THE DAIRY BOARD'S EXPORT MONOPOLY

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ABOUT THE AUTHOR

Winton Bates is an economic consultant, based in Canberra. Before becoming a consultant in 1995, he worked for two years as an advisor in the New Zealand Treasury. Prior to that he held the position of First Assistant Commissioner in the Industry Commission in Australia.

Winton Bates's career has had a focus on analysis of public policy issues. Aspects of his experience which are particularly relevant to this project include his contributions to Industry Commission reports relating to regulatory barriers to competition in Australia and extensive involvement, throughout his career, in analysis of issues concerning industry assistance and trade liberalisation. His interest in regulation of the marketing of agricultural products stems from his initial specialisation in agricultural economics, including seven years working in the Australian Bureau of Agricultural Economics.

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EXECUTIVE SUMMARY

- The Dairy Board's defence of the 'single seller' legislation that prevents potential competitors from exporting dairy products is now

based solely on the proposition that the international dairy market is not a 'fair place'.

• The analysis in this report explains why the Dairy Board's argument should be rejected.

• The central issue is whether retention of the Dairy Board's export monopoly is in New Zealand's overall economic interest. Protection and subsidies granted to industries by foreign governments do not justify a policy of import restrictions by New Zealand nor do they justify controls on exports. Domestic interventions of this kind usually cause resources to be misallocated and used inefficiently and thus reduce potential national income. They add to the burdens on the economy of other countries' policies, rather than offset those burdens.

• New Zealand can and should attempt, through persuasion and negotiation, to modify policies of foreign governments which damage its interests. However, in general, the policy implications for New Zealand of prices prevailing in international trade are the same whether these prices are heavily influenced by the policies of foreign governments or by the natural economic and commercial advantages or disadvantages of New Zealand's trading partners.

• Distortions in international markets for dairy products only provide a possible case for a well-targeted form of government intervention if they give rise to price premiums for New Zealand exports to specific markets that would not be available under competitive exporting. They cannot justify comprehensive monopoly controls.

• The export subsidies, tariffs and import quotas that distort the world market for dairy products do not generally allow exporting countries to capture price premiums in particular markets. It is only when an individual exporting country is granted preferential access to a market that is protected by significant quota restrictions that exporters may benefit from the high domestic price in that market. Such premiums are vary rare and have not led other dairy exporting countries to adopt single seller structures.

• The fact that by and large the world dairy market operates like other markets is illustrated by the similar level of prices in different markets which the Dairy Board obtains on sales of most products.

• Butter is the only product for which prices obtained on export sales by the Dairy Board differ substantially between major markets. The price obtained for butter varies between markets mainly because New Zealand has preferential access to the European Union under arrangements negotiated at the time when Britain joined the European

Economic Community. Sales of butter to the European Union now account for only 9 percent of the total value of New Zealand dairy exports.

• Retention of the Dairy Board's export monopoly is not necessary to ensure that New Zealand continues to capture the premium on sales of butter to the European Union. A much more satisfactory solution would be for the government to remove the single seller status of the Dairy Board and to allocate the EU butter quota to exporters by competitive bidding or tendering, with the proceeds being returned to farmers. Even the option of preserving the EU butter market for the Dairy Board would be preferable to the retention of the existing export monopoly covering all dairy products in all markets.

• Maintaining the Dairy Board's existing export monopoly is damaging to the community's overall interests because it limits innovation, shields the Dairy Board from competitive pressures to improve its efficiency, constrains the industry's ability to attract capital, distorts price signals to dairy farmers through the bundling of returns to on-farm and off-farm investments, and constitutes a barrier to the international linkages that are necessary to take full advantage of opportunities to develop new processes, new products and new markets.

• The Dairy Board's export monopoly does not serve any legitimate objective that cannot be achieved at much less cost by other means. The fact that the international dairy market is not a 'fair place' does not justify its retention. The minister of agriculture has stated that the removal of the monopoly controls is "inevitable". The government, which has the responsibility for taking into account wider community interests, should remove them without delay.

CHAPTER ONE

INTRODUCTION

The legislation granting the New Zealand Dairy Board the power to control the export of all dairy products gives it the status of an export monopoly. Although the Board is able to grant licences to other exporters, it does not approve applications for licences which it considers to be incompatible with its own strategy.

