

Australian Treasury submission to the Agriculture and Food Policy Reference Group

This article summarises a submission by the Australian Treasury to the Agriculture and Food Policy Reference Group (AFPRG).¹ The AFPRG was commissioned in March 2005 by the Minister for Agriculture, Fisheries and Forestry, the Hon Warren Truss MP to develop broad recommendations to improve the profitability, competitiveness, and sustainability of the Australian agricultural and food sectors.²

The submission identifies key economic influences that will affect the sector over the next 10 to 15 years. Cyclical factors such as the drought and the strong Australian dollar are likely to remain relevant in the near term. However, longer term issues such as the declining terms of trade in the farm sector, international developments, demographic change and environmental issues are likely to be more relevant to policy. Each of these factors will create both opportunities and challenges for the agriculture and food sectors.

1 The full version of the Australian Treasury submission to the AFPRG is available at http://www.agfoodgroup.gov.au/publications/australian_treasury.pdf.

2 Further information on the AFPRG can be found at <http://www.agfoodgroup.gov.au>.

Introduction and economic context

The agriculture sector is subject to rapid and constant change and may be substantially different in 10 to 15 years time to what it is today. However, most of the influences that will drive this change are not unique to the agriculture and food sectors and will therefore occur in the context of significant changes in the economy more broadly. Therefore, to ensure the long-term sustainability of the agriculture and food sectors, policy should be set with an understanding of the broader economic context within which the sectors operate.

Currently Australia benefits from a sound, medium-term framework for macroeconomic policy, which has enhanced the economy's resilience to external shocks and contributed to over a decade of macroeconomic stability. Microeconomic reform, including Australia's floating exchange rate, industrial relations reforms and competition policy, have also contributed by facilitating the movement of labour and other resources between industries.

Short-term challenges facing the agricultural and food sectors

Two short-term challenges for the agricultural sector are the recent drought and the current relatively high value of the Australian dollar.

Although not uncommon events, droughts affect agricultural production and economic performance and can harm long-term profitability if not well managed. The current drought has had a severe impact on the Australian economy. In addition, drought can have a devastating impact on individuals and affected communities. Even after drought breaks, the agriculture sector will continue to experience consequences since herds will need to be rebuilt and the depleted water storage will continue to affect production.

The relatively high Australian dollar reflects, to some extent, developments in the non-rural commodity price cycle. Sustained global economic growth, particularly in the USA and China, has seen a significant increase in demand for non-rural commodities such as oil, iron ore and coal. Such increases in world commodity prices have generally been accompanied by an appreciation of the Australian dollar.

Looking ahead, Australia's climate will remain highly variable and droughts will continue to occur. Similarly, it is reasonable to expect that international commodity price cycles will continue to influence the Australian dollar. Like other business risks, it will be important that these risks are managed. In general, individual farmers are best placed to make assessments about the risks facing their farm business and how to manage these in light of their individual circumstances and preferences.

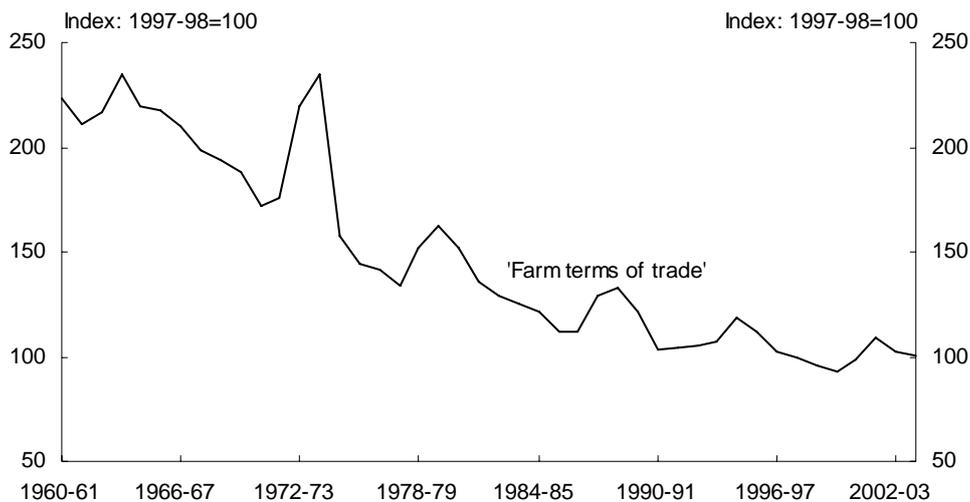
Long-term developments likely to affect the agricultural and food sectors

