INDUSTRY COMMISSION
SUBMISSION TO THE
QUEENSLAND DAIRY INDUSTRY
REVIEW

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Contents

1 Introduction and summary of conclusions

As part of their commitments under the Competition Principles Agreement, all States are to review their regulatory arrangements for the dairy industry. New South Wales is close to completing its review, while Queensland has commenced a review which will report in early 1998.

The Industry Commission made a submission to the New South Wales review in June of this year (IC 1997a). Following a discussion with the review panel, it made a supplementary submission elaborating on aspects of its earlier work (IC 1997b).

In the light of this work, the panel for the Queensland review wrote to the Commission requesting it to make a separate submission on the arrangements in Queensland (see appendix). Amongst other things, the panel requested advice on the assistance provided to the Queensland dairy industry by the current regulatory arrangements. This paper responds to that request.

Consistent with its submission to the New South Wales review, the Commission has limited itself to commenting on the farm-gate controls which govern the pricing and supply of drinking milk. Thus, it has not addressed the broader health and safety and milk quality issues which are also under review.

Moreover, it has not sought to replicate its work for the New South Wales review. Rather, it has attempted to synthesise the key messages on the benefits and costs of farm-gate regulation in the dairy industry and to look at whether differences between the Queensland and New South Wales arrangements alter the policy conclusions of that earlier work.

As set out in the Issues Paper, the dairy industry is a significant contributor to the Queensland economy. At the farm level, milk production is worth more than $300 million a year, making it the fifth largest rural activity in the State. At the regional level, its contribution to economic activity is even more important.

Further, incomes in the sector depend heavily on the farm-gate controls for drinking (market) milk. The Commission estimates that these controls are worth an average of nearly $60 000 a year to the State's dairy farms or around 30 per cent of gross farm cash receipts.

Nevertheless, the Commission considers that the case for retaining the current controls is weak:

- They reduce the efficiency of resource use in Queensland's rural sector and lead to lower consumption of drinking milk. While the efficiency costs associated with lower milk consumption are relatively small, the production efficiency costs are more significant, particularly in North Queensland. This reflects the impact of the pooling system for sales of market and manufacturing milk operating in that region.
- The benefits to dairy farmers are paid for largely by Queensland milk consumers. The tax on consumers could be of the order of 25 cents a litre, or close to $100 million in total. In proportionate terms, this tax on milk consumption is the highest in Australia.
- A tax on milk consumers to subsidise dairy farmers' incomes is an inefficient, and arguably inequitable, way of promoting regional development objectives.

In any event, maintenance of the current arrangements could prove futile if New South Wales deregulates its farm-gate controls and removes the accompanying restrictions on interstate trade in market milk. Without these restrictions, there would be a strong incentive for farmers in the north of New South Wales to transport milk across the border, thereby undermining the regulated price for market milk in Queensland.

Hence, in the Commission's view, the key policy issue for this review is not whether to deregulate, but rather how to deregulate so as to minimise the adjustment burden for farmers and dairy communities.

2 Special features of the Queensland arrangements

In broad terms, the farm-gate controls applying in Queensland are similar to those in New South Wales. The Queensland Dairy Authority sets a minimum price to farmers for market milk and manages or oversees arrangements which limit supply to levels consistent with demand at those prices. As in other States, the price paid to farmers is well above the price that would prevail in an unregulated market. It is through this price-raising effect that the controls assist dairy farmers (see further discussion below).

In South East Queensland — the major dairying region — a statutory quota system is used to determine farmers' access to the lucrative drinking milk market. This is essentially the same as the New South Wales system.

However, in the State's other two dairy regions, the detailed supply management arrangements are different from those in New South Wales. In Central Queensland a quota system also operates, but it does not have statutory backing. In North Queensland, pooling arrangements operate to average the returns from drinking and manufacturing milk, so that all farmers benefit from the higher prices obtained for drinking milk. Similar pooling arrangements apply in Victoria, Tasmania and South Australia.