The Dairy Board's case for an export monopoly

The Dairy Board claims that being granted monopoly rights to export dairy products enables it to achieve higher returns for New Zealand dairy producers. This claim has traditionally been based on several different strands of argument. In the past, defenders of the Dairy Board's monopoly have suggested that:

- competitive exporting would result in 'weak selling';
- competitive exporting would prevent scale economies from being achieved;
- multinationals would enter the market and 'rip off' farmers; and
- competitive exporting would disadvantage the industry because the world market is distorted by government intervention.

The flimsy nature of the first three of these claims is obvious to anyone who understands the way markets work.

Weak selling

Supply and demand factors fundamentally determine prices in the international dairy market. Superior returns can only be retained through factors such as quality, product differentiation and brand loyalty. What evidence is there that the Dairy Board can exert market power without causing overseas consumers to switch to alternative suppliers or substitute products? Why would weak sellers – exporting firms that are not sufficiently 'on their toes' to take advantage of profitable selling opportunities – survive in an environment of competitive exporting? How would the New Zealand dairy industry be disadvantaged if the Dairy Board lost market share to competing New Zealand suppliers, rather than to suppliers from some other country?

Scale Economies

The optimal size of firms and the number of players in an industry are matters to be determined in the market place, not by governments. What is so different about provision of marketing services for the export of New Zealand dairy products that would prevent scale economies being exploited in a contestable market, as occurs in other countries and in other industries in New Zealand?

Fear of multinationals

New Zealand and overseas-owned multinational companies operate in most major industries in New Zealand, including other agricultural industries. There is a trend towards globalisation of many industries. If a large multinational were to become a significant player in the New Zealand dairy industry, what grounds are there to fear that it would be able to capture rents which currently accrue to dairy farmers? How could it 'exploit' dairy farmers and drive prices below competitive levels? If a

multinational processor were to offer uncompetitive prices, what would stop dairy farmers from responding as other farmers do in similar circumstances – by selling their produce to some other processor, or by using their land and labour for some other purpose? Would this be in the interests of the multinational?

As the absence of substance and logic in these arguments has been exposed, they have rightly been abandoned. The Dairy Board has now retreated to the proposition that the sole justification for its single seller status is that the world market is distorted by government intervention. Warren Larson, Dairy Board chief executive, has recently suggested that critics of the export monopoly assume that the world is a 'fair place'. He has acknowledged that: "If that were the case there'd be no need for a Dairy Board" (*The Evening Post,* Saturday June 28, 1997). Subsequently he elaborated on these remarks:

> Internationally it is a question of New Zealand versus the rest, all of whom subsidise dairy production to some degree. If the same trade position, or something remotely close to it, existed internationally, there would be no need for an organisation like the New Zealand Dairy Board. But that is not how the world works (*Straight Furrow,* July 14, 1997).

In its *Corporate Profile,* the Dairy Board seeks to justify its export monopoly in the following terms: "This single seller status recognises New Zealand's vulnerability as a small, unsubsidised player in a distorted and volatile international market: marketing through a sizeable commercial entity with an integrated farm to market network is the only pragmatic response to that situation" (p18). A substantial part of the *Corporate Profile* is devoted to making the point that the international market for dairy products is not a 'level playing field'.

The Dairy Board's assertion that its single seller status is somehow warranted by the fact that New Zealand has to compete in distorted international markets has been rebutted in previous New Zealand Business Roundtable research studies. This report elaborates on previous analysis and asks the following questions:

- What general implications does the 'unfairness' of the international market place have for economic policy in New Zealand? Is it in the interests of New Zealand for the government to impose additional controls on imports or exports when foreign governments subsidise particular industries? Alternatively, is the public interest better served if producers respond to the effects of foreign subsidies on international prices by diverting resources to activities which yield higher returns? Should export monopolies be established for all industries that operate in a distorted and volatile international market place?

- What problems arise from distortions in the international market for dairy products? How large are the distortions? What specific effects do export subsidies, tariffs and import quotas have on the world market?

Do they just reduce the world price or do they result in fragmentation of the market? To what extent do they result in different returns being obtained by the Dairy Board from sales in different markets?

