SUBMISSION TO THE PRODUCTIVITY COMMISSION'S INQUIRY INTO GOVERNMENT DROUGHT SUPPORT

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Executive Summary and Recommendations

The National Drought Policy agreed by the Commonwealth and State Governments in 1992 was based on the principle that drought is a normal feature of the Australian climate and thus of the Australian farmer's operating environment. The policy was intended to provide support to farmers with a long term sustainable future in agriculture to enhance their skills in managing climate risk along with the other risks facing the farm business. These principles remain sound and should continue to inform future drought policy.

However, more than sixteen years of experience in implementing the policy has revealed weaknesses in drought policy settings and the present review provides a good opportunity to refocus the policy on its original objectives and review the instruments through which those objectives are pursued. We recommend that the following changes be made to the implementation of the National Drought Policy:

1. consideration be given to ending the declaration of exceptional circumstances and developing government support measures for farmers to manage climate variability based on individual need;
2. the government undertake an inquiry into farm poverty to determine the nature and extent of poverty among Australia's farmers and any amendments necessary to the welfare safety net to make it accessible to farmers on an equitable basis;
3. if a specific unaddressed welfare need is identified, the Exceptional Circumstances Relief Payment be removed from the National Drought Policy and replaced by a standing farm welfare program, delivered on terms that are equitable with the rest of the community, and on the basis of the individual family's needs and not on the basis of geographically-based exceptional circumstances declarations;
4. the re-establishment grant be abolished;
5. Farm Management Deposits be retained to support income management across the climate cycle;
6. Farm Management Deposits be included in the means test for any support offered to farm businesses during downturns;
7. the farm business support currently offered in the form of interest rate subsidies be replaced by an income contingent loan scheme, either
    a. based on existing exceptional circumstances declarations processes, or
    b. based on individual farm business need, decoupled from geographically-based declaration processes;
8. the income contingent loan have the following features:
    a. repayment be based on gross farm revenue as reported on the farm's Business Activity Statement
    b. farm businesses in receipt of a drought ICL be required to group their ABNs
    c. options be explored for involving the commercial financial sector in the selection of farmers eligible for ICLs and that a form of 'top up' arrangement be considered
    d. a real rate of interest (to be determined with reference to long-term government bond rates) be applied to drought ICLs.

Background

The National Drought Policy was agreed in July 1992 by the Agricultural Council of Australia and New Zealand. Ministers agreed that the policy would be 'based on principles of sustainable development, risk management, productivity growth and structural adjustment in the farm sector' (ACANZ 1992, p 13). The policy included an important caveat relating to 'severe downturns' during which support would be provided to 'those with sound prospects who are temporarily in difficulty' (ACANZ 1992, p 13). This response to severe events was given effect in the exceptional circumstances (EC) provisions of the *Rural Adjustment Act 1992* which provided eligible farmers with interest rate subsidies of up to 100% on commercial finance. A welfare component was introduced into the drought policy in 1994 in the form of the Drought Relief Payment (later the Exceptional Circumstances Relief Payment). The Rural Adjustment Scheme was wound up in 1997 but both the interest rate subsidies and the welfare payment were retained for farmers experiencing exceptional circumstances.

The exceptional circumstances provisions were triggered almost immediately that the *Rural Adjustment Act 1992* came into effect in January 1993 – for excessive rain in South Australia and Victoria. They were also triggered the same year following a collapse in wool prices and to support farmers affected by worsening drought in the eastern states. Since that time, there have been exceptional circumstances declarations in place almost constantly, with some areas experiencing multiple years of declarations and, therefore, government assistance. The conditions under which exceptional circumstances declarations have been made have not been consistent and it is arguable that some areas that have been receiving support have not been experiencing rainfall deficits of an 'exceptional' nature – rather they have experienced the normal variability of the Australian climate.

