

Developing equitable and affordable
government responses to drought in
Australia

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Australia is the driest inhabited continent on earth and also experiences a high degree of climate variability. As such, drought is a frequent occurrence and drought of some magnitude is occurring somewhere in the country most of the time. Since the arrival of European-style agriculture, drought has been a recurring problem for Australia's farmers. The impact has been felt well beyond the farm sector. Although agriculture's contribution to the Australian economy has reduced from 18 per cent of GDP in 1952-53 to around 3 per cent in 1995-96¹, drought still has a significant impact on the overall economy. In 1994, the Australian Bureau of Agricultural and Resource Economics estimated that the drought which was affecting much of eastern Australia at that time had reduced Australia's national income by 0.5 percent or about \$2 billion.

In May 2002, the agenda for the meeting of the agricultural Ministerial Council, recently renamed the Primary Industries Ministerial Council, included consideration of the Exceptional Circumstances program through which support is provided to drought-affected farmers. Exceptional circumstances policy has almost become a standing agenda item for discussion at these meetings with very few not considering the issue in one form or another. At the time of writing, the outcome of the meeting had not been made public but it is understood that the sticking points were the definition of "exceptional circumstances" and the appropriate funding split between the Commonwealth and State and Territory governments.

What is now presented is a contribution to this contemporary policy discussion and development, and is organised as follows. First, we consider briefly the history of Australian drought support policy. It is clear that over the last half-century or so, Commonwealth Governments have acted consistently with the notion that it is appropriate and desirable for taxpayers to support farmers suffering from drought.

Second, we examine critically the arguments typically offered as justifications for government subsidisation of farmers experiencing drought. In general it seems to be the case that there is no obvious and compelling economic rationale for taxpayers to underwrite financial support for farmers in periods of low precipitation. Indeed, it is very

likely that broadly based taxpayer contributions to farmers are regressive when seen in the context of relative lifetime wealth: they involve redistribution from many who are asset-poor to those who might be asset-rich.

Third, we explore several problems of a political and policy nature related to contemporary approaches to drought relief. It appears that there are at least three issues that have concerned policy makers in recent years: the definition of drought for practical purposes; the importance of the distinction between the family farm and the farm business; and the role of drought policy in the context of structural adjustment. We add a fourth consideration to this list – the cost of drought relief and the appropriate means for meeting that cost.

Finally, we offer a novel and alternative approach to the problem, aimed at addressing the conceptual, redistribution and practical weaknesses of current policy. This involves the suggestion of the use of government-financed loans with the unique feature that repayments are required only if and when farm revenues have recovered. The method builds on the foundations underlying the Higher Education Contribution System, which in international terms was the first use of income contingent loans to finance university charges. Many details remain to be explored further, but it is at least clear that considerable potential exists for improvements in drought policy along the lines suggested.

Historical and conceptual context

A brief history of Commonwealth Government drought relief policy

The Commonwealth Government has expended large sums on drought relief in recent decades. Between 1992 and 1996 Queensland and New South Wales experienced prolonged drought which was considered to be the worst such event in the twentieth century. Severe droughts had previously occurred in 1982, 1966 and between 1895 and 1902. As this paper is written, farmers' representatives and the media are already presenting the nascent drought in these two States as a catastrophe of similar proportions. The following sets the historical and conceptual context for Commonwealth Government

involvement in the provision of drought relief as background to the discussion of the problems with present forms of intervention and a possible solution.

In policy terms, drought was treated for many years as a natural disaster. Constitutional responsibility for responding to disasters lies with the State governments and initially the Commonwealth was not involved in disaster relief. However, in 1939, £1000 was provided to Tasmania for bushfire relief and from then on the Commonwealth became involved on an *ad hoc* basis, gradually increasing its financial contribution. The Commonwealth generally shared the cost of personal hardship relief and the restoration of public assets to their pre-disaster standard on a dollar for dollar basis with the States, although this arrangement was augmented with special purpose support, such as that provided by the two *States Grants (Drought Assistance) Acts* of 1966 and the *New South Wales Grant (Flood Mitigation) Act* of 1971.

Through the combination of these mechanisms, the Commonwealth contributed substantial amounts of money to disaster (including drought) relief with little control over the purpose for which the money was spent. In 1966, for example, Menzies virtually wrote a blank cheque for the Premiers of Queensland and New South Wales for drought relief, telling the Commonwealth Parliament that he had promised them that “Commonwealth assistance would cover whatever deficit they ultimately might have in their budgets as a result of drought measures that might be taken”².