• Does the single seller status of the Dairy Board represent the most appropriate response to the problems that arise from distortions in the world market? Can price premiums available in particular markets be obtained without sacrificing the benefits of competition in export marketing that are evident in other dairy exporting countries, such as Australia?

• Should the Dairy Board's export monopoly be retained?

CHAPTER TWO

POLICY IMPLICATIONS OF THE UNFAIRNESS OF THE INTERNATIONAL MARKET PLACE

In seeking to justify the Dairy Board's export monopoly, Warren Larson implied that "neoclassical economic theory" assumes, unrealistically, that the world is a "fair place". Neoclassical economic theory has its limitations – and arguments against the monopoly rest on much broader economic foundations – but Mr Larson's criticism is wildly astray.

The assumptions underlying any analysis should be subject to careful scrutiny. However, any economic reasoning employs simplifying assumptions. The critical issue is whether it matters for the analysis of a problem that particular complications of the real world have not been taken into account.

Does it make any difference to the conclusions of economic analysis or to economic policy in New Zealand whether or not the international market place is 'unfair'? In considering this question it is important to be precise about the assumptions that orthodox economic theory actually makes about international markets. The standard assumption that is made – the 'small country' assumption – is that an individual country has no influence on the price it pays for imports or the price it obtains for exports. The 'unfairness' of international markets only contravenes this assumption if there is something that the individual country concerned is able to do to influence relevant international prices.

When foreign governments have engaged in unfair practices, like subsidising exports, the New Zealand government has sought to have the offending countries change their ways through bilateral representations or international negotiations. While such unfair practices have continued, however, New Zealand exporters have

had to adjust to their effects on export markets. When the government is unable to influence policies of foreign governments which reduce the returns obtainable by domestic producers of any product, the best strategy it can adopt to minimise the adverse effects of those distortions on the New Zealand economy will usually be to allow market forces to divert resources to activities which yield higher returns.

The argument that distorted export markets justify enforced collective action in the exporting of dairy products is a variant of W B Sutch's argument for import protection: that New Zealand could not be 'an island in a sea of controls'. As explained by Roger Kerr:

> The conclusion in the import protection debate was that that view is fallacious, and the same holds for export controls. New Zealand can seek to influence other governments' policies by persuasion or negotiation, but by and large it has to take the rest of the world as it finds it. It only compounds the problems of distorted external markets by imposing additional controls on imports or exports, and in the process becomes poorer than it would otherwise be (Kerr, 1996, p. 149).

The idea that a country does not usually benefit by trying to protect its industries from the unfair policies of other countries often appears strange to people who are used to thinking of international trade as a kind of competitive sport. Paul Krugman, a trade theorist who has a reputation for exploring the implications of imperfect competition (as opposed to simple neoclassical competitive models), has explained the issues involved (in an American context) in a discussion of strategic trade versus free trade:

> If international trade basically means international competition, of course it seems only common sense to do everything you can to help your side win. If import quotas that give our domestic industries the advantage of a protected home base or export subsidies that help them break into foreign markets help America compete, why not go ahead and use them?
>
> Now, many people will concede that if every country follows such policies, the end result will be destructive, because world markets will end up fragmented. So they are willing to approve, grudgingly, of international agreements that limit import quotas or export subsidies. But free trade, to most people, looks like a good idea only if everyone practises it.
>
> Economists who take the theory of comparative advantage seriously, however, don't see the world that way at all. In their view, international trade is *not* a competitive sport. It is essentially a process of exchange, which is usually mutually beneficial. Interfering with this process hurts our economy, even if other countries do not retaliate (and of course hurts us even more if they do)... .

> The economist advocates free trade *regardless of what other countries are doing*. The nineteenth French economist Bastiat once summed it up this way: Saying that our country should be protectionist because other countries do not practise free trade is like saying that we should block our harbours because other countries have rocky coasts (Krugman, 1994, pp. 239–240).

Those who argue that the distortion of export markets by foreign governments is a sufficient condition to justify the establishment or retention of export monopolies are making similar analytical errors to those commonly made by neoclassical economists from the 1950s through to the mid-1970s. In that period many such economists were inclined to argue that governments should intervene in markets whenever they identified some potential source of 'market failure'. The mistakes they commonly made were to give insufficient attention to the question of whether the specific government intervention proposed would actually improve market performance and to overlook the potential costs of intervention.

