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## PROS AND CONS OF TEMPORARY INDUSTRY ASSISTANCE

J. W. FREEBAIRN\*

*La Trobe University*

The objectives and relative effectiveness of different methods of providing temporary assistance to a particular industry experiencing a significant reduction in returns and liquidity are evaluated. It is doubtful that assistance can be justified for resource efficiency reasons. This is argued to be so when the cause of the downturn in industry returns is due to temporary factors, such as drought, and when it is due to long-term trend factors, such as economic growth. While an industry slump can cause welfare problems, most households are able to use contingency strategies, e.g. savings, or resort to existing welfare programs, e.g. unemployment benefits. Direct income grants are preferable to output and input subsidies as means of providing welfare assistance.

### *Introduction*

Australian governments have provided temporary assistance to individual industries for a number of reasons, and a variety of assistance mechanisms have been used. Temporary industry assistance refers to assistance of a particular industry for a limited period of time. Generally there is a consensus, or at least the hope, that the reason for the current collapse of industry returns will be reversed within the foreseeable future, say, a couple of years. While the objectives of providing the assistance often have been vague, they include facilitating the efficiency of long-term resource usage, employment considerations, concern for the welfare of households dependent on the industry for the major source of their income, and a desire to ease the costs of adjustment to change. In many cases the assistance grant has followed industry inspired pressure for 'some assistance' to reduce the effects of significant falls in industry profitability and liquidity.

Numerous examples of ways in which temporary assistance to individual industries has been provided can be noted. Grants, concessional loans, freight subsidies and slaughter compensation fees have been provided by joint Australian and State government schemes to primary producers to alleviate the effects of droughts and other natural disasters. Subsidy payments were made to woolgrowers in 1970/71 and 1971/72 when wool prices were low. Since 1974, temporary assistance to beef producers has been provided by concessional credit and suspension of the export levy. Similar concessional credit schemes have been made available in recent years to producers of copper ore and concentrates. The Rural Adjustment Scheme of 1977 includes provision for 'carry-on' assistance to producers in industries assessed to be viable in a long-run context but currently facing liquidity problems. The debt reconstruction and farm improvement concessional loan grants of the Rural Adjustment Scheme also may be considered temporary

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assistance measures. Limited-period import quotas and tariffs have been used to provide temporary assistance for a number of import-competing industries during the 1974-to-present period. In 1976, excise taxes on motor vehicles were reduced for a six-month period to stimulate demand in the short period. In general, temporary assistance to individual industries can be provided by a diversity of arrangements which effectively augment output prices and demand, or reduce input costs, or directly augment income receipts over a limited period of time.

This paper considers the arguments advanced for temporary assistance to individual industries and the likely effects of the assistance on the performance of the economy. The resource efficiency effects of temporary industry assistance are considered in three contexts: where there is a consensus that the cause of the current liquidity squeeze will be reversed in the near future; where there is a consensus that the cause of the slump in industry returns is of a long-term nature; and where there is uncertainty about the future path of the factors causing the current fall in industry returns. The effects of a temporary squeeze on industry returns and liquidity on the welfare of households dependent on the industry for their livelihood are assessed. Finally, a few comments are offered about the relative advantages and disadvantages of alternative instruments of welfare income support.

#### *Industry Environment and Assistance Needs*

By way of background this section highlights the underlying factors which cause significant falls in returns to a particular industry and it clarifies what is and what is not implied by temporary assistance to an individual industry.

In broad terms, returns to an individual industry over time are influenced primarily by changes in commodity demand and supply. This simplified picture does not deny the importance of other causal factors, such as the competitive structure of the industry, in determining industry returns. However, their influence on changes of returns over time is of lesser importance.

Changes in industry average returns in the long term are influenced by trend changes in the demand for and supply of the industry's output. These changes stem from such factors as economic growth and its effects on relative commodity demand and relative factor prices, trends in Australia's comparative advantage in world trade, and technology changes. These trend developments force long-term pressures for industry adjustment. The magnitude of adjustment needs will be influenced in part by shorter term factors. In the event of long-term and continuing structural changes, industry assistance has to recognise longer term needs for industry adjustment as well as current reductions in industry returns.

