Response to the Productivity Commission Draft report into Rural Research & Development

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ALFA appreciates the opportunity to provide input into the Productivity Commission draft report into rural R&D. This submission represents our third submission to the review. ALFA has additionally contributed and is a signatory to the two Across Agriculture Group submissions.

Given our previous submissions, ALFA will not reiterate our stated arguments but will confine our commentary to the detail within the draft report.

ALFA believes that the primary draft Productivity Commission recommendations in relation to reducing Government spending on agricultural R&D to be too heavily focussed on idealistic economic theory and economic rationalism than the reality faced by agricultural producers and the international markets in which they compete. ALFA believes that the case for increased (not reduced) level of R&D funding given the upcoming challenges in the sector is compelling and should not be ignored by short term politically driven imperatives.

The following represents our specific response to the Productivity Commissions recommendations;

Rural R&D in Australia

ALFA supports the Productivity Commission recommendation to establish a process to collect and maintain robust data on funding and spending within the agricultural R&D context. It is apparent that there is not clear definitive data on public sector funding of rural R&D, neither in Australia or overseas.

To this end, we question the Productivity Commission's analysis and draft conclusion that the public expenditure on rural R&D is extremely generous when compared to other countries and industries. In particular there seems to be contradictory data and reports regarding the level of Government support provided to agricultural R&D in Australia versus overseas. For instance, the Australian Farm Institute research affirms the incompleteness of the OECD data, particularly the near absence of consistent data on private investment in agricultural R&D across countries. Accordingly, we believe that insufficient analyses as been completed to enable the Productivity Commission to propose a recommendation which has such a significant and negative bearing on the agriculture industry.

Government R&D funding

ALFA strongly opposes the recommendation to reduce the 0.5% Gross Value Product (GVP) cap on rural Research and Development (R&D) by 0.025% per/ yr to a maximum of 0.25% of GVP over 10 years.

The proposed reduction appears to be arbitrary in nature, a judgment call without analysis to support the figure. Given there is a large amount of evidence and experience that shows the public benefit from government funded research in agriculture, ALFA remains skeptical that the recommendation is based more on political budget imperatives and unrealistic economic theory than the delivery of efficient and effective R&D outcomes. Agriculture is diverse and highly complex with the recommendations demonstrating a lack of understanding and knowledge of the sector.

A reduction in the R&D funding from the Federal Government to Research & Development Corporations (RDCs) will have direct and immediate negative impacts on agriculture. It is conceivable that the following will result from the proposed strategy;

- Farm productivity and efficiency improvements from rural R&D will reduce over time (as producers and private investors fail to offset the funding reduction) leading to competitive disadvantage issues, income and regional development impacts and an erosion of skills and capacity. It will also further erode intergenerational interest and opportunity in the sector.
- R&D would consequently be solely focussed on short term productivity and efficiency, its benefits would not be socialised as readily (leading to lower adoption rates) and spillover benefits for the wider community would significantly diminish. It would also be expected that investment in long term strategic R&D would not take place as this would provide a less attractive investment option for limited levy funds. Low priority projects will be dropped off the research program which will most likely be medium to long term projects with less of a private

focus. In other words, the impact of less government money into RDCs will be less high risk/high reward, public benefit research.
- Large adjustment costs, free rider concerns and the resulting inability of the levy system to address underinvestment in R&D.
- Significant industry dis-engagement in non-industry specific cross commodity rural RD&E and the loss of national science capability.
- Aggravation of the impacts already felt by the reduction in State Government R&D provision over time. In particular this has led to a significant loss in R&D capacity and resources with any further reduction in funding from the Federal Government exacerbating this impact such that Australia will be reliant on R&D undertaken overseas.
- Negative terms of trade impacts. A potential impact from reduced agricultural R&D spend would be increased importation of agricultural products and R&D as Australia's international competitiveness is eroded over time.

The Productivity Commission accepts that the benefits of rural R&D to industry and the community are significant. However, it argues that following the proposed funding cuts to industry RDC's, only low yielding R&D would be dropped and that in the long term there would be a strong case for producers and private funders to fill the gap left by Government given these benefits.