These analytical mistakes have become less common among economists as they have heeded warnings, such as those of the Nobel Prize winner Ronald Coase, against conducting analysis in terms of comparing imperfect markets with "some kind of ideal world". Coase suggested that "this approach inevitably leads to a looseness of thought since the nature of the alternatives being compared is never clear". He argued:

> A better approach would be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change and to attempt to decide whether the new situation would be, in total, better or worse than the original one. In this way, conclusions for policy would have some relevance to the actual situation (Coase, 1960, p. 517).

Application of a comparative institutions approach along these lines has been a major feature of the economic reforms undertaken in New Zealand since 1984. It remains the most appropriate approach to adopt in considering whether the single seller status of the Dairy Board represents the best available response to distortions in the international market for dairy products.

CHAPTER THREE

PROBLEMS THAT ARISE FROM DISTORTIONS IN INTERNATIONAL MARKETS FOR DAIRY PRODUCTS

In order to assess how best to cope with distortions in the international markets for dairy products it is necessary to have some understanding of the nature of those distortions and the effects they have on market prices.

Distortions in the international market for dairy products

There is no doubt that the international market for dairy products remains distorted by government intervention. The Dairy Board has summed up the situation in its *Corporate Profile*:

> Despite recent commitments by major trading countries to liberalisation, the use of both subsidies and market access restrictions remains a dominating influence on world dairy trade (Dairy Board, undated, p. 8).

The major distortion in the international market for dairy products is the depressing effect on international prices of the protectionist policies adopted by major producing and consuming countries, such as the European Union and the United States, over the past 50 years. In addition to restricting imports, these countries subsidise exports when domestic production exceeds domestic requirements.

The OECD has estimated that the total producer subsidy equivalent (PSE) of assistance to the dairy industry in OECD countries declined from US$55 billion in 1990–92 to US$50 billion in 1994 (OECD, 1996, pp19–21). (The PSE is a measure of the value of monetary transfers to agricultural producers resulting from agricultural policies.) To put the total size of these subsidies in some kind of perspective, a monetary transfer of US$50 billion is around three-quarters the size of the total gross domestic product (GDP) of New Zealand.

The magnitude of the distortion of the returns to producers which is involved in these transfers is apparent from the fact that, averaged over the OECD, the PSE of assistance to dairy producers was 61 percent of the value of dairy production in 1994. There is, of course, substantial variation between countries in the size of these distortions. For the four major exporters, the corresponding PSE figures were: 61 percent in the European Union (which accounts for 47 percent of international trade); 52 percent in the United States (8 percent of international trade); 31 percent in Australia (10 percent of international trade); and 2 percent in New Zealand (24 percent of international trade).

The GATT Uruguay Round was an important step in reducing the distortions in international trade in dairy products (GATT, 1994). The main benefit of the agreement in the short term is the reductions in export subsidies, which are having a greater impact in some markets than in others. The Ministry of Agriculture has indicated, for example, that while the European Union's ability to export subsidised cheese has been constrained by its Uruguay Round obligations, it has had scope to increase subsidised exports of butter and skim milk powder (MAF, 1997, p. 57).

New Zealand achieved some improvements in access to markets in the Uruguay Round, most notably through an increase in the country-specific tariff quota for butter to the European Union, but high protective barriers remain in place in major markets for dairy products. Although an important feature of the agreement was tariffication (the conversion of non-tariff barriers affecting agricultural products into tariff equivalents) the OECD has suggested that "initial tariffs have been set at such high levels for the basic dairy products in most cases that, even by the end of the implementation period, trade is unlikely to flow over them" (OECD, 1996, p. 30).

What effect have these distortions had on the world market?

Despite the major distortions that remain in the international market for dairy products, it is a gross exaggeration to claim, as the Dairy Board does, that 'the concept of "a world dairy market' is meaningless" (Dairy Board, undated, p. 9). The Dairy Board's suggestion that "there is a mix of distinct individual markets for dairy products which operate independently of each other ... and have their own independent price structures" is at variance with information published by the Board itself on the volume and value of its sales in different markets.

