export price of milk. (Strictly, since fresh milk is not traded internationally, the export price is the value of milk as an input into exported manufactured products). Although competition might result in premiums above world prices for market milk---and perhaps for manufacturing milk---due to considerations such as security of supply, the world price would serve in a deregulated market as a benchmark price for all milk.

The reality is that far from being a competitive industry, the dairy industry has long been one of the most highly regulated and assisted industries in Australia. In 1997-98 the average effective rate of assistance for manufacturing milk was 21% and for market milk it was in excess of 200%. The corresponding average effective rate of assistance for the entire agricultural sector was 10% (Productivity Commission 1999, p.4).

An outline of the complex interventions in the dairy industry is provided below. This is done first for market milk, and then for manufacturing milk.

In subsequent sections an account is provided of the reviews recently undertaken of the regulatory legislation for market milk in NSW and Victoria. That is followed by some comments on the review process and

the policy outcome. The focus in the latter comments is on the rationale for the structural adjustment package offered to the dairy industry by the Commonwealth Government if all states agree to deregulate as of 1 July 2000.

### *Market Milk---State Governments Help Farmers Milk Consumers*

The state governments, which under Australia's Constitution have responsibility for price controls and food quality, are the main players in policy for the market milk sector. They license dairy farmers to produce milk and they regulate milk quality. Statutory Marketing Authorities have been established in each state to administer the regulation of the market milk sector. In Victoria the SMA is the Victorian Dairy Industry Authority, and in NSW it is the NSW Dairy Corporation. These bodies have a monopoly on the marketing of milk in their states. All milk produced in Victoria is vested in---becomes the property of---the VDIA, and in NSW it is owned by the NSW Dairy Corporation. These SMAs use their monopoly powers to restrict interstate trade in milk. Specifically, this is done through regulations requiring that milk for sale interstate be purchased at the market milk price.

The state governments have set farmer prices for market milk well above export parity---about 21 cents a litre higher on average, or approximately double, in 1997-98 according to the Productivity Commission. Because of the low price elasticity of demand for fresh milk---Freebairn (1992) assumes -0.05, the Industry Commission (1991) uses -0.15---holding prices up is an effective way to transfer income from consumers to milk producers. The estimated transfer in 1997-98 was \$394m (Productivity Commission, 1999), approximately \$30,000 on average for each of Australia's 13,000 dairy farmers.

With the price for market milk held so high, it is necessary to have a means of rationing farmers' access to this lucrative market. Australia-wide, market milk sales account for around 20% of total milk production. In Victoria, which produces more than 60% of Australia's milk, only 7% goes to the high-priced market milk area. In NSW, the next biggest producer with 13% of national production, around 45% is sold as market milk.

Victoria uses a system of "equitable marketing" to allocate the limited fresh milk premium proportionately to all farmers. That is, each farmer is paid as though 7% of his/her milk enters the fresh milk market, and 93 % the manufacturing market. This approach is used also in those other

states, Tasmania and South Australia, where market milk is a small proportion of total milk production. This “equalised price” approach encourages farmers to produce more milk than the efficient amount, but because the influence of the market milk component on price is small, the excess production is relatively small.

In NSW, and also Queensland and WA, the other states where market milk is around half total production, market milk quotas are used. Farmers must have quota to obtain access to the premiums available for fresh milk. In NSW these quotas have been tradeable, with some restrictions, since the start of the 1990s; previously quota was attached to individual parcels of dairy land, and had to be transferred with the land. For many NSW dairy farmers the value of their milk quota is several hundred thousand dollars---a strong reason to oppose deregulation of farm gate market milk prices.

The idea of the state governments attaching the milking machines to consumers’ pockets and siphoning the proceeds to dairy farmers is an apt metaphor for longstanding market milk policies in each state. The price inelastic demand for market milk makes it well-suited to price discrimination. In the most insightful analysis undertaken of Australia’s agricultural pricing policies, Sieper (1982) spoke of farmers “owning their domestic demand curve”---meaning governments were well disposed to intervening to allow farmers to extract the economic rents available with regulated departures from competition in the presence of inelastic demand.

