RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT INTO GOVERNMENT DROUGHT SUPPORT

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Overview

The Productivity Commission's Draft Report into Government Drought Support makes important suggestions for improving the implementation of the National Drought Policy. Overall its recommendations reinforce the principles underpinning the National Drought Policy and redress the problems that have arisen over the course of its implementation.

We support the Commission's recommendations in several areas:

1. ending the declaration of exceptional circumstances and developing government support measures for farmers to manage climate variability based on individual need;
2. the end of interest rate subsidies;
3. the retention of Farm Management Deposits;
4. the end of transaction-based subsidies; and
5. substantial funding for research and development to assist farmers with the preparation for, management of and recovery from the impacts of climate variability and change.

However, there are two key areas in which we believe the Commission should reconsider its recommendations. The balance of this response to the Draft Report addresses these issues.

Farm poverty and income support

The Commission has missed an important opportunity to call for a comprehensive inquiry into farm poverty in Australia. As we outlined in our submission to the Commission, farm poverty has not been measured effectively since the 1970s and farm income support programs have been developed based on untested assumptions about the nature, causes and extent of low farm incomes in the farm sector. The Productivity Commission makes the same mistake, asserting that 'Persistently low farm incomes … *are likely* to be due to structural problems at the farm or industry level, such as inefficient size or inappropriate land use' (Productivity Commission 2008, pp 165 – emphasis added). This is not supported by evidence and may or may not be true. The clear consequence is that working from this assumption results in the development of farm income support measures that are explicitly linked to agricultural industry policy aimed at facilitating structural adjustment processes. An inquiry into farm poverty would provide evidence on which to determine whether it is appropriate to link farm welfare to agricultural policy and whether adjustments need to be made to eligibility criteria relating to assets tests and mutual obligation to accommodate the needs of farm families.

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We therefore reiterate our recommendation 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.

Income contingent loans

The Productivity Commission has rejected the proposal to introduce income contingent loans to provide a risk management tool for farmers. It is unclear why such a proposal has been resisted as it is a complementary measure to the Farm Management Deposits which the Commission recognise as providing an important contribution to farmers' drought preparedness and risk management. Where Farm Management Deposits offer the farmer the opportunity to draw down on past good years during a downturn, an income contingent loan provides access to surpluses from future good years. This is particularly important for new entrants to farming or those who have accumulated insufficient FMDs to meet their needs. Income contingent loans could be linked to FMDs, with past FMD deposit behaviour being used as evidence that the farmer was adopting risk management strategies and was therefore eligible for an ICL. This would limit to new entrants the potential for adverse selection associated with making such loans available.

Income contingent loans have two important features which make them particularly well suited to the needs of farmers faced with fluctuating incomes; namely they provide default protection for the farmer and they are an income smoothing mechanism. On the first issue, a key problem with farm financing is that farmers are likely to value their farms far more highly than the dollar value placed on the property by the finance sector due to the level of 'psychic income' associated with farming as an occupation (Vincent 1976, p 111). In addition, individual risk perception discounts upside risk and overestimates downside risk (Margolis 1996, p 93); meaning that farmers will borrow less than the finance sector is willing to provide because of their high level of sensitivity to the possible loss of the farm. The default protection inherent in an income contingent loan addresses this apparent market failure. This point could have been made more clearly in our original submission as it is fundamental to our understanding of the special nature of and problems associated with farm financing.

The second advantage of income contingent loans is their income smoothing effect. This has two elements. First, as a mirror image of FMDs, ICLs allow farmers to borrow from future good years to improve their financial position in the present. Second, during the repayment phase of the loan, payments are linked to capacity to pay; thus in very low income years, only very small repayments are required. By contrast, a standard mortgage-style bank loan requires a fixed repayment which in low income years can amount to a very high proportion of the farm's income; potentially causing considerable hardship.

The Draft Report has not made a convincing case for the rejection of ICLs. It cites the ABA's assertion that there is no apparent failure in rural credit markets during drought. However, this only addresses the supply side of credit provision and does not address the problem of farmers' reluctance to take on further credit due to concerns about default risk as outlined above. The Commission accepts the rationale for the provision of FMDs as a risk management tool even though they 'do not appear to address any market inefficiencies' (Productivity Commission 2008, p 177). It should logically see the case for ICLs on the same grounds.

We therefore strongly recommend that

> the Productivity Commission reconsider the adoption of income contingent loans as part of a single risk management program which incorporates Farm Management Deposits.

There are many important tissues of policy detail that we plan to consider in our appearance at the hearings, including a possible role for the commercial finance sector in the implementation of this scheme.

References

Margolis, Howard (1996) *Dealing with Risk: Why the Public and the Experts Disagree on Environmental Issues* Chicago, University of Chicago Press

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Vincent, D P (1976) 'Economic Aspects of Farm Poverty' *Australian Journal of Agricultural Economics* 20(2): 103-118