If individual markets were independent, the returns per tonne from sales in different markets could be expected to vary widely. In fact, as indicated in Graphs 1.1 to 1.6, there is remarkably little variation between markets in the prices that the Dairy Board obtains for its sales of most products. With the exception of butter, the magnitude of variations in price for sales to almost all markets is well within the bounds of what might be expected to occur as a result of normal commercial influences such as the potential effects of exchange rate fluctuations and product differentiation. The percentage of sales to the top ten markets for each product that had returns per tonne within the range of plus or minus 20 percent of average returns per tonne for other markets (i.e. countries not within the top ten destinations) is shown below for 1995/96:

	%
Skim milk powder	93.6
Whole milk powder	100.0
Cheese	93.6
Butter	35.6
AMF/Ghee	100.0
Casein	98.4
Average (weighted by export value)	84.8

There is a good reason why the unit value of New Zealand butter sales is substantially higher in some markets than in others. This is discussed later, but consideration needs to be given first to the question of why the returns obtained by the Dairy Board for other products are similar in most markets despite widely different government support and subsidy regimes.

Variation in Prices Obtained on Export Sales of Dairy Products to Different Markets in 1995/96

Note: In these graphs the average price (returns per tonne of exports) obtained in each market is expressed as a percentage of the average price obtained in destinations other than the top ten markets.

Source: Prepared from data published by the Dairy Board in 'Dairy Facts and Figures 1995/96'.

The effects of different kinds of market distortion

The main forms of government intervention which distort world markets for dairy products are export subsidies, tariffs and import quotas. These measures all encourage increased production of dairy products in the countries in which this industry assistance is provided and depress the world price by diverting additional supplies to other markets.

Export subsidies

Export subsidies are usually used to dispose of production 'surpluses' that arise because domestic prices are kept artificially high for the benefit of domestic producers. The effect of the disposal of these 'surpluses' is to increase the total quantity of supplies flowing into international trade and hence to reduce the prices that other exporters are able to obtain. Nevertheless, competitive forces still tend to equalise the returns per tonne that exporters obtain in different markets when international prices are distorted by export subsidies.

Tariffs

Tariffs cause the consumer price of imports to be raised above the world price by an amount equal to the tariff rate. This leads consumers to substitute domestically produced goods for imports and thus to raise the price of domestically produced goods. In turn, the higher domestic price provides an incentive for increased domestic production. The diversion of imports to other markets tends to depress the

world price, but competitive forces still tend to equalise the returns per tonne that exporters obtain in the country imposing the tariff and in other countries.

Import quotas

Import quotas are similar to tariffs in many respects. As in the case where protection is provided by a tariff, an import quota results in an increase in the domestic price above the world price level. One important difference arises from the distribution of the proceeds arising from the higher domestic price that applies to imports. When protection is provided by tariffs, the difference accrues to the government in the form of tariff revenue. Where protection is provided by import quotas, however, the distribution of the proceeds from the higher domestic price of imports depends on how the quota is allocated.

As explained by ACIL, if the government of the importing country sells import quota competitively, "then virtually all the benefits accrue as sales revenue to that government. Those bidding for the right to supply bid away the premium in competing for the quota... . If the import quota is allocated to domestic importers then they have the potential to capture all the benefits.... . If it is allocated to the foreign exporter then that recipient has the potential to capture the benefits" (ACIL, 1992, p. 57).

It is relatively rare for a government imposing quantitative restrictions on imports to allocate quota to exporting countries. For obvious reasons, governments imposing import quotas generally prefer quota rents to accrue to their own citizens rather than to foreigners. This was the case in New Zealand under import licensing.

It is only when an *exporter* is allocated import quota to particular markets that the protective regime in those markets provides a premium that can be captured by the exporter. There are a variety of other reasons why returns per tonne of exports can vary between markets, but it is only under a very specific set of circumstances that such differences are attributable to the protective regimes of importing countries.

Voluntary restraint arrangements, under which exporters from particular countries 'volunteer' to restrain their exports, have been important in some industries and in some countries. In the case of dairying, however, it is not likely to be in New Zealand's interests to 'volunteer' to restrain exports to any market because this could open the door for other exporting countries to increase their market share.