Declaring exceptional circumstances drought

One of the major problems for a government support program based on geographical declarations of exceptional circumstances is defining such circumstances in a manner which is scientifically justifiable across time and space. A drought in east Gippsland is different in nature to one on the edge of the arid zone, which is different again from a drought in north Queensland or the Pilbara. In addition, separating drought conditions from other agricultural factors is difficult. As Heathcote observed 'the same rainfall which gave a bonanza wheat crop [...] in the 1880s, would be classed as a drought in the 1980s' (Heathcote 1994, p 100). Developing a definition which is meaningful in terms of temporal and spatial difference and is consistent with an underlying principle of understanding and living with the challenges of the Australian climate is highly problematic. The international water resources literature confirms the challenges of defining drought (see for example Dracup *et al.* 1980; Wilhite 2000; Wilhite and Glantz 1985). Further differentiating between 'normal' and 'exceptional' drought compounds the problem.

In policy terms, the existence of the exceptional circumstances provisions has set up perverse incentives for farmers experiencing a drying spell. Where the National Drought Policy was focused on managing dry periods as part of normal climate cycles, the existence of the exceptional circumstances program provides an incentive for farmers and their representatives to make the case that they are experiencing particularly bad conditions as this provides access to interest rate subsidies and welfare payments. This has reinforced the perception that drought is a natural disaster, a concept that was rejected in policy terms with the removal of drought from the Natural Disaster Relief Arrangements in 1989.

The process for declaring EC has also been politicised. Multiple entry points in the declaration process are provided by our federal system of government and the funding arrangements have reduced the incentives for State governments to act as effective gatekeepers for dubious applications for EC declarations. The declaration of EC during election campaigns outside of the established declaration processes has also given the impression that the program is open to political interference, further undermining the scientific integrity of the declaration processes.

It is therefore recommended that

> consideration be given to ending the declaration of exceptional circumstances and developing government support measures for farmers to manage climate variability based on individual need.

The welfare response to exceptional circumstances

The welfare component of the drought program was introduced in 1994 following reports of welfare problems in many drought affected areas. The program was set up to provide farmers in exceptional circumstances areas with access to welfare payments on an equivalent basis to other groups in the community. The major exception was the exclusion of farm assets from the assets test for the new Drought Relief Payment. Otherwise, the payment was offered on the same terms as the unemployment benefit. Importantly, this payment was not dependent on the prospects of the farm business. Where the interest rate subsidies were only accessible by farm businesses with a long term sustainable future in agriculture, the Drought Relief Payment was payable to all eligible farmers in an exceptional circumstances area. This raised concerns about inequities between those in difficulty inside the EC areas and those suffering income stress who had not been declared to be experiencing EC.

In 2005 the Commonwealth government announced changes to the eligibility criteria for the welfare payment, the effect of which was to allow farmers in receipt of an EC welfare payment to earn two and a half times as much per fortnight as a recipient of other forms of welfare (Botterill 2006). This gap was widened significantly in September 2007, when the income test was further relaxed resulting in a $20,000 gap between the exempt earnings of farmers and those of other welfare recipients. This change was justified by the then Minister on the grounds that 'Given the length and severity of the drought, we now link off farm income to the farm business itself. After all, these farm businesses are earning no income themselves, and yet they've got costs such as fixed water charges, local government rates, or lease payments on machinery or the like' (ABC Radio 2007). In essence, this means that the original intention that drought policy only support those with a long-term sustainable future in farming has been abandoned and the welfare system is being used to subsidise farm business operations, confusing the risk management message of the National Drought Policy.

It is important that off-farm income be included in the means test for any farm welfare payments. Welfare is provided by government as a safety net measure to ensure that families do not fall below community-acceptable standards of hardship. It is not intended to provide a reward structure for good management. Farmers in receipt of off-farm income who fail the income test do so because they are considered to be receiving income sufficient to meet their day to day living requirements.

