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## AGRICULTURAL POLICY: THE RATIONALE FOR ONE

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(Paper to a plenary session of the 33rd Annual conference of the Australian Agricultural Economics Society, Lincoln College, Canterbury, February 6-11, 1989)

The case for agricultural policy - indeed for an agricultural economics profession with its own conferences - rests on some recognition that agriculture is different from other industries. I am not going to argue that there is something special about agriculture - I am no modern day physiocrat - rather I argue that every industry has some features, and in that respect has to be treated differently from others.

This the analysis needs to be put in a context - which is also helpful for understanding other macroeconomic issues. In particular, the New Zealand economic debate has been about three different accounts of how economies function.<sup>2</sup> Each account is associated with a view of the role of prices in the economy.

### Three Models of the Economy

The first account, the traditionalist view, is one of 'elasticity pessimism', that is the changes in relative prices have very little supplyside impact. This may be because it is believed that the price elasticities and cross elasticities are very low, or because there will be countervailing reactions - perhaps generated by distributional responses - which nullify any initial changes in the price relativities. Such an economy would be described as heavily indexed.

It is called the traditionalist account because it was a widely held view in post war New Zealand, and was used to justify a variety of interventionist policies such as price, interest rate and wage controls, import and other quantitative licensing, fixed exchange rate management, direct monetary controls. Its macroeconomic management is traditional fixprice Keynesian, that is a fiscal stance that was basically expansionary in the domestic economy, with the balance of payments guarded by high levels of

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<sup>2</sup> Ideally one would like to present only two views of the economic management, as does the Australian group, INDECS Economics. However its expansionist restrictionist dichotomy, while having some relevance to New Zealand, fails to capture the debate here. Perhaps traditionalists in Australia are less important.

protection and inflation dealt with through wage and price controls. The name most associated with the traditionalist view is Rob Muldoon. However a number of economists held some of the views.

At the other extreme are the elasticity optimists to be called monetarists or supplysiders. For them changes in price relativities lead to significant and rapid supply side responses, particularly if there is no government interference in the markets involved. Entrepreneurial responses may be as important as shifts along the supply and demand functions, perhaps more so. Monetarist policies usually involve reducing government intervention, although in recent years there has been emphasis on the need to provide a proper legal framework for the property rights in a private market. It hardly needs to be elaborated that monetarists' macroeconomic policies focus upon control of the money stock.

As the term 'monetarist' is not used here in a pejorative manner, there is no difficulty labelling Roger Douglas and his economic advisers as monetarists. There are also monetarists in the financial sector and universities.

While monetarists are elasticity optimists and traditionalists are elasticity pessimists, the one place their views are reversed is in the money demand function. Monetarists see the function as rigid, while traditionalists see little stable connection between the stock of money and income. But this paper is not going to be about the detail of monetary and fiscal policy, so that paradox need not detain us. Nor will there be much attention given here to the profound ideological differences that generally exist between the two views.

Between these two extremes are the structuralists. They could be characterised as being elasticity pessimists in the short run, and elasticity optimists in the long run, but that fails to capture the crux of their analysis. What really matters is that different industries respond to a stimulus at markedly different rates.

Adjustment problems centre around the lack of foresight of the various economic agents. But even given the same degree of surprise or shock, different industries have different capacities to adapt.

That great industrial economist Alfred Marshall defined his short term, medium term, and long term, by the type of adjustment the industry made, but even the long term when firms are able to adjust their capital stock varies by the type of activity involved. A forester may take three decades to change land use, a cropping change may involve a year. Between the extremes are different sorts of pastoral and horticultural activities. Fishing, manufacturing, mining, energy, transport, property, and the service sectors add to this spectrum, as does the differing long term horizons of households and of the various branches of government. To compound the complexity, human capital has its own rhythm of adjustment.