In the near term, cyclical factors such as the drought and the strong Australian dollar are likely to continue to have an adverse impact on the agriculture and food sectors. However, as policy settings generally last beyond the duration of these effects, it is important that policy does not focus unduly on the short term, but takes into account longer term trends such as the declining terms of trade in the farm sector, international developments, demographic change and environmental issues.

Farmers' terms of trade and international developments

The farm sector has for a number of years faced a long-term decline in farm output prices relative to farm input costs, as can be seen in Chart 1. This ratio is sometimes referred to as the 'farm terms of trade'. This decline reflects the fact that the prices of farm inputs have been rising faster than the prices received for rural commodities (Department of Agriculture, Fisheries and Forestry 2005).

Chart 1: Farm output prices relative to input costs — the 'farm terms of trade'^(a)



Source: Australian Bureau of Resource Economics, *Australian Commodity Statistics 2004*.

(a) This represents the ratio of an index of prices received by farmers to an index of prices paid by farmers.

World growth has been consistently stronger than anticipated in recent years. To the extent that strong economic growth implies increased global demand for agricultural products, there may be opportunities for Australian producers to benefit from higher international prices or through capturing market share in new export markets. This will especially be the case if Australian producers can identify and fulfil the particular demands of consumers in these markets.

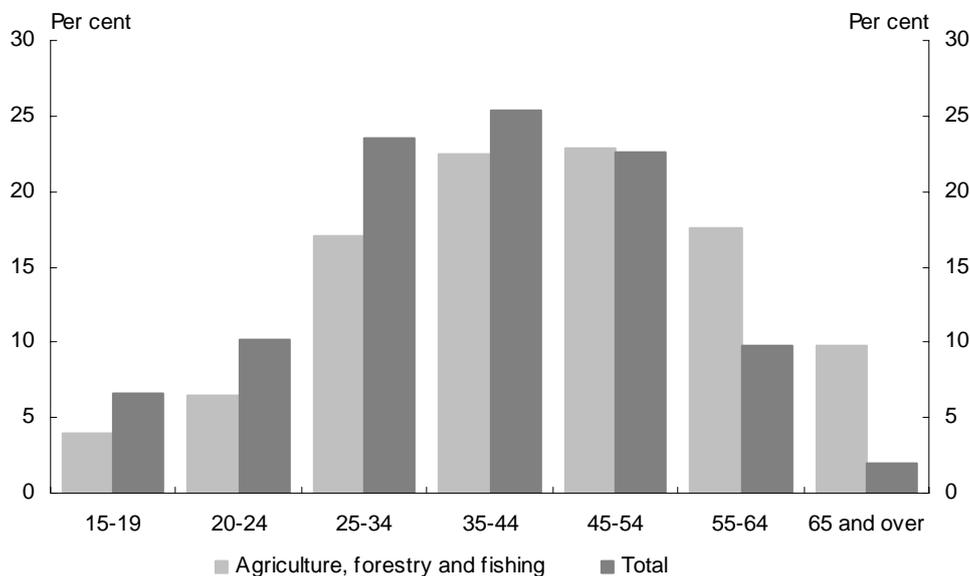
While strong world economic growth is likely to create opportunities, it is also likely to pose challenges. As other countries become more efficient primary producers, competing Australian producers will face increasingly intense competition. Further, if supply to global markets increases as a result, it is likely that agricultural commodity prices will continue to decline, relative to other prices.