Motives for long-term industry assistance include strategic and self-sufficiency goals, compensating assistance for protection of other industries, assistance to offset market failures, income redistribution, and

development of a diversified industrial structure. An important characteristic of these motives is that they seem to be equally valid for periods of both buoyant and depressed industry returns. At a later point consideration is given to the relative merits of using temporary assistance during industry slumps as a means of long-term industry assistance.

Temporary or short-term changes in industry returns are caused by cyclical, seasonal and irregular changes in the demand for and supply of an industry's output. In all cases there is a high probability that the current cause of the squeeze of industry returns will be reversed. Natural disasters clearly fall into the category of causes of a temporary slump in returns to primary producing industries and also to those industries supplying inputs and marketing outputs of primary industries. Cyclical fluctuations in industry returns can come from the demand side, particularly in association with cyclical fluctuations in the level of aggregate economic activity, both at home and abroad, and from the supply side, for example, in connection with recursive supply responses of which the cobweb model is a simplified example. Changes in national and trade policies are examples of irregular shifts affecting industry returns. At least in the area of trade in agricultural commodities, policy-induced effects can be important causes of falls in industry returns.

For many industries, marked fluctuations in industry returns with short-term periods of both buoyant and depressed industry returns are important characteristics of the decision environment. Further, informed and rational entrepreneurs and employees will be aware of fluctuating industry returns. They will commit resources to the industry only if periods of buoyant and slump returns, on average, provide satisfactory long-term returns. In many cases they will adopt return stabilising strategies such as product diversification, borrowing and lending funds, and taking-out insurance.

Clearly the assessment of what is a temporary and reversible squeeze on industry returns and what is the beginning of a longer term structural change often will be a contentious issue.

Temporary assistance in this paper means assistance to a particular industry for a limited and usually prespecified time. No consideration is given to assistance which is generally available to the wider economy, such as general taxation concessions, budget expansion, across the board tariff increases and monetary policy changes. It is presumed that the government intends, when offering the assistance, to withdraw it within a few years (or less), by which time the principal causes of the current squeeze on industry returns will have reversed or the industry will have adapted to trend changes in its environment.

#### *Temporary Changes and Resource Allocation*

Here we consider the case where there is a consensus that the cause of the substantial fall in industry returns is due to factors which will be reversed in the near future. This is the case, for example, with a natural disaster. It was widely used in support of assistance for the beef industry in 1974-76 when it was anticipated that depressed world

market prospects would improve, and it was used in a similar fashion for the copper ore and concentrates industry. A consensus that industry returns will improve within the next few years is an important argument for providing carry-on assistance under the Rural Adjustment Scheme.<sup>1</sup>

Several bodies, including the Industries Assistance Commission (IAC) in its reports on the Beef Cattle Industry (IAC 1975*a*), Copper Ore and Concentrates (IAC 1975*b*), Rural Reconstruction (IAC 1976*a*) and Rural Income Fluctuations (IAC 1978), and the Australian Government (1977) White Paper on Manufacturing Industry have argued that temporary industry assistance can be justified on long-term resource allocation grounds. For example, as a general principal, the IAC Annual Report 1975-76 (1976*b*, p. 13) says:

Where a severe fall in profitability results from temporary factors peculiar to an industry there may be a strong case, on efficiency grounds, for the provision of temporary assistance to a low cost industry to enable it to hold resources necessary for its long-term development. In such cases assistance would avoid the cost of resource movements which would later need to be reversed.

The above resource efficiency argument for temporary assistance to a particular industry rests on two premises. The first is that a temporary squeeze on industry returns initiates a withdrawal of resources from the industry even though the long-term prospects for the industry are favourable. An associated premise is that, once resources leave the industry, they can be rehired or replaced only at great expense. While the ultimate validity of these premises is largely an empirical issue, there are logical doubts about their validity.

Decisions to dispose of, to retain and to purchase industry resources will include some consideration of the ease and costs of selling resources, of holding resources and of replacing resources at some future time. It is convenient to consider the polar cases of industry-specific resources, e.g. specialised equipment, and manpower and animals, and industry non-specific resources, e.g. unskilled labour and light motor vehicles.