*Domestic market support (DMS) for manufacturing milk---the Commonwealth helps with the milking*

The Commonwealth Government has used its tax and trade powers to implement policies to support the price of milk used for manufacturing above the export price. The precise details of the arrangements have changed over time. Under the Kerin Plan of 1986, the essence of the support mechanism was:

1. A levy (tax) was paid by farmers on milk. ( Legally, this is an excise tax).
2. The proceeds of the tax were distributed to farmers as an export subsidy.

By making it profitable for firms exporting dairy products to divert sales from the domestic market, an export subsidy raises the price farmers receive domestically, as well as for exports.

Initially the levy was paid on all milk, including market milk. If 50 % of milk was used in export produce, a levy of 2 cents a litre on all milk could fund a subsidy of 4 cents a litre on milk exported in manufactured products. Because Victoria, Tasmania and SA used a high proportion of their milk for manufactures for export, the DMS involved a transfer of revenue from farmers---and consumers, since much of the levy on market milk was passed on to them---in the market-milk oriented states. The existence of this transfer in respect of manufacturing milk was probably a factor in Victoria not moving into the big NSW fresh milk market years ago. That move would have caused NSW to be less supportive of the DMS, making it less likely it would have lasted as long as it did.

Changes made to the DMS arrangements after the Uruguay round of multilateral trade negotiations were said to end the subsidising of exports--disallowed under the GATT. In reality, the export subsidy was retained, but in a more indirect manner. The “re-jigged” policy was queried by the US, Japan and New Zealand. The absence of a formal protest through the WTO may have been due to strategic considerations in association with the planned “sunsetting” of the DMS in mid-2000.

The level of price support provided through DMS, always much less than for market milk, has gradually decreased since 1986. It is to cease at the end of June 2000.

## **THE STATE REVIEWS**

### *National Competition Policy and Market Milk*

Under the Competition Principles Agreement (CPA) entered into by all states and territories and the Commonwealth in 1995, governments are obliged to review, and where appropriate reform, all laws that restrict competition by the year 2000. Nearly 2,000 pieces of Commonwealth, state and territory legislation are being reviewed over a six year period. The guiding principle for these reviews and the reforms that follow them is that legislation ---and the activities of authorities set up under that legislation---should not restrict competition unless it can be demonstrated that:

- The benefits of the restriction to the community as a whole outweigh the costs; and
  - The objectives of the legislation can only be achieved by restricting competition.

The CPA does not define how any piece of legislation should be reviewed.

### *NSW---divided thinking*

The Review Group for NSW was chaired by NSW Agriculture. Other organisations represented were the NSW Dairy Corporation, the NSW Dairy Industry Conference, the NSW Dairy Farmers' Association, The Cabinet Office and NSW Treasury. The Group reported in November 1997.

The objective of the NSW Dairy Industry Act is said to be: “ensuring the wholesomeness and purity of milk and dairy products in the interest of public health” (NSW Government Review Group 1997, p. vi).

The Review Group assessed six possible reasons for keeping the current price setting and supply management arrangements. These were:

1. “To meet consumer preferences for stable prices;
2. To guarantee an adequate year round supply of milk;
3. To provide producers with countervailing market power;
4. To offset corrupt world prices for dairy products;
5. To encourage state dairy industry development;
6. To provide equitable opportunity of access to the entire NSW fresh milk market and subsequent regional development” (pp. vi-vii).

The Review Group agreed that neither of the first two reasons justified government intervention.

Industry and Corporation members saw the current arrangements as justified by reasons 3 and 4--- the need to give producers countervailing power against processors and retailers, and the need to diminish the impact on the industry of “corrupt” world markets for dairy products. They also supported the present arrangements on the basis of reasons v and vi.

The Chairman and the other Government department members agreed that industry development and countervailing power did not justify

legislated price setting. The Chairman, but not the other department members, saw corrupt world markets supporting the current measures. However, the other department members saw the adjustment costs that would be imposed on the industry with loss of access to the market milk premium as a strong case on reason v grounds for maintaining the present arrangements for a transitional period.