In 1989, the Commonwealth Government decided that drought would no longer be covered by the Commonwealth-State Natural Disaster Relief Arrangements. It is probable that the motivation for the decision was budgetary, as drought relief dominated the disaster relief budget, accounting for 57.6 per cent of Commonwealth expenditure in this area between 1962-63 and 1987-88³. There were also concerns about the misuse of the disaster relief scheme by the Queensland government, with the Commonwealth expressing the view that the Queensland government was using the scheme “as a sort of National Party slush fund”⁴.

The announcement was followed in 1990 with the establishment of a Drought Policy Review Task Force (DPRTF). The Task Force rejected the concept of drought as a specific, defined event based purely on its climatic features and argued that it was inappropriate to treat it as a disaster. The Task Force suggested that “Managing for drought is about managing for the risks involved in carrying out an agricultural business, given the variability of climate”⁵. This approach has essentially underpinned Commonwealth government responses to drought ever since.

The DPRTF Report was followed in 1992 by a Senate inquiry into a national drought policy which endorsed a “self-reliant approach to drought” on the basis that “drought is a recurring feature of Australia’s climate that must be prepared for and managed”⁶. In July 1992 the Ministerial Council, then called the Agriculture Council of Australia and New Zealand, announced a new National Drought Policy. This was based on the same principles of self-reliance and risk management and proposed that the move to this new approach be supported through the Rural Adjustment Scheme (RAS), which was at that time under review⁷.

Rural adjustment schemes have been in operation in some form in Australia since 1935. Major reviews occurred in 1971, 1976, 1985, 1988 and 1992. The post-1975 schemes were very similar in format and tended to focus on the financial position of the farmer as the primary criterion for support. The 1992 review led to a refocussing of the scheme and a new legislative framework. The scheme was more market-oriented than its predecessors and focused on supporting productivity improvements by farmers with long-term, productive futures in agriculture. The incorporation of drought relief into RAS in 1992 was not new as the earlier schemes had also been used on a number of occasions to provide drought support to farmers. For example, in 1971 drought relief was provided to Tasmanian farmers through the *Loan (Farmers’ Debt Adjustment) Act* and in 1991 and 1992 carry-on assistance was provided under the provisions of the 1988 version of the Rural Adjustment Scheme.

However, the major innovation in the 1992 legislation was the introduction of the concept of “exceptional circumstances”, consistent with the principle in the National Drought Policy that, while farmers should prepare for “normal” droughts, there were events for which even the best manager could not be expected to prepare. According to the Minister’s Second Reading Speech, the exceptional circumstances provisions “would allow the Government to respond quickly and appropriately to severe downturns without undermining the direction and purpose of the scheme as a whole”⁸. There was a concern that drought responses in the past had been *ad hoc* and untargeted, and that a consistent, predictable drought policy framework would provide farmers with some certainty. It was hoped that this certainty would assist farmers in managing their businesses in response to market and climate risks and not on the basis of guesswork about possible government largesse in the event of drought.

Under the exceptional circumstances provisions the interest rate subsidies offered under the Rural Adjustment Scheme would be increased during a period declared to be an exceptional circumstance from a maximum 50 per cent to a maximum 100 per cent – this has since been phased down to 50 per cent. This support was, however, limited to those

farmers who would normally qualify for support through the scheme, ie “those farmers with good prospects for long term profitability”⁹. A major flaw with the new scheme was that “exceptional circumstances” were not defined in either the legislation or the Second Reading Speech.

In addition to its review of rural adjustment support, in 1992 the Commonwealth also undertook a review of its income-smoothing scheme, the Income Equalisation Deposits (IED) Scheme. This scheme was also mentioned as part of the National Drought Policy as providing an avenue for financial planning to assist risk management. The IED scheme was supplemented by a farm management bonds scheme, withdrawal from which was only possible in “periods of financial stress caused by factors such as, drought, commodity price collapse, severe disease outbreak etc”¹⁰. The IED and farm management bonds were both seen as mechanisms for moving farmers to a position of self-reliance through the accumulation of financial reserves, a position that it was hoped would reduce the need, if not the calls, for government support during dry spells.

Ironically, the first exceptional circumstances declaration did not relate to drought, but to excessive rain in South Australia and Victoria in early 1993, a decision that meant the new provisions were triggered immediately that the new scheme commenced. From the very start of the scheme, exceptional circumstances came to dominate. Already in drought in 1992, Queensland and northern New South Wales experienced worsening conditions throughout 1993 and 1994 and a series of exceptional circumstances declarations was made.

The last Rural Adjustment Scheme was reviewed in 1997, following which the Minister for Primary Industries and Energy announced that the scheme was to be terminated and replaced with a new package of farm support measures, with the exceptional circumstances provisions set up as a stand-alone program incorporating both the business support element of interest rate subsidies and a welfare component in the form of an Exceptional Circumstances Relief Payment. At the same time the Income Equalisation and Farm Management Bond Schemes were replaced by a new Farm Management Deposit Scheme. The philosophy of the new scheme remained the same as its predecessors, that is, to provide a tool for farmers to accumulate financial reserves to be drawn down during downturns.