With industry-specific resources, even though some firms may leave the industry or dispose of resources as a consequence of the squeeze on industry returns, it does not mean that the resources leave the industry. In view of the longer term favourable prospects for the industry and the relatively low opportunity value of specialised resources in other industries, it is likely that other firms (either existing or new entrants) will acquire the resources. That is, most of the sales will represent transfers of ownership within the industry. By a similar argument, firms recognising the temporary nature of the squeeze on industry returns and the difficulty and cost of obtaining specialised resources in times of more buoyant returns will tend to hoard industry-specific resources during a temporary industry slump. Such hoarding behaviour has

<sup>1</sup> For a description of the 1977 Rural Adjustment Scheme and of previous adjustment schemes see Threlfall (1977).

been documented in the context of labour and particularly for more highly skilled labour.<sup>2</sup>

The less industry specific are resources, the closer will be their opportunity value in different industries and consequently the more likely they will leave the industry. But, by the same argument, the easier it will be to replace these resources when the temporary downfall in industry returns is reversed. That is, the excess supply of and demand for industry non-specific resources to a particular industry is highly elastic in periods of temporary industry boom and slump. Under these conditions, very small costs will be incurred by the industry in releasing industry non-specific resources during a slump and rehiring them during a boom.

Expectations about future industry prospects have an important influence on decisions to expand or contract an industry. To the extent that current industry returns influence expectations, and there is supporting evidence<sup>3</sup>, it could be argued that a temporary slump reduces expectations of the longer term value of resources in the industry and that temporary assistance would offset the undesirable pessimism. Of course, temporary boom periods would have the opposite effect and call for a boom period tax. There is a problem with the above arguments. It is unlikely that the government would be optimistic about the long-term prospects of an industry but that no existing or potential industry entrants also would share that optimism. If a representative government considers an industry viable over the long term, there will be some entrepreneurs sharing these expectations who will be willing to accept the opportunity to purchase resources for which average long-term returns are expected to be above current market prices.

The foregoing arguments conflict with the hypothesis of the IAC and others that a temporary industry slump will result in there being fewer resources in the industry than is justified by longer term industry prospects. Certainly some resources will leave the industry. But most of these will be industry non-specific resources which can be replaced at little cost when normal conditions for the industry return. A large proportion of resource sales by particular members of the industry, and especially industry-specific resources with low opportunity values in other industries, will represent transfers of ownership within the industry. Many firms will have similar expectations that are used to justify government temporary assistance to a particular industry. Their decisions will recognise the costs and benefits of resources over the longer term as well as the current period of temporarily depressed returns.

Temporary industry assistance, particularly that operating directly and indirectly on product and input prices, will have a number of long-term as well as short-term resource allocation effects. The assistance effectively increases the average long-term levels of returns in the

<sup>2</sup> For some empirical evidence see Oi (1962) and Valentine (1975).

<sup>3</sup> While there is a dearth of information about how expectations are formed, there is a consensus that current conditions have some influence, and most econometric studies achieve satisfactory results when expressing expected values as a weighted average of current and past values.

process of raising the current level of returns. In turn, this will draw additional resources over the longer term into the industry. The desirability of expanding one industry over the longer term at the expense of other industries needs to be considered in the context of long-term and not short-term industry policy.

#### *Long-Term Changes and Resource Allocation*

Here we consider the case of a reduction in industry returns caused by shifts in the demand for and supply of a commodity which are not expected to be reversed over the longer term. This could be the case for the Australian manufactured dairy products, pome fruits, canning fruits and textile industries. The question at issue is whether temporary assistance should be provided as an interim measure and what are its effects on the longer term structural adjustment of the industry.

A favourable argument for using temporary industry assistance to facilitate the process of structural adjustment is that the assistance provides flexibility to permit a more orderly and less costly rate of adjustment. Here there are two key assumptions. The first is that entrepreneurs are aware of the need for structural adjustment and believe that the assistance will be an interim measure only. In practice, many entrepreneurs believe, or at least hope, that temporary assistance will become longer term assistance.<sup>4</sup> Further, some actively devote resources through political lobbying for continuation of the assistance measures.