The disparate assessments within the Review Group extended to the public benefits and costs of the market milk regulations.

“In summary, Government department members of the Review Group concluded that the current price setting and supply management arrangements generate direct costs to milk consumers, retailers and processors of approximately \$56-87m per annum, and efficiency costs of \$30-45m per annum. They concluded that the consequential or secondary costs of deregulation, as identified by industry members (regional multiplier and income effects) would be offset by similar multiplier and income effects in other regions and industries. The Government department members of the Review Group therefore concluded that the current price setting and supply management arrangements result in net public costs.

Industry members of the Review Group agreed that the current price setting and supply management arrangements generate direct costs to milk consumers, retailers and processors of approximately \$56-87m per annum, and efficiency costs of \$30-45m per annum. However, they concluded that the efficiency costs of the current arrangements are at most \$16.5m per annum and that there were further efficiency benefits of approximately \$45m per annum. The Industry members estimated the regional income and multiplier benefits at approximately \$145m per annum. The Industry members therefore concluded that the current arrangements result in net public benefits” (NSW Review Group, Executive Summary, 1997 p.8).

The outcome of the differences between the Review Group members was a split bottom line on the key issue of price setting and supply management. The Chairman, Industry and Corporation members---the majority---recommended that the current arrangements be retained. The Government department members, other than the Chairman, recommended that regulated farm-gate prices and supply management for market milk be ended, preferably in a coordinated way across states.

The NSW Government accepted the recommendation of the majority, maintaining the regulatory status quo.

*Victoria---deregulation is the way to go*

The review of the Victorian Act was undertaken by the Centre for International Economics (CIE), a prominent consulting firm.

The objectives of the Victorian Dairy Industry Authority (VDIA), established under the Victorian Act, were summarised by CIE as:

1. Ensuring the supply of sufficient milk to market processors;
2. Equitably sharing the returns from market milk among all dairy farmers;
3. Maximising opportunities for sales of market milk;
4. Ensuring standards of public health and consumer protection;
5. Operating efficiently and effectively.

CIE assessed the community costs of price and supply controls for market milk to exceed the community benefits. It saw no net public benefit from a statutory requirement to maximise opportunities for sale of market milk.

The community benefits of a statutory, industry-specific food safety body, with powers to license industry operators and to determine and enforce food safety standards were found by CIE to greatly outweigh community costs. However, no net public benefit was found in having a dairy-specific statutory consumer protection objective.

CIE's effort to quantify the public benefits from deregulation of market milk in Victoria, using change in producer surplus plus consumer surplus as the welfare criterion, resulted in a net benefit to Victoria of \$5.1m to \$14.2m per annum, with a loss of \$31.9m to \$86.7m to producers outweighed by gains to consumers. The net welfare gain in Australia is some \$7 million greater than the welfare gain to Victoria because deregulation in Victoria forces deregulation---ending price distortions---in other states.

The fall in average revenue per farm in Victoria was put at \$16,000 per year, or 10.2 per cent, under worst case assumptions. For perspective, this was said to be equivalent to the effects of a 4 per cent reduction in the world price for Australia's dairy products, or a 3 per cent appreciation of the Australian dollar against the US dollar. CIE pointed out that such changes are commonplace, and can occur over a short period.



CIE recommended that regulation of price and supply management of market milk in Victoria end on 30 June 2000, and that the VDIA be terminated on that date. It recommended that a dairy industry food safety organisation be set up to operate from 1 July 2000.

The Victorian Government accepted the CIE'S recommendations. In announcing this decision on 13 July 1999, the Minister for Agriculture and Resources, Patrick McNamara said: "This decision has broad support from the [Victorian] dairy industry because it has been clearly acknowledged that deregulation will pave the way for the development of an even larger and more competitive Victorian dairy industry. Government has made this early announcement on the urging of the industry to assist with its representations to the Commonwealth Government for a national dairy industry deregulation adjustment package" (McNamara 1999, p.1).