Is there a case for government involvement?

Governments have delivered drought relief to farmers for decades and this has been justified in a variety of ways. As noted, until 1989 drought was considered to be a natural disaster and this formed the basis of the policy response. As Lawrence has stated :

So-called 'natural disaster' relief is considered an essential backstop by all political parties. The plight of the rural producer suffering the consequences of some unforeseen disaster is the stuff of television documentaries and political speeches. The image of a party is no-doubt enhanced by its generosity in aiding the hapless producer suffering through an Act of God.¹¹

Related to the disaster approach has been a concern with the protection of the resource base, including the preservation of the breeding herd. In its 1992 report on a national drought policy, the Senate Standing Committee on rural and regional affairs argued that "it is in the national interest for the Commonwealth Government to protect and maintain Australia's agricultural base and productive capacity, particularly Australia's breeding herd and flock"¹². Early drought relief schemes reflected this concern with an emphasis on the provision of subsidies for transporting fodder and moving stock to agistment. Although these practices have since been regarded as environmentally undesirable, as they discourage the early de-stocking of land, they are still employed in Queensland and New South Wales. In the latter case, these types of transaction based subsidies were announced by Premier Bob Carr as recently as 29 July 2002.

A further argument for government intervention has related to the adverse impact of previous government policies. In the 1860s and again after both World Wars, active policies of closer settlement were pursued for a variety of reasons. Many of the farms established under these programs have proved to be too small to be sustainable in the face of declining farm terms of trade. Advocates of drought support have suggested that governments have a moral obligation to assist farmers whose problems are not of their own making but are the result of poor past government policy.

It seems to be the case that many of the rationales offered for drought support can be traced back to views of the role of the farm sector which can be best described as agrarianism or, in the Australian context, "countrymindedness". Although not explicitly stated, the agrarian image of agriculture as a virtuous and noble undertaking can be gleaned from a wide range of documents which discuss rural policy in general and drought policy in particular.

In contradistinction to the above, there is perhaps an economic argument for Government intervention to farmers during drought that has some basis involving a possible form of market failure with respect to the delivery of credit to farm businesses. The essential credit argument used to support Government provision of financial assistance is that in some circumstances farmers have lost the support of their financial institution even though it is arguably the case that that are in fact viable over the long term and require carry-on finance to see their businesses through short term difficulties. This perspective underlay the early rural adjustment schemes and later schemes such as the Farm Household Support Scheme.

The above rationale can be seen to make some economic sense given certain bank behaviours. For example, if banks providing credit for rural industries are relatively risk-averse, it is likely that they will understate the capacity for a farm to recover after a drought, and so resist making further credit available in periods of contemporary calamity. While this behaviour is arguably inconsistent with profit maximisation on behalf of the banks, in environments characterised by high climatic uncertainty it might still be rational for credit agencies to be fairly parsimonious. In such circumstances a form of government intervention might be available to address the issue, and this is a main subject of ensuing analysis.

Apart from the above possible reason, a bottom line is that drought policy is essentially politically motivated; the rationales for intervention are often little more than assertions made to support the case for assistance. Part of the issue is that Australian media is very urban focused with few reporters understanding the complexities of drought policy. As a result, media reporting of droughts tends to be sensationalist, using stereotyped images of bare foot children, parched earth and dying sheep with little in depth analysis of the severity of the drought or the ability of farmers to manage its consequences. Heathcote notes that:

In any catastrophe, public sympathy goes out to the victims, but when those victims are the sons of the soil, on the margins of the good earth, struggling to give us our daily bread, the emotional response is tremendous and objectivity is often left behind.¹³

These images can be very powerful in supporting calls for governments to “do something” when there is a drought. The attempt in 1992 to establish a drought policy that would “allow the Government to respond to crises ... in a consistent, structured way rather than through *ad hoc* policy changes”¹⁴ was short-lived. In 1994, the exceptional circumstances provisions of the Rural Adjustment Scheme were supplemented with the introduction of a welfare payment – the Drought Relief Payment. This scheme followed

extensive media coverage of the drought, including the establishment by television personality Ray Martin of the Farm Hand appeal and much greater pressure from the Opposition which had previously pursued a broadly bipartisan approach to drought policy.

A range of reasons has been canvassed by farmers and their advocates for Commonwealth involvement in drought relief, ranging from the plausible to the highly dubious. The removal of drought from the Natural Disaster Relief Arrangements ended the “natural disaster” rationale but the Government continues to be persuaded, possibly by mostly political imperatives, that significant financial outlays are justified when there is a severe drought. The next section discusses the problems with the policy responses to drought that have been implemented to date. This is then followed by a discussion of an alternative approach.