In addition there is the problem of information. In some markets price and quantity information is readily available, in others it is hard to come by. The former tend to trade as auction markets, quickly adjusting to new shocks, the latter are characterised by the spectrum of customer markets. One of the most recalcitrant of all customer markets is the labour market, which plays a prominent part in the structuralist analysis of macroeconomic behaviour.<sup>3</sup>

The variation in adaption rates means that the economy does not respond to a shock in any equilibrium or quasi-equilibrium path. It is not hard to show that a dynamic system with good equilibrium properties may adjust very inefficiently (and slowly) to the new equilibrium following a shock, and that adjustment can be improved by the introduction of control mechanisms. Moreover, there can be no assumption that any equilibrium is unique. If there are multiple equilibria the adjustment path the economy takes becomes important.<sup>4</sup>

The government response to any shocks is also an integral part of the adjustment behaviour. This is not a trivial point, for the monetarist advisers to the government paid little attention as to how fiscal and monetary policy should be altered when the country shifted from a fixed exchange rate regime to a floating regime.<sup>5</sup>

Structuralist macroeconomics is thus largely modern flexprice Keynesian, recognising a role for fiscal and monetary management, but within a context of some elasticity pessimism in the short run but more flexibility in the long run. In a small open economy the growth process is the expansion of the tradeable sector.

There has probably never been a genuinely structuralist as Minister of Finance in New Zealand. There are many structuralists in the academic and policy advocacy area, although they are such a heterogeneous bunch it is sometimes difficult to identify the boundaries. I am a structuralist.

The structuralist differs from the traditionalist analysis because it sees price shocks impacting in the medium and long run, in a reasonably predictable way. Market signals are useful in the

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<sup>3</sup> For an introduction to the concept of customer (and more complex) markets see B.H.Easton, "The Labour Market and Economic Liberalisation" in A.Bollard and K.Buckle (ed) Economic Liberalisation in New Zealand, 1987.

<sup>4</sup> A point stressed by the (now defunct) Victoria school. Zannetti, G. et al, "Opening 'The Books': a review article", New Zealand Economic Papers, 1984, pp 13-30.

<sup>5</sup> From Run to Float, by Brian Easton; paper to N.Z. Economics Association conference, February 1989, to be published as a chapter in The Making of Rogernomics, (Auckland University Press, 1989).

management of the economy, particularly long run management, and often competition is an effective means of regulating a market. In policy terms the structuralist's contrast with monetarist is that the different response rates, and thereby the inherent rigidities in the economy in the short term, offer possibilities where government intervention may enhance economic performance. However such interventions are disciplined in comparison to the traditionalist.

### Managing the Exchange Rate

The remainder of this presentation will focus on the differences between structuralists and monetarists, which is now the main economic debate in New Zealand. Let us go back to the time of the floating of the dollar. Before that occurred a couple of structuralists, the late Merv Pope and Bob Buckle, cautioned that there would be overshooting of the exchange rate.<sup>6</sup> The process by which an exchange rate overshoots is essentially a dynamic one, in which different adjustment processes reinforce each other to drive the exchange rate path away from equilibrium for a significant period.

In the New Zealand case the overshooting was exacerbated by a monetary and fiscal stance which overtly was set independently of the exchange rate. However, covertly monetary policy probably quasi targeted on an overvalued exchange rate. (Indeed it may have been convenient to do so, since an overvalued exchange rate artificially depresses the rate of inflation).

It is now widely accepted - even by Reserve Bank economists - that overshooting began a few months after the currency was floated in early 1985. Most economists would accept that the New Zealand exchange rate is still overvalued, although by how much is a matter of greater contention.

Concomitant with the overvalued exchange rates has been very high real interest rates - typically in excess of ten per cent per annum. This combination meant that capital intensive export industries, such as farming, were in a double bind suffering depressed returns and high input costs. Not surprisingly the tradeable sector has been contracting since the overshooting. That contraction has not only been in output terms, but there has been a loss of production capacity and capital stock, including a reduction in livestock holdings.