## **ASSESSMENT**

In this section some comments are offered on the NCP reviews for market milk and on the policy outcome of these reviews. Comments are made first on the review process and the public interest test, and then on the policy decision. The latter comments focus on questions about the rationale for the structural adjustment package that has been announced to accompany deregulation.

### *The review process and the public interest test*

Under the NCP, much leeway is left to the states to decide how they conduct their reviews. The freedom to determine the composition of review groups is an important element of this. It is unlikely that a review of the NSW Act would have produced the same recommendations had it been undertaken by CIE. By contrast, given the support for deregulation by the dairy industry in the Victorian review, a (Victorian) industry-dominated review of the Victorian dairy industry legislation would likely have led to the same outcome as the CIE review did.

Given the composition of the NSW Review Group, it was probably inevitable that it would not be able to reach agreement on their recommendations. The diverse interests of group members was somewhat reminiscent of that for members of the Sugar Industry Task Force set up by Federal Primary Industries Minister Simon Crean in April 1992 to help him decide how to respond to an Industry Commission report with a

deregulatory thrust (Edwards 1993). Unlike the sugar task force, however, the NSW milk review group included members from the Cabinet Office and the Treasury who might be expected to see consumer interests as important.

The National Competition Council, responsible for overseeing the implementation of NCP, was critical of the NSW review: “The Council has some concerns with this review, given the differences of view between the dairy industry representatives and the independent members advocating reform, and is pursuing these with NSW” (NCC 1999, Overview). In the event, deficiencies in the NSW review process were downgraded in policy-relevance with the subsequent Victorian decision--which forced deregulation on the other eastern states.

There is a long history of contention about the merits of setting the objective of government bodies in very broad terms. Requiring an organisation, or a review group, to have regard to the “national welfare” or the “public interest” leaves much scope for interpretation and differences of view. In its favour, it avoids the need for governments to undertake the---often impossible---task of specifying fully the welfare function.

The NCC says: “The principle underpinning the NCP is that reform should be introduced when it serves the overall community interest”(NCC 1999, Overview). Further: “The NCP does not prescribe what constitutes the community interest, but rather recognises that it can encompass a range of possible factors that are likely to vary from case-to-case.”

The absence of precision about the NCP public interest test made it easier for the NSW Review Group to divide in their assessments. If the public interest criterion were equated with the economist’s social cost benefit analysis it would have been harder for the majority in the NSW Group to give the weight they seemingly did to regional multiplier effects and other local benefits having disregarded offsets elsewhere. They would then have been constrained to a narrower analysis more like the standard economic surplus analysis carried out by CIE.

A final point to be made about the State market milk reviews is that it seems unfortunate that they could not be coordinated. There is now agreement by all states that deregulation needs to occur in a coordinated way. This may well have been easier to achieve---though not necessarily

yielding a more attractive adjustment package to the industry---with a less fragmented approach to the review process.

*The Commonwealth Government helps again---“nice work if you can get it”?*

During and following the Victorian review there was much political activity directed to winning financial assistance for dairy farmers in association with deregulation. In the course of this interaction the Government asked the dairy industry, through the Australian Dairy Industry Council, to consider options for its future. On 28 September 1999 the Federal Minister for Agriculture, Fisheries and Forestry, Warren Truss said: “The Government had been approached by the dairy industry for support for a transition package. The Federal Government is prepared to implement a \$1.8b structural adjustment package for the dairy industry, should all States decide to make deregulation legislative changes from 1 July, 2000....the package would assist restructure of the industry by helping farmers improve their efficiency and competitiveness after deregulation. Exit payments of up to \$45,000 will also be available for farmers who choose to leave dairying”.

The average payment to dairy farmers in NSW and Victoria under the package is \$142,500 and \$72,000, respectively. Aggregate payments are \$582m for Victoria and \$259m for NSW (Senate Committee, p.146).

The package is to be funded by a levy of 11 cents a litre on all retail milk sales.