Even if it is assumed that temporary industry assistance does not alter the desires of entrepreneurs to adjust to changes in long-term supply and demand conditions, there remains the second key assumption that the assistance will facilitate the adjustment process. The assumption presumes that additional liquidity is required to purchase and install new equipment, to amalgamate and rationalise production units and to adapt resources for use in other industries. On the other hand, the additional returns could be interpreted as justifying retention of existing procedures.

There are several reasons for rejecting, as sound policy, temporary industry assistance on resource allocation grounds when the factors causing the squeeze on industry returns and liquidity are long-term structural changes. By preserving industry returns, the temporary assistance reduces the incentive for the industry to adjust to new conditions. The assistance is more likely to delay the time at which inevitable adjustments have to be made than would be the case if no assistance was provided. That is, if long-run structural adjustment is necessary, temporary assistance serves only to delay inevitable resource adjustments and associated costs.

<sup>4</sup> A telling example of how temporary assistance can become, in effect, a form of long-term assistance (in this case for polyester yarns) is described in IAC (1976b, Appendix 1.3). A sequence of temporary assistance measures is documented over the period June 1962 to June 1976. In recent years the operation of 'temporary' import quotas has been extended and re-extended and there have been extensions of concessional credit arrangements for the beef and copper ore industries.

At the same time, the assistance helps preserve an outmoded industry structure for a much longer period than would have been the case in the absence of the assistance. This effectively means a longer period of inefficient allocation of resources.

#### *Uncertainty*

In reality, often there will be doubt as to whether the fall in industry returns is due to temporary or to long-term factors. Following the analyses of the previous sections, the uncertainty problem should not be of great concern to the government decision of whether to provide temporary assistance or not; it will, however, be vital to private decision makers. This is because it was argued that temporary industry assistance is not desirable for efficient resource allocation irrespective of whether the fall in returns is due to either short-term or long-term factors.

#### *Other Resource Allocation Issues*

Two other aspects of temporary assistance to an individual industry as it affects the efficiency of resource usage are of interest: as an instrument of long-term assistance and moral hazard effects.

Temporary assistance has been suggested as an alternative instrument to continuous long-term assistance for providing compensating and other assistance to low-cost industries. It was widely discussed under the heading of countercyclical assistance by the authors of the Green Paper on Rural Policy (Harris et al. 1974). In a similar vein the IAC Annual Report 1975-6 (1976b, p. 15) argued that temporary assistance should be more readily available to industries with low levels of assistance than those with higher levels.

Its principal advantage seems to be the potentially greater political acceptability in providing assistance to generally profitable and often highly profitable export industries when compared to such instruments as a long-term subsidy on output or inputs during boom as well as slump periods. Certainly, as argued above, temporary industry assistance will increase the volume of resources drawn into the industry over a long-term as well as short-term horizon.

There are, however, a number of disadvantages. In the minds of entrepreneurs, the relative value of a dollar of assistance almost certainly will be less if it is provided as temporary assistance than if it is provided as a long-term continuing form of assistance. There will be uncertainty about when the assistance will be provided, that is, about what constitutes a significant fall in industry returns and liquidity. There will be uncertainty about the amount and perhaps the form of the assistance. Such uncertainty will be greater the more *ad hoc* the temporary assistance policy. Because of the uneven temporal pattern of industry assistance, temporary assistance may have important and unsatisfactory equity implications as compared with long-term assistance. For these reasons temporary industry assistance should be regarded as a less cost-effective way of promoting long-term industry expansion than long-term industry assistance.



A related issue concerns the argument for concessional credit for an industry facing a temporary squeeze on industry returns because of alleged market failure in the capital market. It is critical to note that temporary assistance, as opposed to long-term assistance against market failure, would be justified only if the market failure can be shown to be greater or more marked during periods of a temporary industry slump than at other times. W. Bates (personal communication, 1978) has noted that he 'would expect the consequences of a distorted credit market to be more serious during a period of depressed returns when less internal finance is available'. In general, the first best policy would be to correct the market imperfection rather than provide industry assistance.