There are also differences in the detailed workings of the quota systems in South East and Central Queensland compared with the system applying in New South Wales. For example, in Queensland, quotas are denominated in terms of the right to supply a litre of milk for every day of the year. In New South Wales, a quota gives the holder the right to supply a litre of milk during a particular four week period. And, unlike New South Wales, Queensland has no formal quota exchange.

These differences in the detailed working of the Queensland quota systems do not appear to have any significant ramifications for the applicability of the analysis in the Commission's submissions to the New South Wales Review. Nor does the non-statutory nature of the Central Queensland system.

However, the pooling system applying in North Queensland does introduce a new dimension to the analysis. As discussed below, it is likely to increase the efficiency costs of regulated farm-gate prices.

3 Assistance to the Queensland dairy industry

As requested by the review panel, the Commission has prepared estimates of the assistance provided to dairy farmers by the current farm-gate controls. In its view, this assistance to farmers is paid for largely by consumers through higher milk prices (see further discussion below).

To provide an overall picture of support provided to the industry, the Commission has also estimated assistance to Queensland farmers from the Commonwealth arrangements for manufacturing milk.

The Commission has calculated four summary measures: the nominal rate of assistance, the price distortion, the producer transfer and the effective rate of assistance (see box 1).

The Commission stresses that these measures primarily reflect the transfers from consumers to producers under the current arrangements. As such, they do not indicate the net efficiency costs to the community as a whole of the current arrangements, or provide an accurate guide to likely resource flows if the arrangements were dispensed with. For example, the net efficiency costs are likely to be only a fraction of the producer transfer estimates reported in table 1. Further, under the quota regimes applying in Central and South East Queensland, assistance provided to dairy farmers by the farm-gate controls need not increase total milk output. This is in contrast to the usual effect of assistance in increasing an industry's output. (These issues are discussed in detail in section 5).

Box 1: The Commission's assistance measures

The nominal rate of assistance: This measures the assistance provided to an industry's outputs. It is equal to the percentage increase in gross per unit returns attributable to that assistance.

The effective rate of assistance: This measures net assistance provided to an industry's value added. It is equal to the percentage increase in unit value added, after accounting for the benefits of assistance on outputs and inputs, and the tax effect of any tariffs and other policy-induced cost imposts on inputs.

The price distortion: This measures the price-raising impact of assistance to an industry. It is equal to the percentage increase in prices at the ex-factory or farm-gate level attributable to that assistance. (If all assistance to an industry's outputs increases prices and all production is sold domestically, then the nominal rate and the price distortion will be the same.)

The producer transfer: This measures the dollar value to producers of assistance on an industry's outputs. While such transfers are not directly comparable across industries, they are an accessible indicator of the significance of government support for a particular activity.

IC (1997a) provides more details on these measures and the underlying assumptions and qualifications.

Nonetheless, the estimates are a useful input to any analysis of the benefits and costs of the current arrangements. The nominal and effective rate estimates allow comparison of the level of support provided to dairy farming in Queensland with that provided to dairying in other States and to other activities in the economy. And, as well as providing an indication of the tax on milk consumers, the producer transfer estimates provide a guide to the likely significance of the adjustment challenge facing the industry in the event of deregulation of farm-gate pricing and supply.

The Commission's estimates

As discussed in detail in IC (1997a), the Commission's assistance estimates for market milk are derived from the difference between the regulated farm-gate price (less any costs incurred by farmers in transporting milk to processors) and an estimated price for that milk in an unregulated market. For the purposes of this calculation, the 'benchmark' unregulated price is set equal to the Australian average price for otherwise identical manufacturing milk, plus a 20 per cent loading for the cost of assuring out of season supply.

As is apparent from table 1, milk production in general, and market milk production in particular, are very highly assisted compared with most other agricultural activities. Moreover, as set out in the Commission's initial submission to the New South Wales review, assistance to market milk has increased substantially in recent years. This is in contrast to declines in assistance to virtually all other parts of the economy.