Separating the farm family from the farm business is an ongoing challenge for rural policy – Mauldon and Schapper identified the problem in the 1970s , referring to the farm as a 'unity of business and household' (Mauldon and Schapper 1974, p 65). Various government reviews have taken different approaches to handling this feature of the family farm. The Henderson Poverty Inquiry of the 1970s concluded that low farm incomes were likely to be the result of sub-optimal rates of structural adjustment in the farm sector and suggested that the best policy response was through measures to promote agricultural structural adjustment (Musgrave *et al.* 1975). This was the direction taken in the Rural Adjustment Schemes of the late 1970s and the 1980s. In 1992, it was recommended by the consultants reviewing the Rural Adjustment Scheme that welfare be removed from the scheme (Synapse Consulting (Aust) Pty Ltd 1992). Ministers agreed, and the Farm Household Support Scheme was set up, followed by Farm Family Restart and Farm Help. The National Drought Policy made a clear distinction between the farm family and the business and the 1997 review of rural adjustment policy argued for business and welfare programs to be clearly distinguished (McColl *et al.* 1997, p vii). However the 2005 and 2007 changes blurred this distinction.

Farm poverty has not been measured systematically since the Henderson Inquiry. The EC Relief Payment and related programs have been based on assumptions about the existence of farm poverty, its nature and causes. As has been argued elsewhere

> policy needs to be based on evidence rather than simply on assumptions and the issue of the treatment of the farm asset needs to be reassessed. Research is required into the extent, nature and causes of farm poverty in Australia. Methodological and definitional problems associated with poverty research cannot be avoided – and in addition to the difficulties experienced in general poverty research, work will be needed on the treatment of farm assets and the consideration of wealth in determining farm welfare. As far as possible the welfare of the farm family will need to be disentangled from that of the farm business. (Botterill 2007, p 44)

It is therefore recommended that

> the government undertake an inquiry into farm poverty to determine the nature and extent of poverty among Australia's farmers and any amendments necessary to the welfare safety net to make it accessible to farmers on an equitable basis.

If a need is identified for a farmer-specific welfare program, this should be delivered on the basis of individual needs. Basing access to the welfare safety net on geographical boundaries creates inequities and the *causes* of low farm incomes should not be relevant if farmers do not have the resources to meet basic family needs.

It is recommended that

> if a specific unaddressed welfare need is identified, the Exceptional Circumstances Relief Payment be removed from the National Drought Policy and replaced by a standing farm welfare program, delivered on terms that are equitable with the rest of the community, and on the basis of the individual family's needs and not on the basis of geographically-based exceptional circumstances declarations.

Removing the eligibility for welfare from any drought support program would reinforce the business focus of the National Drought Policy and also greatly reduce the politicisation of the program. Media images of drought-affected families are powerful in evoking public support for governments to 'do something'. If these families are receiving welfare support on an equitable basis, governments are better placed to implement policies in a manner consistent with the original intent of the National Drought Policy, ie 'in a consistent, structured way rather than through ad hoc policy changes' (Crean 1992).

Farm exit

Related to the assumption that farm poverty is the result of suboptimal rates of structural adjustment has been the ongoing use of re-establishment grants since the early 1970s as an incentive to marginal farmers to leave the land. As has been argued in more detail elsewhere (Botterill 2001), re-establishment grants have been a policy failure. The 1997 review of the Rural Adjustment Scheme noted that 'there is no objective evidence that the availability of re-establishment grants has been a major factor in decisions by farmers to leave agriculture' (McColl *et al.* 1997, p 51) and a review of the scheme in 2000 found that as many as 79% of those who accepted the grant would have left the land anyway (O'Neil *et al.* 2000, p iv). The main problem with the exit grant program appears to be the mismatch between the monetary incentive on offer and the very strong non-monetary reasons farmers stay in agriculture even in the face of considerable hardship. There is no good public policy reason to continue to offer these grants. If the government wishes to encourage marginal operators to leave agriculture, research is needed into the types of incentives that are likely to achieve that outcome.

It is therefore recommended that

> the re-establishment grant be abolished.