Turning to the specific context of agriculture, there has to be considerable doubt as to whether market failure in the capital market exists. The Bureau of Agricultural Economics (1977) study of the rural credit market found no evidence that too little credit is made available to agriculture; if anything, the opposite seems more likely. Standen (1977) found significant statistical evidence for increased bank borrowing by the rural sector during squeezes on industry liquidity. While these findings do not disprove the existence of market failures, they are consistent with rejection of the hypothesis.

The provision of temporary industry assistance may have a number of unsatisfactory resource allocation effects which can loosely be described as moral hazard.<sup>5</sup> General knowledge that some form of assistance will be forthcoming in the event of a downturn in industry returns reduces the incentive for employers and employees to provide contingency arrangements that they otherwise would have done. Such behaviour would be reflected, for example, in less insurance, including the failure of insurance markets to even develop, and smaller reserve or contingency funds.

Such behaviour may have important implications for other sectors of the economy. For example, anticipation of the receipt of temporary industry assistance will reduce the need for precautionary reserve funds. Where available funds are an important determinant of investment expenditure, and there is much supporting evidence of such behaviour, one effect of providing assistance during a temporary squeeze of industry liquidity will be an increase in demand for scarce equipment in a boom period as less funds are reserved for future slumps. That is, the provision of temporary assistance for one industry may lead to exaggeration of that industry's peak demands on its input supplying industries.

#### *Industry Slumps and Welfare*

One of the stated objectives of government provision of temporary assistance to particular industries has been to support the living standards of households whose income is dependent upon the well-being of

<sup>5</sup> An interesting discussion in the specific context of natural disaster, floods, is in Forsythe (1975).

the industry, and certainly minimum welfare support is a basic society objective. In this section some general principles of temporary falls in industry returns and the creation of welfare problems are considered.

Two different conceptual aspects of the welfare implications of a temporary fall in returns to a particular industry can be noted in the context of the long term and short term. For the long term, and particularly in cases where the long-term prospects of the industry are considered to be viable, adequate funds should be generated, on average, to meet satisfactory income levels. This should apply to both employees and employers. Rational decisions to enter the industry would be made after consideration of anticipated returns during boom, average and slump periods. Further, usually contingency arrangements would be made to maintain adequate consumption levels during the slump periods, e.g. insurance, product diversification, saved funds, credit access. The decision problem is one of distributing a variable income stream, which, on average, is considered adequate and perhaps some more to justify risk taking, to match a more stable required consumption stream.

Even so, in a short-run context some individuals may have inadequate funds for current consumption as a consequence of a temporary industry slump. Such situations do arise. They could be associated with unrealistic forecasts of the long-run average level of, and the short-term variability of, industry returns, with improvident financial management and saving insufficient funds in boom periods to be drawn upon in slump periods, and with imperfections of the capital market. The study should not, however, end here.

#### *Available Welfare Assistance<sup>6</sup>*

Already society has set up a number of policy arrangements to provide minimum welfare support to its less fortunate members. General government welfare programs, such as unemployment benefits, are available to meet the minimum current consumption needs of households affected by a temporary industry slump. In practice, these programs are applicable to most households, including all of those headed by employees. For these households, industry assistance is not required as a welfare support instrument.

In practice, however, there are some difficulties in using the unemployment benefits scheme to provide minimum welfare needs of some self-employed persons. This is evident in the case of farmers. The eligibility conditions require that the person be willing and able to accept suitable work and that no such work is available. Eligibility problems arise for the self-employed person who has to devote considerable time and resources just to maintain assets which, although expected to provide adequate returns on average over the long term,

<sup>6</sup> For a further discussion of the relative merits of welfare assistance measures see, for example, IAC (1978) and Priorities Review Staff (1975).

provide inadequate returns during the current period of a temporary industry slump.

Other welfare support measures are available to farmers as part of the Rural Adjustment Scheme of 1977. 'Carry-on' assistance by means of concessional loans is available to farmers assessed to be viable in the long run but currently experiencing liquidity problems. Household support is available to farmers judged to be non-viable in the long run and who are prepared to leave their farms. Eligibility in both cases requires that the farmer has been unable to obtain sufficient credit from the normal channels of finance. So far these measures have not been extended to self-employed persons in non-primary producing industries.