Table 1: Assistance to milk production in Queensland and Australia, 1995–96

	Queensland	*Australia*
Market milk		
– price distortion (cents/litre)	25.6	20.6
– producer transfer ($m)	95	380
– nominal rate (per cent)	88	71
– effective rate (per cent)	>200	>200
Manufacturing milk		
– nominal rate (per cent)	11	7
– effective rate (per cent)	30	19
All milk		
– nominal rate (per cent)	50	21
– effective rate (per cent)	>200	62
Average for agriculture		
– nominal rate (per cent)		4
– effective rate (per cent)		12

Source: Commission estimates

As table 1 also indicates, assistance to market milk in Queensland is considerably higher than the Australian average. Indeed, the estimated price premium attributable to the current farm-gate controls in Queensland of more than 25 cents a litre, is more than 4 cents a litre higher than the premium in any other State.

The Commission notes that its estimates assume that Queensland farmers incur an average cost of 2 cents a litre in transporting milk to processing plants. This assumed margin is towards the lower end of margins in some of the other States for which the Commission has detailed transport cost information. Increasing the transport cost margin would result in lower estimates of assistance for market milk than are reported in table 1. However, given the size of transport margins relative to the overall price premium for market milk, such reductions would not invalidate the basic conclusion that market milk production in Queensland is very highly assisted.

Table 1 also reports assistance provided to manufacturing milk production in Queensland through the Commonwealth market support arrangements (see IC 1997a for details).

As estimated in the table, these arrangements provide somewhat higher assistance in Queensland than the Australian average. This reflects the lower than average manufacturing milk price in Queensland — 19.2 cents a litre (net of transport costs) in 1995–96 compared with the Australian average of 24.3 cents a litre.

But when allowance is made for the levy paid by farmers on market milk production to help pay for Commonwealth subsidies to manufacturing milk, there is little benefit to Queensland farmers from the Commonwealth arrangements. In 1995–96, the Commonwealth levy of 1.9 cents a litre on market milk production raised around $7 million from Queensland dairy farmers. Those same farmers received around $8 million under the support arrangements for manufacturing milk. This result contrasted strongly with the outcome for Victorian farmers who paid levies of around $10 million but received $110 million in payments.

Quota price data

In its submissions to the New South Wales review, the Commission used data on prices for market milk quota to check its assistance estimates. In essence, the price that farmers pay for the right to supply the lucrative fresh milk market provides an alternative estimate of the price-raising effects of the farm-gate controls. As quota systems for market milk operate in Central and South East Queensland, this check can also be applied to the Queensland arrangements.

The Issues Paper for this review states that the price for a 'day litre of quota' is currently around $350 in South East Queensland and around $300 in Central Queensland. The Commission understands that a day litre quota entitles the holder to supply a litre of market milk every day of the year in perpetuity. Hence, on a per day basis, these purchase prices are equivalent to around 95 cents a litre in the south east of the State and around 80 cents in the central region. Discounting this 'in perpetuity' per litre rate then provides an estimate of the 'one-off' value for the use of quota which should approximate the price-raising effects of the farm-gate controls.

In its initial submission to the New South Wales review, the Commission discussed in some detail what an appropriate discount rate in the dairy industry should be. Given the uncertainty facing farmers about the future of farm-gate controls, it settled on a discount rate of 25 per cent. While high, this rate was well below that implied in advice provided by the New South Wales Dairy Farmers Association to farmers contemplating the purchase of quota.

Applying a 25 per cent discount rate to the Queensland data would give a value of quota in one-off use of between 20 and 24 cents a litre — only slightly less than the Commission's estimated price premium. Moreover, farmers will discount the price of market milk quota to reflect the levy they must pay under the Commonwealth support arrangements for manufacturing milk. This levy, which is scheduled to end in 2000, was nearly 2 cents a litre in 1995–96. And any restrictions on the transfer of quota between farmers and regions will further diminish its price. While the Issues Paper suggests that quota are now freely transferable, it is not clear, for example, whether short term leasing arrangements are permitted.

In sum, the quota price data reported in the Issues Paper seem broadly consistent with the Commission's estimates of the increase in returns to Queensland dairy farmers from the current farm-gate controls.