Problems with the usual approaches

Australian governments have continued to grapple with the problem of developing an appropriate policy response to drought. A number of related issues challenge policy makers:

- the question of the definition of drought;
- the high level of integration between the farm family and the farm business, which means that policy makers need to confront the issue of whether drought support should be directed at the whole farm unit or be limited to the farm business; and
- the question of structural adjustment, which has important implications with respect to eligibility for drought support programs, ie whether support should only be available to farmers who are viable in the long-term.

In addition to these issues troubling policy makers, we suggest that the question must be addressed about how drought relief is financed and whether more equitable approaches can be developed.

The definition of drought

There is no agreed definition of drought. It can be meteorological, hydrological, agricultural and/or socio-economic¹⁵. In essence, it is drought's impact on human activities that is its most important feature – it is the result of a mismatch between demand for and supply of water¹⁶. Heathcote suggests that “the same rainfall which gave a bonanza wheat crop ... in the 1880s would be classed as a drought in the 1980s”¹⁷, due to the increase in the economic break-even point in wheat yields. The expansion of agricultural activity into marginal areas can also create the perception that droughts are increasing. Glantz notes the trend for human settlements to work their way “down the rainfall gradient” into marginal areas which are less suited to agricultural production¹⁸.

Australia's National Drought Policy was based on the principle that farmers should manage the risk of drought as it is a normal feature of their operating environment. Taken to its logical conclusion, such a construction of drought does not require drought declarations, as farmers adapt their management practices in response to the climatic conditions they face.

However, the introduction of the exceptional circumstances concept meant that severe drought needed to be separated from so-called “normal” drought events. The first few declarations of exceptional drought were based on fairly subjective assessments of the severity of the drought. By 1994, the Commonwealth and State governments moved to develop more objective, “scientific” criteria for the declaration of exceptional droughts. In October 1994, the Ministerial Council agreed six core criteria which would be taken into account by Commonwealth and State/Territory governments in considering exceptional circumstances applications. These criteria were:

- 1) meteorological conditions;
- 2) agronomic and stock conditions;
- 3) water supplies;
- 4) environmental impacts;
- 5) farm income levels; and
- 6) scale of the event.¹⁹

The framework specified that a rare and severe drought was a “once-in-a-generation” circumstance²⁰, with the meteorological situation as the threshold event. In 1999, the Ministerial Council blurred the definitional issue by removing the primacy of

meteorological criteria and agreeing that “Income becomes the key measure to determine the impact of the event, and whether assistance should be provided”²¹.

The biggest problem that has been encountered in the administration of the exceptional circumstances program has become known as the “lines on maps” problem. Since the 1992 National Drought Policy was announced, the focus has been on limiting drought support to those farmers experiencing extreme or exceptional drought. The objective has been to provide support only when the situation is dire – and not when the farmer is suffering a “normal” rainfall deficit. The exceptional circumstances support schemes for farm businesses have also been budget limited so elements of rationing have occurred. In order to determine eligibility, policy makers have identified geographic areas which are considered to be experiencing a severe downturn. This inevitably has resulted in farmers on the margins of such areas being excluded from support when their situations are arguably indistinguishable from those of their neighbours. In some cases, farms in need of assistance do not receive any help. To address this apparent inequity, the ministerial council agreed in August 2001 that

Farmers outside the defined zone, but who are in reasonable proximity and can also demonstrate that they are affected by the same exceptional events, will be eligible to make application under the same terms and conditions as those within the defined zone.²²

This decision has simply moved the lines rather than removing the inequity.

A further problem with the existing approach relates to equity between farms and the risk that poor managers are “rewarded” with government support. This concern was highlighted as early as 1965 when a Select Committee of the NSW Legislative Council recommended that

the measures of assistance which we believe would assist are in the form of incentives, not hand-outs. Hand-outs should be discouraged because this sometimes comes to the point where the least deserving receives the most assistance, and the man who has been a good manager and done a great deal to prepare for some such catastrophe as drought can be the one who will not receive any form of assistance²³.

The absence of an adequate definition of “severe” drought combined with the need to ration support through geographic criteria suggests that a scheme which is not tied to a meteorological event may be more equitable in providing support to farm businesses in financial difficulty. Such an approach is discussed below.