Farm business support: Farm Management Deposits

Farm Management Deposits are a tax-effective mechanism for farmers to accumulate financial reserves during high revenue years for use during downturns. They are consistent with the National Drought Policy's objectives of self reliance and risk management. However, in recent years they have been exempted from eligibility criteria for EC support. It is important that FMDs are seen as the main mechanism for supporting farmers to manage their cash flow across the climate cycle so they should be included in the means test for any form of business support offered during downturn. It is often asserted that farmers should not be required to access FMDs because they are a form of superannuation. This is a spurious argument. Changes to superannuation in recent years provide all members of the community with a range of choices for the accumulation of retirement savings and these are equally available to farmers. FMDs were not set up for this purpose.

It is recommended that

> Farm Management Deposits be retained to support income management across the climate cycle;
>
> Farm Management Deposits be included in the means test for any support offered to farm businesses during downturns.

Farm business support: Income Contingent Loans

The main policy instrument employed by the Commonwealth government to support farm businesses experiencing exceptional circumstances is the interest rate subsidy. Interest rate subsidies have been part of government structural adjustment policy for decades. They have attracted criticism by previous reviews, with the 1997 review of the Rural Adjustment Scheme arguing that 'the payment of exceptional circumstances interest rate subsidies is inconsistent with the broader [...] objectives of encouraging self-reliance'. The review also found that 'interest rate subsidies discriminate against farmers without debt or who take steps through off-farm investments and income to prepare for drought' (McColl *et al.* 1997, p 50). A different approach needs to be considered.

An income contingent loan (ICL) involves the provision of loan finance for agreed activities and has the following critical characteristic: loan repayments depend on the future economic circumstances of the loan recipients. The key point is that when those assisted experience adverse financial outcomes, they have no repayment obligations in that period, since the collection of the debt is based on capacity to pay. It is this feature of income contingent loans which delivers the benefits to borrowers of both default insurance and consumption smoothing (Chapman 2006).

In general, an ICL can be thought of as a public sector financial instrument designed to address aspects of so-called 'market failure'. Some of the shortcomings of the operation of the private sector with respect to risk might result in an absence of private sector institutions developing in response to social and/or economic need (such as concerning the commercial provision of loans for human capital investments), and in this case public sector intervention has the capacity to fill a significant void.

In other cases there might well be evolved market responses to particular private sector needs, but these might be handled more equitably or in administratively more efficient ways through the use of an ICL mechanism. In many possible applications the issue of equity looms large, since some current government grant schemes are arguably regressive (for example, taxpayer grants to farmers for drought relief – see Botterill and Chapman 2006). For each possible application it is important to be precise about the nature of a market failure, and/or the alleged advantages of an ICL compared with current or alternative approaches, in order that the nature of the problem and its potential solution are easy to understand.

One of the important motivations for ICLs organised through the public sector is that such interventions, compared with commercial bank loans, have the capacity to reduce significantly risks for borrowers in ways that might be both equitable and beneficial to society generally. In some cases these arrangements mean that finance can be made available for projects that would otherwise not occur because of a lack of access to a bank loans. As implied above, there are other reasons for such interventions, such as to reduce public sector outlays and to make fairer government intervention by reducing the extent of taxpayer subsidies. A major theme in the literature related to ICLs is that the provision of loans with such a feature has the two fundamental benefits of protecting borrowers from both default and repayment hardship (Chapman 2006). Perhaps the best-known ICL is the Higher Education Contribution Scheme, instituted in Australia in 1989.

The Productivity Commission's *Issues Paper* for this inquiry raised the option of income contingent loans as an alternative to interest rate subsidies. We have discussed this proposal previously (Botterill *et al.* 2004; Botterill and Chapman 2004; Botterill and Chapman 2006; Chapman *et al.* 2004) and the scheme has been modelled using ABARE data and testing different scenarios for collection of the loan as well as the impact on both government revenue and on the financial position of different groups of farmers (Kelly *et al.* 2004).