It may be possible for the Dairy Board to obtain access to import quota in some markets by purchasing firms engaged in processing or distribution in those markets. It should be recognised, however, that when this occurs the value of the import quota is likely to be capitalised into the value of the firm being purchased. When the cost of obtaining access to quota via such transactions is subtracted from market returns, it is unlikely that a premium price is obtainable by these means. This is not to deny, of course, that there may be sound commercial reasons for New Zealand exporters owning downstream processing or distribution firms.

Prevalence of quota rents available to New Zealand exporters

As a result of the tariffication process under the Uruguay Round, countries which impose high barriers to imports of dairy products have moved some distance towards providing protection by means of tariffs rather than non-tariff barriers. Quantitative restrictions on imports have been converted to tariff quotas, which apply a tariff to over-quota imports rather than prohibiting them. Because these tariffs have typically been set at very high levels and are being phased down only gradually, tariffication is unlikely to have a large effect on market access during the next few years. Looking further ahead, however, is important to recognise that tariffication involves an important change in trade policies which is likely to result in a substantially less constrained world trading environment for dairy products than has existed in recent decades. In that situation even the most ardent advocates of controls on New Zealand dairy exports would have to acknowledge that their case had evaporated.

It should also be recognised that even now most New Zealand exports of dairy products are not subject to quota restrictions. Exports that are subject to some form of import quota probably represent less than 30 percent of total New Zealand exports of dairy products. In 1996, approximately half New Zealand's exports went to markets in which quotas were applied to some dairy product imports. However, a substantial proportion of New Zealand's dairy product exports to these markets consists of products, such as casein, that are not subject to quota restrictions.

The dairy product import quota that importing countries have allocated specifically to New Zealand has amounted to a small proportion (estimated to be of the order of around 10 percent) of the total value of New Zealand exports of dairy products in recent years. Such preferential access is confined to particular products in a few markets.

In the case of butter, preferential access to the European Union represents a substantial proportion (40 percent by volume in 1995/96) of total New Zealand butter exports but only 9 percent of the total value of New Zealand dairy exports. New Zealand exports of butter are provided preferential access to this market under longstanding arrangements that have their origins in the 1970s, in negotiations which took place before Britain joined the European Economic Community. As an outcome of the Uruguay Round, New Zealand's butter tariff quota was fixed at 76,667 tonnes per year from 1995 to 2000. Imports eligible for this quota are subject to a much lower tariff than applies to out-of-quota imports of butter.

On the basis of a comparison of tariff rates applying to quota and out-of-quota imports of butter to the European Union, the maximum benefit New Zealand could obtain from this preferential arrangement would have been around $3,500 per tonne in 1995, phasing down to around $1,700 per tonne in 2000. The premium actually obtained by New Zealand on sales to the European Union has been somewhat lower than this, however, because the tariff rate applying to out-of-quota imports is greater than the margin between the domestic price in the European Union and the average

price that New Zealand obtains in other markets. The tariff rate applying to over-quota imports provides such a high barrier to imports that it has no influence on the domestic price of butter in the European Union.

The premium that New Zealand obtained on sales of butter to the European Union on 1995/96 sales is estimated at $1,540 per tonne. On the basis of information published by the Dairy Board, average returns per tonne on sales to the European Union are estimated to have been 51 percent higher than average returns in other markets in 1995/96. The total value of the premium applying to eligible sales (76,667 tonnes) to the EU market in 1995/96 is estimated at $118 million. By coincidence, this is the same as ACIL's estimate of the total value of the corresponding premium applying in 1990/91 (ACIL, 1992, p116). However, ACIL's estimate for 1990/91 involves a larger price difference ($2,025 per tonne) applied to a smaller quota (58,170 tonnes).

Although import quotas have also been allocated specifically to New Zealand in some other markets, the volumes and values of product involved are much less significant than in the case of the EU market for butter. For example, Canada has allocated a butter import quota to New Zealand which increases from 1,200 tonnes in 1995 to 2,000 tonnes in 2000. The United States has allocated import quotas to New Zealand for various types of cheese, but the premium obtained is likely to be quite small, given the OECD's assessment that "for all practical purposes" the domestic price of cheese in the United States "is no longer being supported" by the US government (OECD, 1996, p. 32).