Australia's demographic challenges

Over the next decade or so, Australia's ageing population is likely to have significant impacts on the Australian economy. The comparatively older workforce in the agriculture, fisheries and forestry sector can be seen in Chart 2. At the time of the 2001 census, 50 per cent of people employed in the agriculture, fisheries and forestry sector were over 45 years of age, and 27 per cent were over 55, compared to just 34 and 12 per cent respectively of the total workforce.

Many people employed in the agriculture, fisheries and forestry sector aged 45 and over will leave the industry over the next two decades. Given the trend towards a decline in the number of new farmers and farm employees entering the industry, this exit due to age will need to be accompanied by increased productivity (output per worker) if production levels are to be maintained.

Chart 2: Age profile of workers in the agriculture, fisheries and forestry industry



Source: Australian Bureau of Statistics, *2001 Census of Population and Housing*.

Generational change will create challenges within the agricultural and food sectors. For example, labour shortages are a risk if large numbers of experienced farmers or farm workers retire in a short period of time. Other challenges could relate to the retirement decisions of farmers who wish to continue living on the farm but are unable to pass the running of the farm onto their children.

However, demographic change also represents a potential 'once in a generation' opportunity to restructure and improve the productivity of Australia's agriculture and food industries. For example, the injection of new ideas could assist the sectors to innovate and achieve the structural change and productivity improvements that will be essential for long-term viability. It could also provide an opportunity to accelerate the rate of farm consolidation where this is economically desirable and where little has occurred to date.³

Environment and land use issues

While many of Australia's natural resources are renewable, there is a need to ensure that they are managed sustainably. The consequences of poor resource management practices have the potential to undermine the productive capacity of the agricultural and food industries both now and in the future.

Existing problems of dryland salinity and poor water quality in the Murray-Darling Basin illustrate the impact of previous land and water degradation on current production. It is likely that the agricultural sector will face further challenges of this nature as the consequences of poor practices in the past continue to emerge and where resource management practices remain unsustainable. While not easily quantifiable, the potential costs to production from unsustainable resource use are likely to be substantial.

It is therefore important that policy takes into account issues of resource access and pricing; trade in water and other resources; the role of regulation; public goods provision and inherent conflicting public and private interests; and broader social goals in relation to environmental sustainability and biodiversity.

³ Large farms typically achieve stronger productivity growth than smaller farms, partly because the benefits of new technologies can be greater for larger farms (Productivity Commission 2005).

Responding to opportunities and challenges

The importance of productivity growth

Productivity growth is central to the performance and international competitiveness of Australia's agriculture sector and to the economy more broadly. The productivity challenge facing the agriculture sector is no different to the choices that confront all other sectors of the economy. Changes in consumer tastes, technology and world markets mean that all sectors of the economy must evolve and adapt over time.

At the enterprise level, productivity growth involves producing more or better quality output with the same inputs or producing the same output with less inputs, and thus at lower cost. At the macroeconomic and industry levels, productivity growth is fostered by allowing resources such as capital, labour, land and water to move to the most productive activities. This may involve resources moving between different agricultural activities or changes in the mix of agricultural and other activities taking place within the economy.

Primary responsibility for achieving productivity improvements lies with individual farmers since they are best placed to assess the potential of specific changes on their particular farm. Individuals also have the greatest incentive to innovate since they receive a direct benefit if they can reduce their costs or achieve better prices for their product by better tailoring it to the needs and preferences of consumers. They are also best placed to take into account their own circumstances when making decisions that involve balancing the short-term risk that a potential productivity enhancement might fail against the longer term risk that they might become unviable if they don't change.