This contraction has occurred on top of a major restructuring arising from the economic liberalisation, including the removal of industry support measures of licensing, protection, and subsidisation. Indeed it has been possible for the government to argue that

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<sup>6</sup> "Do Exchange Rates Need an Anchor?", Quarterly Predictions, March 1985, pp 42-47.

difficulties in any particular industry were due to the restructuring from liberalisation. But as all of the tradeable sector is in great difficulty the argument sounds hollow.

As the structuralist critique emphasises, the real exchange rate is crucial to the health of the tradeable sector. The overshoot rate has had disastrous consequences.<sup>7</sup>

The monetarist position is along one, or all, of the following lines. First it has been argued that the market rate is always the equilibrium rate.<sup>8</sup> Whether this statement is anything other than tautology is unclear. Second it has been argued that the government could do nothing to reduce the overvalued exchange rate. This arises from the view, documentably held by the officials at the time of the float, that there is very little, if any, connection between the fiscal stance and the exchange rate. It is not even clear whether the advocates considered that the monetary stance affects the exchange rate. The third argument is that getting down the rate of inflation was a higher priority. It is this defence to which historians are likely to most pay attention.

### Is There an 'Ideal' Industry?

One could explore these issues at further length, but there is a more fundamental issue. The monetarist model assumes that all firms in all industries are like those in elementary textbooks with physical and human capital malleable, and market information readily and cheaply accessible.

These characteristics do not describe the vast majority of industries, but there is one where the correspondence is close - the financial sector. Its most important commodity, financial paper, is extremely malleable, exit and entry is relatively simple, and transactions typically occur in auction markets.<sup>9</sup> There is an unfortunate tendency to treat these financial markets as 'ideals', in the sense of being models to which all other markets and industries should aspire.

In order to extend the compass of the financial sector ideal to other industries, the monetarists have had to misapply some

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<sup>7</sup> B.H.Easton, The Exchange Rate Since 1981: Performance and Policy, NZIER Discussion Paper 30, 1986, and R.A.Buckle, "Sequencing and the Role of the Foreign Exchange Market", Bollard and Buckle, op cit.

<sup>8</sup> providing there are no government interventions in the currency markets.

<sup>9</sup> D.Harper Financial Services Industry: Effects of Regulatory Reform, NZIER Research Paper 35, 1986.

standard economic concepts.

- 'Neutrality' is used as an absolute notion, where it really is a relative one.

- The notion of 'contestability' has been stretched to the point where some adherents argue that all markets for which there is no government restraint on entry are contestable.<sup>10</sup>

- The rational expectations account of financial markets is manipulated to an interpretation of capital malleability in all of the corporate sector, despite the scientific evidence for the theory being tenuous and contradictory, while the evidence against it in its extreme form is compelling.

The hidden agenda is that financial institutions are a standard and everyone else should be treated the same as them.

The treating all firms as if they were in the financial sector is crazy, but that has been the thrust of industrial policy in recent years. The only way the majority of firms can behave like financial institutions is when their scale is zero; it is not accidental that the majority of firms are moving in that direction.

An example of the foolishness is the government's approach when attempting to extract the resource rental from its ownership of the fishing stock. It assumed that the fishing licenses were similar to financial paper, so that the value of the licences reflected the value of the royalties. However the assumption goes all awry when a few simple facts are added, such as

- the fishing industry is not in equilibrium and is unlikely to get there readily because of its existing capital stock,

- there are a few players in the fishing industry who are likely to play oligopolistic games rather than be pure competitors,

- fishers have low short run marginal costs compared to average costs,

- the licences transacted on the open market are a small, and untypical, set of all the licences.

Forcing all other industries into the procrustean mould of the financial sector is absurd, since the reason we can analyze the latter so easily is because it is atypical and simple.