Income contingent loans are consistent with the principles of the National Drought Policy and offer a clear alternative to interest rate subsidies. ICLs mirror Farm Management Deposits in that farmers essentially borrow from future good years rather than from past good performance. Income contingent loans could be combined with Farm Management Deposits in a single farm business financial risk program through which farmers draw down their FMDs and then have access to an ICL once their reserves are exhausted. This would also address one of the limitations of FMDs, that is that new entrants may not have time to accumulate reserves before they encounter a downturn.

Features of an ICL for drought relief

Availability

An income contingent loan could be offered on the basis of existing EC declaration processes or, in the event that declarations are ended as we have recommended, on the basis of individual farm circumstances. In administrative terms, the former would be quicker and easier to implement and could be seen as an interim program in a transition to the ending of declarations for the reasons outlined above.

Collection of ICLs

The collection of a drought relief ICL raises two main issues: the implementation of a threshold below which farmers are not required to repay and the repayment mechanism itself.

It is suggested that a drought ICL not include a repayment-free threshold. Farm receipts reflect to an important extent farm size which means that if repayments were not required for revenue below a certain level the policy might excuse all repayments from small farm units (even in periods in which a significant proportion of small establishments are not experiencing economic hardship). Since an ICL requires contributions when debtors have the capacity to pay, a threshold would nullify to some extent this advantage of the ICL. It would also have an unfortunate behavioural characteristic of systematically encouraging the participation in the scheme of those farms expecting to have relatively low gross revenue in the longer term, thus undermining the prospect for the government of high levels of collection.

In order to ensure that the loan is repaid, it is proposed that the debt be collected on the basis of gross revenue rather than taxable income. Gross revenue is already reported on the Business Activity Statement (BAS) which farm businesses complete for GST purposes. Because gross revenue is a relatively crude measure of farm welfare, it is proposed that the repayment rate be set at a very low level. In Kelly *et al* (2004) we have modelled repayments at both 2% and 5% of gross revenue.

In order to avoid the potential for farmers to circumvent repayment by holding an ICL against one ABN (Australian Business Number) and reporting their income against another, farm businesses with a drought ICL should be required to group their ABNs and report their activities on a single BAS. Many farm businesses are already grouping their ABNs on the advice of their accountants.

Change of farm ownership structure

Attaching the ICL to an ABN has the further advantage of ensuring repayment should the ownership of the farm business be rearranged or changed entirely. On the sale of the farm there would be a requirement for the ICL to be paid in full. When a rural property is purchased, a number of searches are already undertaken – this would be extended to an ABN search to determine if there was an outstanding drought ICL on the property. The purchaser could then require that the loan be paid out or agree to take it on for an associated reduction in the purchase price of the property.

In the case of the death of the farmer the property is likely to either be sold, in which case the above scenario applies, or continue in operation in which case the ICL would continue to be paid out of the operations of the farm.

The reconstitution of a partnership would require a new ABN in which case the ABNs of the former partnership are required. This would alert the ATO to the existence of an ICL.

Bankruptcies are a rare occurrence in the rural sector as banks monitor their clients' financial positions and tend to encourage sale before bankruptcy occurs. That monitoring process would take account of the existence of an ICL as one of the obligations of the farm business.

Eligibility

To ensure that drought ICLs are not taken up disproportionately by poorer farmers who are less likely to repay the loan, it is proposed that the commercial banks be involved in determining eligibility for the scheme. An ICL could be treated as a 'top up' to additional bank credit. Under such a scheme, the farmer would approach a commercial bank for additional credit. An ICL would then be made available in proportion (to be decided by policy-makers) to the commercial finance available. This arrangement would give the bank some certainty that the additional credit they provide would be repaid as well as providing the farmer with access to greater resources in times of need.

Applying a real rate of interest to the ICL would further minimise the incentives for poorer operators to use the ICL scheme as there would be no implicit subsidy that would benefit those who took longer to repay the loan, ie those with lower future revenue, over those who paid it off quickly.