4 Implications for retail milk prices

In its submissions to the New South Wales review, the Commission argued that farm-gate controls in the dairy industry benefit farmers by taxing milk consumers.

The implication of this argument is that if farm-gate controls were abolished, retail milk prices would fall by an amount similar to the Commission's price distortion estimates. Based on 1995–96 prices, this would suggest a retail price fall in the vicinity of 26 cents a litre in Queensland. However, this price distortion estimate includes the Commonwealth levy on farmers of 1.9 cents a litre (in 1995–96). Thus, were deregulation of the farm-gate controls to occur before 2000 when the levy arrangements will end, the implied fall in the retail price of milk would be around 24 cents a litre.

During the New South Wales review process, dairy interests strongly disputed this aspect of the Commission's analysis. There were two main strands to their arguments:

- It would not be economic for farmers to supply market milk at the farm-gate price of around 30 cents a litre implicit in the Commission's analysis. Thus, a higher price would be required to equate market demand and supply, meaning that the Commission's price distortion estimates overstate the potential fall in retail milk prices.

- Larger retailers would take the opportunity provided by deregulation to increase their margins, further diminishing or even eliminating any retail price reductions. In support of this contention, dairy interests drew parallels to retail price increases in those States which have deregulated post farm-gate controls, as well as to increases in milk prices in New Zealand following deregulation.

Farm-gate prices

The Commission acknowledges that an average farm-gate price of around 30 cents a litre would be insufficient to sustain many existing Queensland dairy farmers under current methods of production. ABARE financial data (1997) suggest that average dairy farm cash costs in Queensland are around 30 cents a litre. And, when allowance is made for depreciation and the value of family labour, the per litre cost rises to more than 40 cents. However, caution is required in interpreting the ABARE data given that costs apparently include those associated with non-dairying activities undertaken on dairy farms. Non-dairying activity represents somewhere between 10 and 20 per cent of total farm activity on average.

But in any event, reference to *average* production costs in the industry *at the present time*, inevitably leads to an overly pessimistic view of the industry's cost competitiveness in the future.

While many higher cost producers could find it difficult to reorganise their operations to supply market milk profitably at 30 cents per litre, many of those with lower costs may well be able to do so, especially if they can obtain additional resources cheaply to increase throughput (see below). Indeed, in 1995–96, Queensland farmers supplied around 380 million litres of milk for manufacturing at an average price (net of transport costs) of only about 19 cents a litre.

The Commission notes the industry's argument that, while returns on this out-of-quota manufacturing milk more than cover marginal costs, usually they do not cover average costs. The industry goes on to argue that the market milk premium is necessary to render total milk output profitable.

In economic terms, however, this means that farmers are operating with unrealised economies of scale. The implication is that with rationalisations and farm amalgamations to increase throughput, average costs would be lower (see further discussion below).

The improvements in productivity necessary to make total milk production profitable at a price of around 30 cents a litre may seem daunting when viewed in isolation. However, they become less so when viewed in the context of ongoing improvements in productivity in the dairy industry in Queensland and the rest of Australia, and in the rural sector more generally. For example, between June 1991 and June 1996, dairy farm numbers in Queensland declined by 13 per cent, yet milk output rose by 20 per cent. With the total herd size changing little, average yield per cow increased by more than 30 per cent over this period (ADC 1996).

Yet despite the farm rationalisation of recent years, at around 450 000 litres a year, average dairy farm output in Queensland is still 30 per cent lower than the average for Australia and 40 per cent below Western Australia — the best performing State in terms of output per farm. This suggests that there is considerable scope for further amalgamations to enhance the capacity of Queensland farmers to supply market milk at the deregulated price level implied by the Commission's assistance estimates.

In summary, the Commission emphasises that assessments of the industry's capacity to supply market milk at around 30 cents a litre must take into account expected and potential improvements in farm productivity, rather than being based on current cost and productivity levels.