The farm family and the farm business

Australian agriculture is dominated by the family farm. Less than one percent of farm operations are incorporated²⁴ and there is a large number of small farms. The top 20 per cent of farms produce 80 per cent of farm output²⁵. In spite of recent attempts by governments to describe farmers as “farm business managers”²⁶ and references to the “farm family business”²⁷, it remains true of much of family farming in Australia that it is characterised by a “unity of business and household”²⁸. The family farm has its origins in land reforms of the 1860s when the colonial state governments moved to wind back the influence of the wealthy squatters and promote the development of “an industrious yeomanry”, as much a social ideal as an economic objective²⁹. In recent years, governments have emphasised that farming is a business and have structured programs in pursuit of economic objectives. The 1992 Rural Adjustment Scheme was focused on productivity improvement and its replacement, similarly focused, given the catchy title “FarmBis”. The idea that farming is a business is not new. In 1912, in what he described as a “text book on Australian agriculture”³⁰, Grasby wrote that “farming is very largely a matter of business”³¹.

In spite of this, the unity of farm business and farm family is still strong and governments have struggled with the issue of whether support should be structured to recognise this unity or whether it should clearly separate household and business support. In its 1990 Report, the Drought Policy Review Task Force suggested that the government should treat the farm as a single entity by recommending that “[t]he income support needs of rural families in severe financial difficulties are appropriately addressed through the Rural Adjustment Scheme”³². Only two years later, the consultants reviewing the Rural Adjustment Scheme gave the opposite advice³³. The government chose to follow the latter’s suggestion. More recently, the 1997 review of the RAS stated that

Welfare assistance should not be delivered through instruments that assist businesses. Such an approach confuses the objective of the intervention, does not effectively target the welfare problem and distorts market signals to farm businesses receiving assistance.³⁴

Attempts to separate family income support from farm business support, however, raise some issues for policy makers. Australia’s general social welfare safety net is primarily focused on wage and salary earners and the asset-rich, income-poor status of farm families can exclude them, even when they qualify for support on all other criteria. In general, welfare support in Australia is offered to those in need without regard to their future earning capacity. People who access the unemployment benefit may later in life accumulate significant assets but this does not detract from their right to access income

support when they are in need. A similar approach should apply to farm families, however a discussion of such a scheme is beyond the scope of this paper.

The question of business support is however, a different issue. Traditionally disaster relief in Australia focused on the relief of personal hardship and the restoration of public assets to pre-disaster standards. It is worth noting that “An important aspect of Australian government policy [was] that generally no assistance [was] made available for the repair or restoration of private assets affected by natural disasters, whether partially damaged or completely destroyed”³⁵. Recent policy approaches have shifted the emphasis more towards the preservation of private assets with schemes to provide interest rate subsidies to allow farmers to sustain their businesses during drought. This raises some equity issues as, while it is undoubtedly true that farmers experiencing drought will be receiving low incomes, it is very unlikely to be the case that they are economically disadvantaged in a lifetime sense. Many farmers in this situation are asset-rich, taking into account the value of their properties and, once the drought finishes, they will be back on track although many will have received considerable financial benefits to help them through the trauma.

The issues raised by the integration of farm business and farm family relate to:

- the equity of providing government support to asset-rich individuals during downturns;
- the business structures of many farms which enable farmers to “hide” income and an emphasis on capital accumulation at the expense of income³⁶ which makes assessment of a farm family’s true income situation very difficult; and
- meeting the welfare needs of the farm family without undermining the Government’s industry policy objectives for agricultural businesses.

Structural adjustment

One of the key principles guiding the policy-makers who developed the original drought policy in 1992 was that any response to drought should not undermine the structural adjustment process in agriculture³⁷. This principle extended to the provision of welfare support on the basis that untargeted income support could act as a subsidy to otherwise unviable businesses. Although there is no empirical evidence to support this assumption, and in fact it may be groundless³⁸, it had an important influence on the structuring of drought support policy. The centrality of this approach is reflected in the Minister’s Second Reading Speech: “There will be a focus on improved farm productivity,

profitability and sustainability through structural adjustment and more effective management of the farm business”³⁹.

The Drought Relief Payment, introduced in 1994, modified this approach by making income support available for all farmers in areas declared to be in drought exceptional circumstances, irrespective of the health of their businesses. Its replacement, the extended Exceptional Circumstances Relief Payment is also decoupled from business performance. The interest rate subsidies currently available under exceptional circumstances conditions, now with a maximum of 50 per cent, continue to be available only to farmers who are considered viable in the long term.

The National Drought Policy was structured in such a way as to ensure that drought support would be consistent with ongoing structural adjustment in the farm sector. Its emphasis on risk management and the provision of support only to those with a viable future in the industry was designed to ensure that the principles of self reliance and ongoing productivity improvement were promoted. The major problem with such an approach is that, during downturns, support is denied to those deemed to be unviable. The only support options have tended to involve farm exit – an option which can seem particularly harsh when the farm family is already facing the stress of drought. Until the introduction of the Drought Relief Payment this meant that farmers had no access to support for either the business or the family.