It is recommended that

> the farm business support currently offered in the form of interest rate subsidies be replaced by an income contingent loan scheme, either
>
> a. based on existing exceptional circumstances declarations processes, or
>
> b. based on individual farm business need, decoupled from geographically-based declaration processes;

It is further recommended that

> an income contingent loan have the following features:
>
> a. repayment be based on gross farm revenue as reported on the farm's Business Activity Statement
>
> b. farm businesses in receipt of a drought ICL be required to group their ABNs
>
> c. options be explored for involving the commercial financial sector in the selection of farmers eligible for ICLs and that a form of 'top up' arrangement be considered
>
> d. a real rate of interest (to be determined with reference to long term government bond rates) be applied to drought ICLs.

Advantages of an ICL for drought relief

Equity

Any government support program is ultimately paid for with taxpayers' money. Under the current guidelines for interest rate subsidies, an individual farm business can receive a grant of $100,000 or $500,000 over five years. It is acknowledged that few if any farmers receive assistance of this magnitude, however the grants amount to substantial transfers between the taxpayer and the farmer. One of the characteristics of farming is that farm families are often income-poor and asset-rich. This means that, although farmers are in short term difficulty during drought, over their lifetimes they are likely to be wealthier than the average taxpayer who funds their drought relief. While the community generally does not object to assisting those in difficulty, it is also not opposed to the principle that they repay some or all of that assistance when they are in a position to do so.

Protection from default and loss of property

Because of the close links between the farm family and the farm business discussed above, farmers are likely to be risk averse and take on lower levels of debt than their circumstances would otherwise suggest they can bear. This is because of the very high non-monetary value placed on the family farm and the consequent very high cost associated with its possible loss. Income contingent loans spread the risk of farm business loans. Because repayment is on the basis of revenue, an income contingent loan protects the farm asset from default and loss of the property due to poor revenues.

Income smoothing

As noted above, ICLs have a feature known as "consumption smoothing", or income smoothing. This is because an ICL is repaid on the basis of capacity to pay, with the repayments thus being sensitive to the farm's financial situation. Mortgage-type loans (the usual form of borrowing) do not have this feature. Thus an ICL can be seen to protect borrowers against the financial hardships associated with normal borrowings.

Common criticisms of ICLs for drought relief

Farmers don't pay tax

The most common criticism of the application of income contingent loans to drought relief is the belief that farmers are tax minimisers and capable of 'hiding' income. The consequence of this is that an ICL along the lines of HECS-HELP and FEE-HELP (previously known as HECS), which calculates repayment obligations on the basis of taxable income, would not work as farmers would either never trigger the repayment threshold or would underpay due to understatement of their actual income position. We have addressed this potential problem by suggesting that repayment be collected as a small percentage of gross revenue as reported on the Business Activity Statement.

Farmers could avoid repayment through sale of the farm, inheritance arrangements or the reconstitution of partnership arrangements

A second common criticism of the approach is that, as the Commonwealth would have no claim over the farm asset, repayment of an ICL could be avoided through the sale of the farm, inheritance or changes to partnership arrangements. These concerns are addressed through the attachment of the ICL to the farm's ABN.

Issues paper's concerns

The Productivity Commission's *Issues Paper* argues that

> Income contingent loans face many of the same issues as other input subsidies, such as the current EC interest rate subsidies. One such concern is that there is the potential for the most likely recipients of assistance to be less prepared farmers, who do not have viable businesses and whose incomes may never recover sufficiently for them to be obliged to repay the loan (known as adverse selection). (Productivity Commission 2008, p 17)

As discussed, the ICL could be designed to minimise this risk through combination with commercial bank finance in a 'top up' style arrangement whereby the government-financed ICL is available in proportion to the commercial finance available. Second, applying a real rate of interest to the ICL would minimise the incentives for poorer operators to use the ICL scheme. The *Issues Paper* does not elaborate on the other issues facing input subsidies that might also apply to ICLs.

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