In any event, even if the farm-gate price under deregulation were to settle at, say, 35 cents a litre, the implied tax on milk under the current controls would still be around 20 cents a litre. Thus, the Commission reiterates that whatever the precise magnitude, there can be little doubt that the impact of the current arrangements on farm-gate returns is large.

Flow-on to retail prices

The claim that 'middlemen' rather than consumers will capture the benefits of deregulation is often made by industries seeking to retain government controls which provide a benefit to them.

Separation of the impacts of deregulation from other influences on prices is often difficult. Yet there is evidence from a range of sectors to suggest that a substantial portion of the benefits of removing anti-competitive regulations does flow on to consumers, provided there is a competitive market place. This is why much of the debate in relation to dairy deregulation has been about the competitiveness of the food retailing sector and, in particular, about the likely behaviour of the large food retailing concerns.

The Commission has not undertaken a detailed analysis of the degree of competition in the retailing sector.

However, it notes that the argument that retailers could appropriate the cost savings from farm-gate deregulation relies on their having and exercising sufficient market power to hold retail prices at pre-existing levels. Presumably, this sort of power would not be limited to single commodities such as milk. Thus, if the argument is correct, the expectation would be that the profits of the large food retailers would be relatively high.

In fact, unpublished ABS information obtained by the Commission indicates that during the first half of the 1990s (the latest period for which the data were available), food retailing as a whole was only marginally more profitable than retailing generally. Moreover, during 1993–94 and 1994–95, against most profitability measures, small and medium food retailing enterprises — those employing fewer than 200 people and with assets of less than $200 million — outperformed larger enterprises in the sector. This is seemingly at odds with the view that large food retailers are exercising significant market power. The perception that food retailing is competitive is ostensibly shared by the ACCC which recently has approved a merger in the sector — between Woolworths and Cannons in the ACT.

This is not to rule out the possibility that retail milk margins will rise in Queensland in coming years. In December 1998, Queensland will abolish regulation of milk margins beyond the farm-gate. As discussed in IC (1997a), such regulations in Queensland and elsewhere have been designed to suppress processing and retailing margins. Thus, not surprisingly, these margins have apparently risen in States which have deregulated their post farm-gate controls.

Of itself, however, this is not evidence of the abuse of market power. That is, it may reflect no more than processing and retailing margins rising to competitive market levels.

This serves to illustrate that, in looking at the likely impact of farm-gate deregulation on retail prices, it is important to ‘net out’ the effects of deregulation beyond the farm gate. Any upward pressure on retail prices from an end to the controls on retail and processing margins will occur whatever happens to the farm-gate controls. Viewed in this context, subsequent deregulation of the farm-gate controls offers the prospect of a significant price offset for Queensland milk consumers.

In sum, the Commission is confident that deregulation of the farm-gate controls would mean that retail milk prices in Queensland would be significantly lower *than otherwise would be the case.* And, in the unlikely event that retailers and processors exercised market power to appropriate most of the benefits at the expense of consumers, there would presumably be grounds for taking action under Trade Practices or similar legislation.

5 Longer term efficiency and regional considerations

The preceding discussion suggests that uncertainty about the precise impact of farm-gate deregulation on retail prices should not be an over-riding consideration in whether or not to retain the current controls. Rather, any case for retention should centre on wider efficiency or social grounds.

Potential benefits of the current controls

In its submissions to the New South Wales review, the Commission discussed in detail the key 'public interest' arguments put by the dairy industry to support retention of the current farm-gate controls, namely to:

- ensure continuity of supply of quality fresh milk at stable prices;
- offset the market power of dairy processors and retailers;
- provide a bulwark against the vagaries of 'corrupt' world markets; and
- support regional economies.

The following section synthesises the key points made in those earlier submissions.

Continuity of supply and stable pricing

A long standing rationale for regulating the farm-gate price of drinking milk is to ensure continuity of supply and stable prices. Implicit in the latter is the presumption that consumers would resent fluctuations — down as well as up — in milk prices.

Because the cost of producing milk varies over the year, deregulation may well lead to seasonal variations in milk prices.