Before leaving this obsession with the financial markets, it needs to be pointed out that they have benefited from various forms of assistance not available to the rest of the economy, including

- the legal framework of the securities market is primitive,

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<sup>10</sup> Greer, D.F. Contestability in Competition Policy: Replacement, Supplement, or Impediment?, paper to Fulbright Seminar; 'The Influence of American Economics on New Zealand Thinking and Policy', September, 1988.

although there are slow steps to reform. Disclosure laws to shareholders and investors are particularly inadequate.

- financial institutions do not pay GST like other firms,<sup>11</sup> while household purchases of foreign exchange for service payments are usually exempt from GST.

- the income tax regime on investment income is arbitrary, taxing the inflation component of interest and exempting nominal capital gains.

Any assistance given to the financial sector is, of course, at the expense of the rest of the economy. This occurred through the high exchange rate, high interest rate structure so the financial sector (and the associated commercial building sector) expanded while the rest of the economy stagnated and contracted.

This expansion continued as long as confidence did, but the short term speculation was not underpinned by any long term gains. Not surprisingly the bursting of the speculative bubble plunged the financial sector into the same contraction as the rest of the economy.

#### Searching for Nonexistent Neutrality.

It is fallacious to assume that there is some ideal industry type to which all others should conform. There is no pure and perfect notion of neutrality.

For instance when the government attempted to systematise the taxation regime on unrealised income held in stocks, it treated a forest which grows for thirty years similarly to a manufacturers' stockholding which turns over every three months. That may be how elementary financial textbooks treat time, but a even a nodding acquaintance with capital markets indicates that in practice financial markets do not treat thirty year capital the same as three month capital held over 120 or so times.

Between those extremes lies the agricultural sector, not only in terms of the valuation of livestock on the hoof but also in other areas such as the maturing of wine. Like forestry they are suffering under a regime which is allegedly neutral but favours the short term."

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<sup>11</sup> Financial institutions pay GST on its inputs, and corporate users of financial sector services do not get exemption for GST paid by the sector. Households pay the inefficient stamp duties.

<sup>12</sup> Just to show how meaningless is the expression 'neutral', the new tax regime is not neutral towards inflation. Ironically the regime that was abandoned for forestry was neutral to inflation.

• ... Taxation on Forestry: Comments on the Consultative Document, by Brian Easton, NZIER Working Paper 86/11.

As another example of the problem of treating all industries the same, consider the difficulties the nation is getting into over the Maori Land claims to various resources: land, forests, fisheries, and energy. While the Treaty of Waitangi offers a context of general social principles, there is no overall economic approach which offers a unified treatment for all the Maori claims. At least to the Maori mind it is not a matter of converting each claim into a piece of financial paper.

The proverb

"He kura kainga e hokia; he kura tangata e kore e hokia" translates as

'the treasure of land will persist, human possessions will not'.

However a free monetarist translation of the proverb

"Toitu he kainga, whatungarongaro he tangata" becomes

'debts will still remain when the people have disappeared'. It could be a summary of the current economic policies."

### The Need for an Industry Policy

Even within industries there is a lot of heterogeneity, because industries tend to be defined as institutional and historical entities, rather than as economic ones. It is not merely the differences between and within agricultural, pastoral, and horticultural farming. This agricultural economist's conference includes a session of deep sea fishing, but there is nothing on land based silviculture.

It is this heterogeneity which leaves the structuralist cautious in terms of industry intervention. But as Alan Bollard said the issue is one of 'policy by design rather than policy by default'.<sup>13</sup>

The most fundamental issue is to get the macroeconomic environment right. No industry policy is going to have much useful effect if the real exchange rate is hopelessly overvalued and real interest rates are well above any plausible real growth rate. It also helps to have an expanding rather than contracting economy.

The alternative strategy would be just too awful to think about, if it had not already happened. When these 'big indicators' got hopelessly out of line with common sense the government kept on, with disastrous consequences for the productive sector. We may not

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<sup>13</sup> The proper translation is 'The land remains when the people have disappeared'.