CHAPTER FOUR

IS AN EXPORT MONOPOLY THE BEST ARRANGEMENT TO CAPTURE PREMIUMS AVAILABLE TO NEW ZEALAND?

In the preceding chapter it has been established that:

- despite the distortions in international markets for dairy products, returns obtained by the Dairy Board on export sales have been similar in most markets for products other than butter;

- exporting countries are only able to benefit from the high domestic prices in markets protected by restrictive import quotas if they are granted preferential access to those markets; and

- it is relatively uncommon for New Zealand exports of dairy products to have preferential access to particular markets, but import quota allocated to New Zealand does enable a substantial premium to be obtained on sales of butter to the European Union.

It is debatable whether any government intervention is necessary to ensure that the benefit of the relevant premiums flows to New Zealand. If competition among New Zealand exporters resulted in a scramble to fill quota in the premium market, some rents that presently accrue to dairy producers could be dissipated. It should not be assumed, however, that such an adverse result would necessarily occur. In other situations of this kind it is not uncommon for exporting firms to cooperate with each other to achieve satisfactory arrangements to fill quota in premium markets. For example, Japanese car exporters have been able to cooperate in such a way as to capture quota rents when subject to 'voluntary' restraint arrangements in the US market. In the Australian dairy industry, the allocation of country-specific quota for the US cheese market is decided through negotiations within the industry itself, although the Australian government nominates the exporters that will fill the quota to the US authorities.

If there was widespread potential for export monopolies to be able to capture price premiums in international dairy markets, other major dairy exporting countries could be expected to have maintained or introduced export monopolies. The only factor that could make a difference in New Zealand's case is the preferential access which it obtains in the EU butter market. The quota rent obtained in that market is not only much larger than any quota rent available to New Zealand in other markets but is also much larger than quota rents obtained by other dairy exporting countries on the preferential access they have been granted in some markets.

The benefits to New Zealand of the premium on sales of butter to the European Union are sufficiently large that government intervention of some kind is probably desirable to ensure that they are not dissipated. Maintaining the Dairy Board's export monopoly is only one option for enabling New Zealand producers of dairy products to continue to capture quota rents in that market. The issue to be considered below is whether there are alternative arrangements that would achieve this objective more efficiently.

What are the alternatives to the Dairy Board's export monopoly?

One alternative would be for the government to sell export quota for the EU butter market to competing exporters through a form of competitive bidding or tendering. This would combine the benefits of capturing the premiums and establishing competition among exporters (ACIL, 1992, pp. 58–59).

Another alternative would be to reserve for the Dairy Board the right of access to the EU butter market while allowing other exporters to sell to other markets. This would open up most of the dairy export market to competition, but it would not remove the risk that some of the benefits of premium sales could be used to support uneconomic marketing activities by the Dairy Board.

Irrespective of how the quota is allocated, important issues arise as to how the quota premium should be distributed. Although a case could be mounted that rents from the EU butter quota belong to the New Zealand community generally, they have in the past been allowed to flow to dairy farmers. If it is accepted that this approach is still appropriate, a further issue is whether the payment should continue to be made to farmers as part of a 'bundled' return on sales of milk, or whether it should become a component of a separate dividend payment not directly related to current production levels. (This dividend payment would also include a return on the accumulated past investments of farmers in dairy companies and the Dairy Board).

The bundling of the premium from butter sales to the European Union and other off-farm returns into a single payout price for milk is undesirable because farmers base their production and investment decisions on the returns they obtain from alternative uses of their resources. With bundling, the averaged return per kg of milksolids which farmers receive on additional production is greater than the value of that additional production on world markets (measured in terms of the revenue obtainable from additional export sales, less costs of processing). This tends to encourage excessive use of resources in dairy production at the expense of other farm products and to depress international prices. The net effect is to reduce the overall return that farmers can obtain from their resources.

The premium resulting from the EU butter quota is estimated to amount to about 4 percent of the average farm gate payout per kg of milksolids in 1995/96. As well, there is a much larger price distortion, estimated by Ireland Wallace and Associates (1995) at 25 percent of producer returns, associated with the 'bundling' of returns from off-farm investments in processing companies and the Dairy Board into the farm gate price of milk.