However, this would be no different from variations in the price of meat, fruit, vegetables and the like. For these staples, variation in prices, rather than regulation, is the means of ensuring year round supply. At those times of the year when production costs are higher, or when produce must be transported from more far flung regions, prices rise. When production costs are lower and supply more plentiful, prices fall.

Given that consumers cope with price variation for other staples, it is not clear why some seasonal variation in milk prices should be a problem for them. This is especially the case given that abolition of the current farm-gate controls could see average prices over the whole year in Queensland 25 cents a litre lower than they would otherwise be.

Providing countervailing power against powerful buyers

An extension of the argument that food retailers would appropriate the cost savings from farm-gate deregulation is that, in a deregulated market, retailers and processors would drive down prices paid to farmers below competitive market levels.

As discussed above, the scope for major retailers to exercise significant market power is open to question.

But even if retailers or fresh milk processors do have some market power, cooperative ownership in the manufacturing milk sector would constrain any abuse of that power. That is, if food retailers or non-cooperative processors sought to unreasonably reduce prices paid for drinking milk, farmers could instead sell their milk to the manufacturing cooperatives. This alternative outlet for milk production puts a floor in returns to farmers for drinking milk.

More generally, the Trade Practices Act contains general sanctions against the misuse of market power. Producers in any industry can take action under this Act.

A bulwark against corrupt world markets

Another argument for price support via farm-gate controls is to offset the impact of government subsidies to dairy farmers in other countries. These subsidies reduce export returns on milk used in Australia's manufactured dairy exports. In so doing, they also reduce the likely farm-gate price for market milk in a deregulated environment.

Were these overseas subsidies a temporary aberration, the provision of compensating assistance could possibly improve production efficiency.

However, in this context, the concept of temporariness relates to the time horizon of investments in the dairy industry. That is, the compensating assistance argument could have force only if the duration of corrupted prices was considerably less than this investment time horizon.

Clearly this is not the case. Overseas subsidies have been in place for decades and are likely to remain in force well into the next century, albeit at gradually declining levels. Thus, corrupted world prices will set the return that Australia as a nation gets from devoting resources to dairying rather than to other agricultural pursuits.

In this regard, dairying is by no means unique. Australia's beef and wheat producers, for example, also face corrupted world markets. Yet they do so without any 'compensating' assistance.

Therefore, the Commission does not consider it appropriate to attribute a 'compensating' production efficiency gain to the current farm-gate controls.

Supporting regional economies

Some would argue that supporting regional economies rather than improving efficiency is the main justification for retaining the current farm-gate controls. As noted earlier, dairying is a significant contributor to a number of regional economies in Queensland.

Ending the current income transfer to dairy farmers would, of course, have adverse effects for these regions. The severity of these effects would vary from region to region depending on such things as:

- the overall significance of dairying to particular regional economies;
- farmers' capacity to offset lower prices through productivity improvements;
- the scope for them to diversify into other agricultural pursuits; and
- alternative employment opportunities outside agriculture.

That said, the Commission acknowledges that these regional impacts would most likely be significant over the longer term as well as during the adjustment phase (see below).

However, losses in the dairy regions of the State would be offset by income benefits of a similar value in other regions (although the benefits would be more widely dispersed). These benefits would come from increased consumer spending on other goods and services made possible by reduced expenditures on milk (and flow-ons from any increase in profitability in the processing and retailing sectors). Thus, in broad terms, longer term regional benefits and costs would tend to cancel each other out.

There is an argument that transferring income to regional areas improves efficiency by encouraging people out of overcrowded cities.

But even if this argument has validity, an across-the-board tax on fresh milk to subsidise dairy farmers' incomes is an inefficient, and arguably inequitable, way of addressing the underlying urban externality. As discussed in the Commission's report on impediments to regional industry adjustment (IC 1993), if governments wish to sustain population in particular regions, there are advantages in approaches designed to make the regions concerned more attractive to capital generally, rather than sponsoring individual firms or activities to locate there.

The efficiency costs of the current controls

The Queensland farm-gate controls have both consumption and production efficiency costs. Unlike the income transfers to farmers from the rest of the community, wasted consumption opportunities and an inefficient use of farm resources are a *net cost* to the community as a whole.