The dairy industry, long the beneficiary of a complex of government regulation that transfers income to them from consumers, seems to have succeeded in winning another large payment as a *quid pro quo* for accepting the end of regulation---which most of them would in any case have experienced as a result of Victoria’s decision. At first glance this may appear reasonable. After all, it is widely accepted that compensation is a valid way to allow groups that would otherwise be losers to share in the gains from---and thus become supporters of--- efficiency-increasing policy changes.

For a number of reasons, however, it would be too charitable to explain the dairy compensation package in this way.

- First, the ending of the DMS at 30 June 2000 was announced by Minister Crean in early 1992, seemingly a reasonable period of notice.

The Senate Committee expressed concern at compensation for the ending of DMS: “This was seen as inequitable , given that the sunset of the DMS had been foreshadowed well beforehand and it was seen to be unjustified to compensate for that loss” (Senate Committee 1999 p. 158). The main gainers from compensation for manufacturing milk are Victorian dairy farmers, who in 1998 produced 72 per cent of that milk (Senate Committee, p.7). (Notwithstanding its concerns at compensation for manufacturing milk, the Committee made no recommendations directed to reducing it).

- Second, in the predominant milk state, Victoria, the dairy industry supported deregulation in the review---before an adjustment package was on the agenda. It saw gains in competitiveness in manufacturing and potential sales of market milk interstate offsetting the loss of the market milk premium within Victoria. In fact, the dairy industry in Victoria viewed regulation of market milk and of manufacturing milk as the “major obstacles ” to improving Australia’s international competitiveness in world dairy markets (ADIC 1999, p.6). At the review stage, anyway, the Victorian dairy industry appeared to support deregulation without compensation.
- Third, the funding of the compensation package is by a tax on milk consumers. Large, low income families will be hurt most. This conflicts with widely held notions of equity. The Senate Committee concluded: “The funding of the package via a consumer levy appears to be opportunistic. Consumers will probably not get any real benefits from the deregulation of the farmgate price for market milk, at least not in the short to medium term. The Committee is therefore at a loss to understand why consumers should fund the package”(Senate Committee 1999, p. 167). (Nevertheless, again, the Committee made no recommendations for changing the funding arrangements to benefit consumers). For balance, economists should point out that, except under extreme assumptions about elasticities, a consumer levy will ultimately be borne partly by farmers/processors/distribution firms.
- Fourth, the often-made argument (e.g. Truss 1999; ADIC 1999) that the levy is unlikely to increase the retail price of milk because the removal of the regulated farm-gate price will reduce the retail price more than the levy increases it is could be viewed as disingenuous: the relevant counterfactual is deregulation of the farm-gate price without a consumer levy, which could be expected to give a retail price much lower than with regulation.

The case for deregulation of the dairy industry without compensation can be stated as follows. Upon the introduction of the Crean Plan for manufacturing milk in 1992 it was stated that support for manufacturing milk would be phased down over the period to end-June 2000, and that there would be no more legislated support for the sector after that date. Victoria is overwhelmingly the main beneficiary from the DMS, and it has been evident since 1992 that its ending would make it attractive for Victoria to walk away from the “pseudo-gentlemen’s agreement” and send market milk into NSW, and other states. NSW should have prepared for this. The fact that they did not means that any responsibility for compensation---which should be viewed as confined to market milk, for which policy responsibility rests with NSW---should lie with NSW.

Clearly, this line of argument did not hold sway. It does appear, however, that Victoria may have accepted such an approach---at least before the stepping up of the politicking following the Victorian review. But once it became clear that the Commonwealth was sympathetic to ---again---using its tax powers to transfer income from long-suffering consumers, Victorian producers wanted a share of the largesse. This attitude was reinforced by the fairness view that, as a manufacturing milk state, Victoria had been “feeling the pain” since 1986, when the program of reducing price supports in this sector was initiated under the Kerin Plan.

The Commonwealth indicated that it wanted a consensus proposal from the industry---a proposal that was acceptable to all states. With this political requirement, any “purist” argument to confine the package to market milk was untenable. “Victoria had to be on board”, meaning that the adjustment assistance had to include market milk.