<sup>14</sup> Hands on, Hands off, or Hand Outs: Industry Policy for New Zealand, NZIER discussion paper No 28, (1984).

remedy it all in this century, such has been the size of the destructuring, and the degree of hysteresis that occurs to industries based upon long term capital investment.

We need not here go into the details of a better economic management. My view is that if a change in fiscal and monetary policy is insufficient to realign the big indicators reasonably rapidly, then it may be necessary to go for direct intervention in the foreign exchange market. Even so, direct intervention will not work for long unless the fiscal and monetary stance are consistent with its intervention levels.<sup>13</sup>

Macroeconomic policy sets the context in which industry policy operates. The structuralist approach is cautious broadbrush intervention; described by Bollard as 'hands on, not hand outs'.<sup>14</sup>

### The Scope of Industry Policy.

Admittedly, there is the temptation to pursue the logic of the optimal tariff regime, which suggests a better allocative performance can be attained by a finely tuned set of interventions. However it is rare to have the required information, and in any case the small allocative gains of some interventions can be overwhelmed by substantial administration and compliance costs. There is also, in my judgement, the likelihood for the political economy process to choose interventions whose actual public benefit will tend to be below the estimated (and advocated) benefit.

However the structuralist treats these points as cautions not prohibitions. In particular where the net gains are great a properly constructed intervention would be supported. I, for instance, am happy to advocate additional taxation on alcohol and tobacco consumption on the basis of the evident public externalities.

While it is difficult to prescribe particular interventions for a specific industry without a detailed analysis of the industry situation, including a sound empirical understanding, there are some general rules.

First, the greater concentration should be upon general interventions aimed at industry groups rather than specific firms or industry subgroups. This supports emphasis upon general industry training programs, upon the research component of R&D, and upon policies to harmonise industry assistance.

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<sup>13</sup> I have no hesitation in grabbing a child putting their fingers in a fire. My preferred child management approach of education and prevention can be applied after.

<sup>14</sup> ibid.

Second, I do not have a lot of respect for the measure of the effective rate of assistance, at least as it is used in New Zealand. It is too static an approach, and needs to be put in a general equilibrium context, including that of fiscal impact. However if an activity has an ERA markedly out of line with the rest of the economy assistance should be withdrawn. Conversely, interventions which increase an activity's ERA to being markedly out of line with similar activities should be avoided.

This is as close as I can offer to a working definition of 'neutrality' for the design of interventions. It should not be used to convert everything into an idealised financial sector.

Also when evaluating the benefits of intervention, the distribution of the benefits should be assessed. It is not only a matter of avoiding the fallacy that an increase in national income is always in the public benefit.<sup>17</sup> A distributional component to an evaluation enables a sensitivity analysis to assess the burden of risk. This was the most fatal error in the Treasury rules on cost benefit analysis, which led to the "Think Big" debacle with the downside risk of almost all the Major Projects being borne by the Crown.<sup>18</sup>

Behind these remarks on measuring the impact of intervention is the recognition that for a variety of reasons, some of which are not particularly economic but say for social and environmental reasons, there will be interventions, which may unavoidably have unintended side effects. For instance, I do not know what the justification is for the odd way we tax investment income. What can be said is that it distorts investment decisions and, failing reform of the taxation, some further interventions may be justified. This gives us a third reason for intervention; to ameliorate the impact of other interventions which are either justified in their own right, or which for political reasons cannot be withdrawn.

The fourth group of reasons for intervention surround the inability of financial markets to deal with the long term. Nor need we adopt the view that uniform discounting reflects how time should be handled, even when there is no uncertainty. This suggests that government may be properly involved in the stimulus of long term investment and savings, and the discouragement of short term investment and disinvestment. However the earlier remarks of ensuring the private sector bears a fair share of the risks are particularly pertinent here, noting that a properly functioning tax

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<sup>17</sup> B.H. Easton, The Impact of Economic Liberalisation on Economic Welfare, Paper to NZPC Conference on Social Policy and Inequality in Australia and New Zealand, Wellington, November 1988.