Consumption costs

As set out above, the current farm-gate controls may increase retail milk prices in Queensland by as much as 26 cents a litre, or close to 30 per cent. Assuming a price elasticity of demand of –0.15 (see IC 1991), the implied reduction in milk consumption is around 4.4 per cent or some 16 million litres a year. The implied consumption efficiency cost is therefore around $2.1 million a year.

Production costs

While harder to quantify, the production efficiency costs of the current controls are likely to be more significant than the consumption costs.

The farm-gate controls reduce production efficiency in two ways. Price support can lead to an overall increase in milk production using farm resources which would produce more benefit to the community if used in other activities. Price support mechanisms can also lead to an inefficient distribution of production within and across States.

Within Queensland, these effects will vary across regions because of the different ways in which price support is administered. Specifically, the efficiency costs of the pooling system in North Queensland are likely to be proportionately higher than the costs of the quota systems operating in the other regions.

As discussed in detail in IC (1997a), where market milk quotas are used to implement price support, there may be little incentive for farmers to increase overall milk production. That is, on the production side, the primary effect of quotas can simply be to redistribute milk from the manufacturing to the fresh milk market. In these circumstances, the usual production efficiency costs from an assisted increase in output would not arise.

However, this does not mean that the market milk quota schemes in Central and South East Queensland have no production efficiency costs.

- Any restrictions which limit the movement of quota to farmers who can produce milk most cheaply will increase the cost of meeting overall market milk requirements.
- The quota system involves administrative and compliance costs for the Queensland Dairy Authority, processors and farmers.
- The argument that the market milk premium is necessary to support some farmers' manufacturing milk production suggests that the current system may well have led to some increase in overall milk production.

The production efficiency costs associated with the price pooling system operating in North Queensland are easier to estimate. Under that system, returns from market and manufacturing milk are blended, so that all farmers automatically benefit from the higher prices for market milk.

Unlike the quota system, the pooling system contains a clear incentive for producers to expand total milk output beyond the efficient level. Under the quota system, returns on 'marginal' out-of-quota milk production are equal to the competitively determined, manufacturing milk price. But under the pooling

system, the return on marginal production is higher, being equal to the weighted average of the market and manufacturing milk prices.

In 1995–96, total milk production in North Queensland totalled around 120 million litres of which 48 million litres were sold as market milk. The Commission estimates that reducing the farm-gate market milk price to around 30 cents a litre would have reduced the weighted average price to farmers from about 34 to 23.6 cents a litre, or around 30 per cent. Using a reasonably conservative output elasticity of 1.5 (see IC 1991), the implied reduction in production in North Queensland would have been 45 per cent or more than 50 million litres a year. The implied production efficiency cost of the current controls in this region is therefore close to $3 million a year.

Finally, like the arrangements in other States, Queensland's market milk regulations almost inevitably contribute to an inappropriate distribution of milk production across Australia. The farm-gate controls and the related regulations limiting interstate trade in market milk mean that each State meets most, or all, of its market milk requirements. On the presumption that the cost of production varies across States, this reduces efficiency from Australia's point of view. That is, with unrestricted interstate trade in market milk, it would be possible to meet Australia's overall market milk requirements more cheaply.

Some argue that deregulation would not result in significant interstate trade because of natural protection provided by transport costs and the presence in each State of sufficient low cost producers to meet local market milk needs. The implication is that the efficiency costs of the current State-based production configuration are relatively small.

But clearly there would be potential for trade in market milk between Northern New South Wales and South East Queensland in the event of farm-gate deregulation. Ultimately, only the market test provided by deregulation will conclusively resolve the debate on the significance of the costs associated with the current restrictions on interstate trade.

6 Conclusion

In the Commission's view, the case for Queensland retaining its farm-gate controls is weak.

The efficiency arguments to support the current controls are far from compelling and could apply equally to other industries which receive much less government support. And, the controls have demonstrable efficiency costs, as well as being a significant tax on milk consumers.