Policy makers are concerned, however that drought support for marginal businesses can in fact keep them going. If a farmer can make ends meet during good years and get support during bad years they can remain in farming even if their businesses are in poor shape. Governments interested in structural adjustment would prefer to see these marginal properties change hands either through amalgamation or be taken on by better resource managers who will manage the farm more productively.

Financing drought relief

Although the point is not given much coverage in discussions of drought policy, a critical issue is to recognise that government outlays for drought relief have to be financed in some way and that public sector subsidies are paid for from tax revenue. This means that all taxpayers are contributing to drought relief, and this raises the critical equity point related to farm assets. The vast majority of taxpayers do not own significant wealth-producing assets, meaning that it is likely that most of those paying for drought

relief will be less advantaged over their lifetimes relative to the farmers being assisted. In other words, grants to drought-stricken farmers are very likely to be regressive in a life-cycle context: they redistribute income away from those with less wealth on average.

Moreover, grants-based schemes are expensive. For example, in the three years 1993-94 to 1995-96, the Commonwealth Government in nominal dollars spent in excess of \$210 million on exceptional circumstances interest subsidies with a further \$82 million in 1994-95 and around \$130 million in 1995-96 outlaid on the Drought Relief Payment⁴⁰. It is worth noting that these aggregate figures disguise significant grants to individual farm operators. The average grant received by way of an exceptional circumstances interest rate subsidy in 1994-95 was a little over \$17,365. Currently, expenditure on exceptional circumstances support is in the order of \$100 million per year. These costs to the Budget have several obvious consequences, such as the diversion of government assistance from other (perhaps more deserving?) projects, or higher levels of taxes than would otherwise be the case.

Because of the regressivity associated with the nature of drought financing, the case for a drought relief subsidy seems to be weak. However, the possibility raised above that there may be a form of credit market failure suggests that there might be still be a case for government intervention. Under some unusually adverse and risky circumstances commercial banks might well be overly cautious with respect to the provision of new or the extension of existing lines of credit. In such circumstances there is arguably a valid reason for government financial intervention; the critical issue then concerns the nature and form of this intervention. The issue defines the remaining contribution of the paper.

An alternative approach: Income related borrowing

In essence, a government providing grants-based drought assistance faces an unpalatable series of choices: to have high levels of assistance is expensive and inequitable with respect to the relative economic circumstances of those providing the subsidy; to have low levels of coverage means that there are necessarily a large number of farms in need of help but not receiving any; and, there will be the arbitrary rules defining eligibility, implying that some properties experiencing drought-caused hardship will receive no assistance at the same time that other properties in the same circumstances will be eligible for considerable support.

The following sets out an alternative approach to drought support. In line with recent trends in government policy, it suggests the separation of the farm business from the farm family and as such, focuses only on the support needs of the business. It attempts to address a number of the major problems of the 1992 National Drought Policy and its successors by rejecting the need for drought declarations and “lines on maps” to determine eligibility. It also accepts the risk management approach underpinning recent drought responses.

The suggested approach offers improved forms of drought relief with respect to the above issues under the presumption that drought assistance will remain a significant aspect of agricultural economic policy in the near future. Thus the following is simply a possible alternative instrument for achieving the objectives of the National Drought Policy while addressing some of the equity problems inherent in the current approach.

Income related borrowing: Conceptual issues

The proposal builds on the risk management approach to drought pursued by governments since 1989. As part of that general strategy farmers have the capacity to build financial reserves in preparation for drought through the Farm Management Deposit scheme which provides a mechanism and tax incentives for farmers to prepare in advance for downturns such as drought. However, for those circumstances which are prolonged and for which the farmer has acquired inadequate reserves, or for farmers new to the industry who have not had time to build reserves, an additional policy instrument might be desirable.

The approach outlined below has been motivated by the view that there are major advantages associated with the use in public policy of government based income related loan policies. The first international policy of this type was Australia’s Higher Education Contribution Scheme (HECS), introduced in 1989 as a response to university funding problems⁴¹. While the basic motivation for HECS might seem to be a long distance from drought relief, there are remarkable similarities between the two areas. To assist understanding it is useful to describe the conceptual basis of student financing and in so doing make explicit comparisons with drought relief policy.

Governments face three broad options with respect to the financing of university education. Of great interest is that many of the consequences of each of the three approaches apply also to drought relief policy. This is now illustrated.

A no charge system

A university education could be offered to academically eligible students without charge, and this was essentially the nature of the Australian system from 1974 to 1989. Such an approach is very much in the flavour of current drought relief grants, in that assistance is offered to drought eligible farmers without charge.