Government can also play an important role in maintaining and facilitating strong productivity growth over the longer term. However, historically, the bulk of assistance to the Australian agricultural sector was provided through a range of statutory marketing arrangements, regulations and price supports – policies which stifled competition, innovation and productivity. The gradual introduction of competition over the last two decades has given growers more marketing control over their products and enabled innovation and productivity improvements.

The objective of Government policy is to encourage competition, promote innovation, encourage better risk management, reduce regulation and business complexity and take into account possible impacts on the rest of the economy, now and in the future. One consideration that will remain relevant is the impact of agriculture on the environment and the future productivity of the resource base. In this regard, one challenge is how to design policies that will assist the future viability of agriculture through productivity improvement, while minimising environmental degradation and adverse impacts on the broader economy.

Industry assistance

Compared to other countries, government support provided to the agricultural sector in Australia is relatively low. Recent estimates from the Organisation for Economic Cooperation and Development (OECD) show that Australian assistance to agriculture (as a per cent of gross farm receipts) was around 4 per cent in 2003, which is markedly lower than the OECD average of 32 per cent.

However, while it compares favourably with the OECD, the Australian agricultural sector still receives a significant amount of assistance relative to other Australian industries. The agricultural sector benefits from an effective rate of assistance of 4.1 per cent of industry gross value added, including budgetary, tariff and regulatory assistance (Productivity Commission 2004). This is second only to the manufacturing sector.

When one sector receives special treatment such as subsidies or tax concessions, then the competitiveness of other sectors will be reduced since they will have to pay more taxes. Further, the supported industry will be larger than it would otherwise be and will therefore use more inputs such as labour and capital. For example, the Productivity Commission found that government subsidies to the ethanol industry raise the cost of wheat products, and so raise the cost of feed for the pork industry (Productivity Commission 2005). Such effects illustrate the need for agricultural policies to be evaluated within a long-term, economy-wide framework.

If assistance for an industry is considered necessary, it should be targeted at enhancing its long-term productivity. In practice, this is difficult since the provision of assistance to one sector can reduce productivity in other sectors. Similarly, it is important to avoid creating expectations that further assistance will be provided if productivity objectives are not met.

In addition to the efficiency losses that can result from assistance, there are also budgetary implications to be taken into account. Direct government payments for industry assistance either reduce the amount of government funds available for other areas of expenditure (such as health and education), or increase the tax burden, or do a combination of both. Like all sectors in the Australian economy, the agricultural sector will need to adapt as fiscal pressures intensify.

Trade

Government policy should also aim to promote increased international competition. The Australian agricultural sector is highly export-oriented – it is estimated that for the period 1997-98 to 1999-2000 around 64 per cent of Australia's agricultural production was exported (Department of Agriculture, Fisheries and Forestry 2005).

Future growth in Australian agriculture is likely to depend more on export markets than on the comparatively small domestic market.

Distortions and other barriers to trade can inhibit access to vital export markets. The Australian Government is committed to pursuing the removal of international trade barriers that preclude and restrict trade in agricultural products. Policies that promote free trade will be crucial to providing and improving access to international markets as well as ensuring Australian producers have access to competitively priced inputs.

The future of agriculture and food policy

The agriculture and food industry faces near-term pressures such as the drought and the relatively high Australian dollar. However, in the long term as these cyclical factors subside, the industry will face challenges such as the ageing of the population; the declining farm terms of trade; international developments; and environmental sustainability. Given this broader economic context, the viability of the industry depends on ongoing productivity improvement and increased international competitiveness.

In general, the policy settings that will allow the agriculture and food sectors to maximise their competitiveness and sustainability will be those which promote competition and innovation, reduce barriers to trade, encourage better risk management, address sustainable resource management and reduce regulation and business complexity. These policies should be determined with regard to their potential impacts on other sectors of the agricultural industry and the economy more broadly, including the natural resource base.

Given the importance of innovation and productivity improvement, it is important not to lock in existing practices or create other impediments to change. In this respect, the agricultural and food sectors will need to be increasingly flexible and adaptable to meet changing and often unpredictable circumstances.

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