<sup>18</sup> B.H. Easton, Thinking Big About Economics and Operations Research, paper to the AGM of the Wellington Operations Research Society, October 1988.

system can be a useful means of allocating gains and losses.

Fifth, where an industry is in strong long term structural contraction, or in need of rationalisation, government involvement with the private sector may be appropriate. This is not only to ease the social costs, but it may lead to a stronger competitive outcome. The alternative may be a private sector monopoly to carry out the restructuring, which may in the long run unhelpful to related industries and consumers.

An instance I have in mind is the need for a major reorganisation of the meat processing industry. Without government involvement it is likely to be delayed, inept, and unresolved. Having said that the government itself needs to wait until there is sufficient commitment from the private sector, and needs to ensure its financial involvement is well defined and limited.

The justification for such involvement is the asymmetry in expansion and contraction, known as the hysteresis effect." In particular contractions tend to involve greater industry rigidity than expansion.

Underlying rigidity in a market or industry, which is severe and cannot be resolved by increasing the competitive structure of the market, is a sixth reason for intervention. The most evident area of this attention is the labour market. There is a peculiar monetarist prescription for labour markets which amounts to converting them into financial markets. Real people are not financial paper; attempting to treat them as such is fatuous.

Another area where the monetarist prescriptions have been leading to worrying rigidities is in competition policy. There has been increasing concentration in some key markets, including ones intimately involved in supplying to, and purchasing from the farm sector. In some cases it is hard not to conclude that market has reached the point of monopolisation. Yet there is little protection to consumers and suppliers from such dominance.

More generally, intervention to promote competition or to regulate an uncompetitive market is a seventh reason for intervention. Structuralists prefer market competition, but accept that there may be good reasons for monopolies. In the latter case it makes no sense to allow monopoly, and then expect market competition to regulate it.

An important source of monopoly can be external factors. For instance in a study of the Dairy Board I concluded that given the structure of the world market, and given the 'common carrier' aspect of dairy processing in most regions the present externally

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" D.Mayes Changes, NZIER Discussion Paper 31, 1986.

monopolistic structure of our dairy industry was not too wrong.<sup>20</sup> More generally external trade policy is a reason (number eight) for industry policy.

Finally, there are the standard allocative reasons for intervention of externalities, economies of scale, uncertainty, informational deficiencies and transaction costs. In the past the reasons for these were some times exaggerated, but never-the-less there are occasions when these are relevant reasons.

Altogether then, here are nine general reasons for industry policy

1. intervention at a general level rather than specific level;
2. when seeking neutrality, use ERAS with caution and an understanding of their deficiencies, when using project evaluation criteria to include distributional impacts and risk incidence;
3. it may be necessary to intervene to ameliorate interventions for social, environmental, or other purposes, or in other markets;
4. the inability of financial markets to deal with the long term may be a reason for intervention;
5. an industry in strong contraction or in need of rationalisation may need assistance;
6. industries and markets suffering severe rigidity which cannot otherwise be avoided are candidates for intervention;
7. as may be measures to promote competition and regulate monopoly;
8. external trade policy has to be linked in with an industry policy;
9. there are the standard 'market failure' reasons.

The list is unlikely to be comprehensive; market realities have an ability to surprise economic theorists. More important each is a reason that may justify intervention. The cautions against excessive intervention must be stressed. One only has to look at the appalling economic management of the monetarists over the last few years, and of traditionalists before them to be very aware that there is 'government failure' as well as 'market failure.

How these principles should be applied to the agricultural industry is outside the brief of this paper. In any case specific industry policy design requires specialists. But

- yes there should be an industry policy for agriculture;
- yes there should be an agricultural economics profession;
- yes they should have conferences.

BRIAN EASTON

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<sup>20</sup> B.H.Easton, "Should the New Zealand Dairy Board Remain a Statutory Monopoly?" in New Zealand Dairy Board, Background and Perspectives, February 1988.