There are two basic problems with having a “free” university charging arrangement. The first is that such a system is highly regressive in a life cycle context. Because “free” means financed by all taxpayers, the vast majority of whom will not have had the privilege of a university education and who will in general experience over their lives far lower incomes than the graduates they have financed⁴².

The second problem with not charging for higher education is that governments will often find themselves unable or unwilling to finance further expansions of the university system; budgets are, after all, limited. In the late 1980s this was a major problem for Australian higher education. Many academically eligible prospective students were denied a university education because the Commonwealth government was not prepared to provide the funding necessary to allow an expansion in the number of places to accommodate the excess demand⁴³.

It is remarkable that both of the problems associated with not charging for university education are present in different forms with respect to grants-based drought relief. That is, such an arrangement is essentially regressive in that subsidies are provided by relatively asset-poor taxpayers to relatively asset-rich farms. As well, it is clear that drought expenditures are insufficient to provide relief to all eligible farms because, as is the case with university financing, policy-makers have judged that there are not sufficient taxpayer resources available to assist all those in need.

Leaving the system to the market

Instead of providing university education free of charge, governments could leave the system to the market and allow universities to charge fees with no public sector financial assistance being offered to poor students. However, in such a circumstance prospective students with no access to finances will face enrolment barriers, for two reasons.

First, the commercial banking system will be unwilling to provide loans. The basic reason is that borrowing undertaken for investment in human capital is risky, and unlike as is the case for loans for housing mortgages, in the event of default the bank is unable to cover its losses through the sale of collateral – slavery is, after all, illegal. This “capital market failure” on the supply side is the basic reason that governments intervene in the provision of student finances.

Second, some potential students – particularly those with uncertain prospects – may be very reluctant to commit themselves to repaying loans to banks (even if such loans are available). If the future turns out to be poor, borrowers will have repayment obligations which might be hard to meet, or can only be met under duress. If hardships result in default, there will be major adverse implications for a former student’s credit reputation and thus access to future borrowings. In short, “leaving the system to the market” won’t work.

These commercial bank financing problems are arguably faced also with respect to agricultural credit provision. That is, under some risky circumstances banks will be unwilling to lend to tide a farm over and/or help finance a farm’s recovery. Unlike the case for investments in human capital however, banks will have access to collateral to sell in the event of default; but if the drought persists the bank may believe – perhaps accurately – that the value of the property is not such as to cover the risks and transactions costs of the loan.

Income related loans

A third broad approach to university financing involves the use of income related loans, and this is the method used in Australia (and increasingly, a large number of other countries). In 1989 HECS was introduced to address the university funding problems associated with either not having a charge, or of leaving the system to the market.

The defining characteristic of HECS is that university charges are paid if and only when a former student’s income exceeds a given threshold; at that time this threshold was average earnings. There is a critical issue associated with having an income contingent aspect to a loan. This is that if repayments depend on future success, it becomes very likely that the arrangement is associated with no risk of default for the borrower. And it is this absence of default risk that seems to be the reason that HECS has not been associated with the erection of barriers to university participation by the poor⁴⁴.

It is also instructive in the case of HECS that administrative costs of collection have turned out to be small, at less than half of one per cent of current revenue. This is because the Australian Tax System is very efficient. How such a scheme might work in the context of farm incomes is not completely clear, however, and is considered further below.

A HECS-type system replacing grants-based drought relief has the following advantages. First, it means that the assistance is not regressive. Farmers will have been helped to sustain their businesses when they needed such help, with potentially low burdens only for average taxpayers. Second, because much of the assistance will be repaid, the government will be able to afford to offer support to the vast majority of farmers in trouble. This will avoid the charge and reality of arbitrary rules with respect to eligibility.

There may be no sound reasons why the scheme could not be generally available to farmers at all times and not be linked to drought declarations. Such a scheme would be consistent with the principle that drought is a normal part of Australia's climate and would contribute to the removal of a "disaster" approach to drought support. An eligibility criterion may be required that farmers using the scheme are first denied commercial finance to ensure that the Commonwealth is not simply competing with the commercial financial sector. Participants in the scheme would also need to demonstrate that they were *bona fide* farmers and not earning large amounts of off-farm income.

Income related borrowing for drought relief: Implementation issues

There are many important parameters and issues related to the successful implementation of an income related loans scheme as part of a public sector response to drought (and potentially other agricultural calamities). The first relates to the basis of collection, or unit of repayment

Repayment of the Higher Education Contributions Scheme (HECS) debt is triggered when the former student's taxable income reaches a threshold. This mechanism works because the majority of graduates find employment as wage and salary earners and it is relatively straightforward for the Australian Tax Office to determine when the repayment threshold is triggered and to collect the repayments. Taxable income is a good measure of the former student's actual income situation.