ALFA contends that reducing Government funding in rural R&D per annum will not result in producer and private R&D funding filling the gap left by Government (despite the high benefit cost ratios that exist). The reasons why this supposition is unfounded are as follows;
- Rural R&D investment by its nature has large lag periods from outlay to return. Accordingly, there is limited incentive for private investors to invest given the risks and extremely long periods before returns on investment are experienced.
- The cost of ground breaking rural R&D is large whilst the benefits are not guaranteed and hence risky. Accordingly, there is a disincentive for individual producers to directly invest in rural R&D outside the levy arrangements.
- In contrast, under the levy arrangements, the benefits of rural R&D are often incremental and socialised across all producers. Accordingly, even if the return on investment were shorter (let's say 5 years), individual producers still would find it difficult to quantify and hence appreciate the benefits. As a result, it would be difficult for producers to justify large increases in R&D levies as is proposed.
- Producer levies would not be able to fully offset the proposed reduction in Government funding due to highly fluctuating and generally low average incomes for the small to medium sized enterprises that exist in the sector. For instance, the Australian Bureau of Agricultural Research Economics concluded that average farm profits for broadacre businesses in 2008/09 was -$7,000[1]. With Australian farmers receiving the second lowest level of Government assistance among OECD countries, they already are at a distinct disadvantage in the highly distorted international markets in which they compete[2]. This is why there is already some resistance to the current levies being paid. The proposal will only exacerbate the current imbalance regarding overall Government support provided to Australian farmers versus their international competitors.
- The diversity of interests among producers within an industry also influences their incentives to act collectively by increasing levy funding. Relevant aspects of this diversity among agricultural producers include: the size of the firm, its technology, and the age of the operator. These aspects will influence whether particular producers can expect to adopt the resulting technological innovations, and thereby benefit from levy funded research. How much they will benefit and when are also important considerations.
- Academic research also confirms that producers will under-invest in agricultural R&D given the responsiveness of demand to changes in price for agricultural goods and resultant supply shifts at all price levels. Alston, Freebairn and James (2003, 2004) examined producer interests and the national interest in relation to levy funded research and concluded that if demand for agricultural goods is less than perfectly elastic (which is the case in reality), and research

[1] ABARE (2009), Australian Farm Survey Results, sourced from the internet 7/6/10 http://www.abareconomics.com/publications_html/economy/economy_09/afsr09.pdf

[2] OECD (2009), *Agricultural Policies in OECD Countries: Monitoring and Evaluation.* Sourced from the internet 7/6/10 http://www.oecd.org/document/54/0,3343,en_2649_33773_43202422_1_1_1_37401,00.html

causes a pivotal supply shift (the logical impact of R&D), the producer share of benefits is smaller than their share of costs of the levy, and as a result producers will under-invest in research from a national point of view[3].
- Australia, unlike countries such as the United States, has a relatively small agricultural sector yet has high regulatory costs for private investors to commercialise R&D. The example of animal health products is instructional in this context with the Australian Pesticide and Veterinary Medicines Authority requiring significant testing of such products under Australian conditions before they can be registered. As a result of the low return and high cost structure in Australia, few drenches and vaccines are registered in Australia relative to countries such as the US whilst imports of generic chemicals are readily available. Accordingly, in the absence of significant Government contributions, there is limited incentive for private investors to undertake significant rural R&D investment in Australia. If rural R&D investment were to be undertaken overseas as a result of the recommendation, Australia would jeopardise its competitive advantage in international markets.
- Australian legislation in regard to Intellectual Property is not as advanced as countries like the US with this particularly pertinent in the grain industry with Plant Breeders Rights legislation and the End Point Royalty collection system hampering the ability of breeding companies to fully recoup their R&D costs.
- The majority of the productivity and efficiency benefits from rural R&D are passed onto consumers in the form of more affordable, safer more ethically and sustainably produced food. This is because producers end up with only around 33% of the retail dollar with processors, transporters, wholesalers and retailers sharing the majority and because around two thirds of Australian agricultural production is exported. Given that producers don't receive the full benefit of rural R&D, they are less inclined to put more levy money into R&D.