Temporary industry assistance by means of raising output prices or reducing input costs will augment the incomes of both industry employees and employers. Employee incomes are supported to the extent that the assistance facilitates employment of more people. Employer incomes are augmented to the extent that some of the assistance is reflected in an increased level of operating surplus accruing to management and capital resources.

The effectiveness of assistance to a particular industry in providing additional employment has to be considered in the wider context of society's goal of full employment. In particular, it needs to be determined whether the same level of additional employment could have been obtained by assisting other industries, including those experiencing boom conditions, or by using fiscal and monetary policy. In the assessment it is worth recalling an earlier observation that the greater part of unemployment caused by a slump in returns to a particular industry falls on industry non-specific labour, generally the lower skilled, rather than on industry-specific skilled labour. That is, except for geographical considerations, most of the people losing jobs are highly mobile as between different industries. The resolution of the relative effectiveness of different instruments in creating employment ultimately becomes an empirical issue depending, in part, on the instrument and the industry.

An additional concern is that providing assistance to one industry, particularly in the form of output price increases, while increasing employment in the assisted industry, can concurrently reduce employment in other industries. This possibility is discussed in some detail in the 1976-7 Annual Report of the IAC (1977).

Assistance that raises the output price or lowers input prices for a particular industry is likely to be less direct, more costly and less equitable as a method of welfare support than direct methods of income assistance. For example, the former gives a constant level of assistance per unit of output and it is unlikely that this pattern of assistance corresponds with the pattern of welfare needs. In rural industries the needs of most small (output) producers for welfare support during an industry slump are at least as great as those of large producers, yet the latter receive more assistance from output subsidies and tariffs than do the former. Also, there are few specialist or single commodity producers.

One line of defence of using output and input subsidies as a welfare support instrument, rather than direct income grants, is their alleged greater administrative ease and speed of implementation. Certainly there are administrative costs and delays in assessing the eligibility of individuals for unemployment benefits and especially so for 'carry-on' finance and household income support under the Rural Adjustment Scheme. Also, on some occasions, direct income grants will be made to some households not in need of assistance and in some cases the grants will not be made or too little will be offered.

### *Conclusions*

Reductions in industry returns and liquidity are associated with temporary and reversible reasons, including natural disasters and cyclical fluctuations, and with longer term structural changes, including those stemming from economic growth. Many instances can be noted in which particular industries have sought and in fact have received temporary assistance from governments to bolster their returns. In most cases the assistance has been granted with the objectives of maintaining resources in the industry, of facilitating adjustment and of supporting the incomes of households dependent on the industry for much of their livelihood.

It is doubtful that there are resource efficiency gains to be had from offering temporary assistance to particular industries. Where the current downturn in industry returns is considered to be temporary and where the longer term prospect of the industry is considered viable, rational entrepreneurs, using similar and perhaps better information than the government, will hire resources in view of their current and longer term returns. Many instances of resource transfers, particularly for industry-specific resources, will be transfers within the industry and not out of the industry. Industry non-specific resources can be replaced at a later date at little cost. In the case of a long-term downturn in industry returns, temporary assistance primarily delays and does very little to dissipate the need for and cost of inevitable structural adjustment. Temporary assistance is a second-best way of providing long-term industry assistance justified for compensatory, market failure, industry diversification and other reasons.

While significant squeezes on industry returns and liquidity provide preconditions for the creation of some welfare problems, the number of households so affected may be very small. In the case of temporary downturns, many households fall back on their private contingency arrangements, including savings, credit, insurance and employment elsewhere.

For those remaining in need of welfare assistance there are general welfare support programs. The needs of employees and some employers are met by unemployment benefits. In practice, unemployment benefits may not be attractive for all self-employed persons. The 'carry-on' finance and household income support provisions of the Rural Adjustment Scheme fill most of the gap in the case of rural producers.

While temporary assistance to a particular industry does provide income assistance for both employers and employees, it is a blunt instrument for meeting society's minimum welfare objectives. In general, direct income grant schemes are expected to be more cost effective per dollar of assistance.

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