Of course, the public benefit test underlying the Competition Principles Agreement has dimensions other than efficiency — for example, regional and social impacts.

But on these grounds as well, the case for retention of the current controls *in the longer term* is weak. Clearly, the controls boost activity and jobs in the State's dairy regions. However, there are matching costs for other regions, albeit less concentrated than the benefits. More generally, an across-the-board tax on milk is an inefficient way of promoting regional development.

For these reasons, the Commission considers that Queensland should deregulate its farm-gate controls in the dairy industry. Indeed, if other States deregulate their controls, trying to maintain the status quo in Queensland would probably be futile. That is, with much lower farm-gate prices in other States and no restrictions on interstate trade, there would be a strong incentive for farmers in these States to export market milk to Queensland. This would quickly undermine the regulated price in Queensland.

Thus, the Commission sees the key issue for this review as being how to deregulate in order to minimise disruption in the industry and adjustment costs for farmers and dairy communities, rather than whether to deregulate.

Managing adjustment

The transfer to Queensland dairy farmers of close to $100 million under the current arrangements indicates that farm-gate deregulation will pose a sizeable adjustment challenge. This transfer is equivalent to about $60 000 per dairy farm or some 30 per cent of average cash receipts.

Easing the adjustment burden could involve giving farmers notice of future deregulation, but retaining the current arrangements for a further 'grace' period. Alternatively, deregulation could be phased in. This would involve progressive reductions in the regulated farm-gate price for market milk until such time as the regulated price fell below the unregulated price.

Delayed or phased introduction could provide the means for even recent investments in the dairy industry to earn a reasonable rate of return. But at the same time, it would deter new investments which were dependent on artificially inflated milk prices. Phasing or delayed deregulation would also mean that reductions in dairy farmers' incomes and the flow-ons for dairy communities occurred more gradually.

If phasing or delayed deregulation was not sufficient to ameliorate adverse adjustment impacts, it would be possible to provide some specific regional assistance. This could extend to some form of quota buy-back arrangement (at

least in the central and south east regions of the State). However, as the Commission's initial submission to the New South Wales review argues, a buy-back scheme would not be without problems. For example, it would provide the same level of adjustment assistance to farmers who have reaped the benefits of higher market milk prices for many years as to those who have purchased quota only recently.

Suffice it to say that the range of adjustment options available to government means that transitional costs are not a reason to retain the current farm-gate controls in perpetuity.

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Appendix

Copy of a letter received on 8 September 1997 from the Queensland Dairy Legislation Review Committee:

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Dear Mr Scales

The Committee has been appointed by the Hon. T J Perrett MLA, Minister for Primary Industries to undertake the review of the *Dairy Industry Act 1993* in terms of the requirements of National Competition Policy.

The Committee is undertaking a comprehensive program of consultation as part of the review process and would like to receive as many views as possible regarding regulation of the Queensland dairy industry. The attached Issues Paper has been developed to outline the review issues and to form the basis for public submissions.

In view of your continued involvement in the estimation of assistance measures to the dairy industry, I would like to invite the Industry Commission to participate in this review by forwarding a submission which includes the Industry Commission's findings regarding assistance to the dairy industry both at the national and state level, and to present this submission to the Committee.

I am aware that the Commission has participated in the New South Wales dairy legislation review in a similar manner and the Committee has considered both

of the Commission's submissions in that regard. While the Queensland review issues are similar it should be noted that there are a number of significant differences in the ways in which the two industries are regulated (eg supply management and promotion). The Issues Paper details the Queensland arrangements.

I am cognisant of the short time period to the scheduled close of submissions on 3 October 1997 and would be prepared to consider an extension if necessary.

A series of hearings will subsequently be conducted to gather further information. Should the Commission choose to make a submission it may also wish to present it at one of the hearings to be conducted in Brisbane on 14 November or 11 December 1997.

I would be obliged to receive your advice in due course and would be pleased to provide any further information required.

Yours sincerely

Hon. Sam Doumany
CHAIRMAN

Att. Issues Paper