We would also argue that whilst the proposition that reducing Government R&D funding will help drive efficiency gains in RDC's, unfortunately the small gains made will be more than offset by the overall negative impacts from the reduction in public funding. ALFA believes that other mechanisms would be far more effective to deliver such efficiency gains than major cuts in Government R&D funding. The recommendation would also not deliver more effective R&D as successful research depends on the project, the timing and often luck.

The Productivity Commission has questioned why some agricultural industries contribute above or below the matching GVP cap for R&D. The reason why this occurs is that the R&D challenges of each agricultural industry are different and the returns on investment of R&D across agricultural industries are similarly different. Agriculture is very diverse and R&D spending is only undertaken (irrespective of the matching dollar) on projects where it can be demonstrated that the outcomes will provide a net benefit to industry and indeed the general public. For example in the grain industry the return on investment from let's say varietal yield improvements is far more readily quantifiable than genetic pasture improvements in the meat and livestock industry due to seasonal variations. Accordingly, it is more likely that grain producers will invest above the GVP cap than the livestock industry.

We also argue that it is often extremely difficult to determine beforehand whether certain R&D projects will deliver net public benefits or indeed net private benefits. Accordingly, it is impossible to structure R&D programs on this basis.

Creation of RRA

The draft report recommends that a new RDC ''Rural Research Australia' (RRA) be created to fund broader R&D covering energy as well as land and water matters. It is proposed that it would be funded up to $50 mill/ yr from Government and RDC monies.

ALFA opposes the recommendation on the basis of the following arguments;
- It would create a new structure with associated overheads thereby increasing administrative costs to deliver R&D compared to the RDC model – a structure which the Productivity

[3] Alston JM, Freebairn JW, and James JS (2004), *Levy-funded research choices by producers and society*. Australian Journal of Agricultural and Resource Economics

Commission itself agrees has a number of strengths. Notably the Productivity Commission report states that redirecting funding towards Government departments, CSIRO's or universities would lessen the interaction with producers and create potentially costlier mechanisms to deliver such funding. The same argument applies to the proposed RRA.

- It would result in R&D being subject to political influence and the Federal Government attempting to pick winners. Such an arrangement would potentially jeopardise funding for arguably more important long term research to political whims and topical issues.
- The creation of a cross sectoral R&D body will not necessarily increase the amount of cross sectoral R&D because by its very nature, R&D that has cross sectoral benefits can be quite industry specific. For example, the delivery of carbon abatement needs to be investigated on an industry by industry context. The same applies for water use efficiency. Accordingly, this research should be conducted by individual RDC's.
- The Rural Industry Research & Development Corporation is already in place to deliver such cross industry R&D funding without the set up costs, additional overheads and Government interference.
- The transferral of Government rural R&D funding to RRA is at the expense of Government funding towards RDC's that contribute towards productivity growth and efficiency gains.

RDC model

ALFA supports the recommendations that all RDCs should be formally required to participate in a cross-RDC project evaluation process and that every RDC should be required to have an independent performance review. We do not have a position as to how frequently such a performance review should be conducted as the R&D project framework requirements would vary across each RDC. However with respect to MLA, we believe that an independent review (given the costs involved) need not occur more frequently than every 5 years.

We would support the recommendation that DAFF be required to prepare a consolidated, publicly available, annual report on RDC program outcomes. Such a process would impose an onus on the Government to effectively monitor the RDC program and take prompt and effective action to deal with any ongoing poor performance by an RDC

Levy arrangements

ALFA supports the retention of the levy mechanism and the recommendation for a maximum time limit of 6 months for Government to change levies after the receipt of a compliant request. Unreasonable delays in the implementation of ALFA requests to alter the proportion of grain fed beef R&D and marketing levy amounts has occurred in the past.

We would also support combining R&D and marketing levies as this would allow the correct allocation of funds between the two (with the approval of levy payers) as the need arose. As stated previously, it is currently a difficult and protracted process to alter the levy amounts between the two.

Whilst ALFA has concerns regarding the Levies Revenue Service not correctly attributing beef levies towards grain fed beef R&D, we are cautious regarding the costs involved with the recommendation to have routine performance and communication impositions on the organisation and whether the benefits to levy payers would override the costs involved.