In the case of farms, the situation is more complex. The true financial situation of the family farm is difficult to determine due to the blurring of business and family expenditure. Johnson explains:

There are several problems with analysing poverty among the self-employed. First many household expenditures such as housing costs, may have been paid wholly or in part by the business so there is an unidentified in-kind source of income; second many businesses may receive tax discounts on expenditures that apply to their households as well as to their business; third businesses may have the opportunity to average income over several years so that negative income may be recorded, and finally the structure of the business may involve more than one income unit making attribution of income difficult.⁴⁵

These perquisites of farming combined with the opportunities within the tax system for the self-employed to find deductions mean that taxable income is a misleading indicator of actual income⁴⁶. As a financial planner in New South Wales recently observed, "I am constantly amazed at the low 'taxable income' of rural people yet the high level of 'actual' income – in other words the high level of deductions"⁴⁷. Her comments applied to self-employed people in rural areas, including farmers and included a reference to the fact that depreciation "was actually a 'non physical book entry' and could actually be seen to represent [the] household food bill for the year"⁴⁸.

Taxable farm income is therefore not a useful measure of a farmer's actual income situation. Musgrave *et al* listed several problems with identifying farm income accurately, including:

- in the short run, depreciation does not represent a loss of funds available to the household;
- some personal costs (for example part of motor vehicle expenses) are charged to the business expenses on farms; and
- off-farm income is relatively common on small low-income farms and this increases disposable income.⁴⁹

The bottom line is that an income contingent loans scheme for drought relief should not use taxable income as the basis for collection of the loan. Instead it would appear to be much more preferable to use a measure of total revenue, such as gross sales, or of profits, such as gross operating surplus (the difference between total revenue and total costs), and to impose a flat percentage levy in periods following the borrowing.

Both measures are collected for the Business Activity Statement for GST purposes, and are thus available on a quarterly basis. Gross operating surplus would have to be calculated

and reported in an additional line, but available information suggests that this would not be difficult.

The use of revenue or gross operating surplus as the basis for loan collections is not ideal, since in some periods a high level of total revenue is not necessarily indicative of a high level of farm material welfare; for example, in difficult times involving the sale of assets. Consequently, to help insure against such exigencies, it is proposed that the levy be a low proportion only, perhaps a maximum of 5 per cent and/or have a ceiling on the level of repayments in any one year.

A second major issue concerns the rate of interest on such loans. One approach would be to have the real rate of interest set at zero; that is, adjusting the debt only for inflation. Compared to a real rate of interest, the scheme would have two properties: insurance against the size of the debt escalating in times of continuing adversity; and an implicit subsidy from taxpayers as the government would be losing the opportunity cost of the funds for each period in which the debt remained unpaid.

Alternatively, the scheme could be designed in a way that implicitly imposes a broad rate of interest, as HECS currently does. Specifically, students choosing to pay a HECS debt up-front receive a 25 per cent "discount", which is equivalent to repaying nominally an additional one third of the debt. An illustrative example is that farmers borrowing say, \$10,000, would agree to repay, say \$13,000. Given that apart from this there would be no additional real rate of interest, the monies recovered would come at around no cost to the budget. The extent of the subsidy is, however, ultimately a decision of government.

Finally, as is the case with HECS, a trust fund could be set up in which loan repayments were hypothecated to be used only to help finance additional agricultural credit outlays. Over the longer term this arrangement has the advantage of demonstrating the net benefits to government of moving away from a grants-based system towards a more equitable and affordable drought assistance system.

Conclusion

While this proposal requires further research and thought in terms of the practicalities of its implementation, its strengths are clear:

- It is consistent with the National Drought Policy which has been in place since 1992 and which enjoys broad bipartisan support.
- It builds on an approach of self-reliance and risk management, allowing farmers to manage the risk of drought over the lifetime of their involvement in agriculture.
- It can be implemented in such a way to decouple support from drought events entirely to reinforce the reality that Australia has a highly variable climate and this is a fact of life for farmers.
- It addresses many of the equity issues associated with existing policy, ie between farmers either side of the boundaries delineating drought and non-drought areas, between good managers and poor managers, and between farmers and the non-farm community.
- It addresses the problem of regressivity associated with the provision of subsidies by all taxpayers.

Eastern Australia appears to be entering another El Niño episode and drought is once again on the public agenda. It is therefore timely to consider alternative policy instruments which are arguable effective in relieving farmers' financial difficulties but avoid many of the inequities inherent in the measures that have been applied to date. A HECS model of income contingent loans has the potential to provide governments with an equitable and affordable alternative to the interest rate subsidies that are currently available.

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