The cost to the New Zealand economy of the price distortions associated with the bundling of returns from on-farm milk production and off-farm investments in processing and marketing into one payment has been conservatively estimated at $145 million per annum (Tasman Asia Pacific and ACIL, 1996). The price distortion associated with the bundling of the return from the EU butter quota premium is estimated to result in a further cost to the New Zealand economy of approximately $23 million. This is equivalent to wasting 20 percent of the benefit to New Zealand of the premium paid on butter sales to the European Union. The total cost to the New Zealand economy of both forms of bundling ($168 million) involves waste equivalent to 1.4 times the total benefit to New Zealand from the premium it obtains on butter sales to the European Union.

Would the alternatives achieve the objective at lower cost?

Two alternative approaches to the retention of the Dairy Board's export monopoly have been identified above. Both would achieve the objective of ensuring that New Zealand captures the benefit available on butter sales to the European Union without incurring significant additional costs or risks of other adverse consequences.

By contrast, maintaining the Dairy Board's export monopoly to capture the limited quota premiums available is like using a sledgehammer to crack a nut. Moreover, there are usually adverse consequences when governments insulate firms from competition. If a firm is granted a statutory monopoly there is a high risk that:

- it will adopt inefficient management practices – opt for a quiet life, pay excessive salaries relative to market benchmarks, engage in wasteful capital expenditure, fail to take entrepreneurial risks etc;

- it will be susceptible to pressures from various groups (for example, suppliers of inputs for which market demand is declining) to cross-subsidise between various outputs and inputs and hence to blur the transmission of market price signals from consumers to input suppliers; and

- opportunities for developing new products, new processing techniques and new markets will be forgone because the incumbent monopolist will be less innovative.

The Dairy Board strenuously denies that its management practices are inefficient. It is difficult to verify this claim, however, precisely because the Dairy Board has a statutory monopoly in the provision of marketing services for New Zealand dairy exports. The existence of the statutory monopoly means that the usual commercial test of ability to function profitably in a competitive market cannot be applied.

If the performance of the Dairy Board matches the rhetoric it adopts in its *Corporate Profile*, it has nothing to fear from competition. The critical success factors identified in that document include 'flexibility and adaptability', 'customer intimacy', 'commitment to R&D and technology development', 'maintenance and growth of strong brands' and 'operational excellence'. If the Dairy Board's monopoly were removed, any firm wishing to enter the market would also have to contend with the advantages which it claims to derive from its close links with the dairy processing firms which own it.

With reference to the second point listed above, it has been suggested by John Luxton, among others, that the administrative mechanisms used by the Board to allocate returns have a bias toward large-scale commodity processing and do not provide sufficient reward for new, often risky, investment which is required to get into specialist areas (Luxton, 1997). However, the Dairy Board's chief executive, Warren Larson denies that it uses its export monopoly to cross-subsidise between products and markets (*Straight Furrow*, July 14, 1997). The best way to test whether the administrative procedures used by the Dairy Board are biased would be to allow its suppliers to make alternative export arrangements if they wished to do so.

The third point is probably the most important one in considering the consequences of the Dairy Board's export monopoly. The existence of this monopoly clearly forecloses opportunities for other players to search on a continuous basis for new

product, processing or market opportunities. Although the Dairy Board has the power to license other exporters, "simply allowing constrained opportunities to obtain licences to export in competition with the boards is unlikely to unleash such entrepreneurial activity" (Kerr, 1996). The Dairy Board has often refused to grant export licences to potential exporters of dairy products as the Associate Minister of Agriculture, John Luxton, noted in a recent speech to the Dairy Section of Federated Farmers. He commented as follows:

> ... if the Board doesn't do it, or doesn't license it, it doesn't happen. It's saying to this businessman risking his money, we don't want you to add value to New Zealand dairy farmers' milk (Luxton, 1997).

The export monopoly has also acted as a virtual prohibition on international linkages which could lead to the introduction of outside capital into the New Zealand dairy industry. Large international firms have been deterred from making investments in New Zealand comparable to those made in Australia by firms such as Nestlé and Kraft. Australia is also benefiting from joint ventures between its processing firms and foreign concerns such as Meiji Milk Products, Mitsubishi, and Snow Brand. The expansion of international linkages of this kind would have the potential to help overcome market access problems as well as to introduce additional capital and expertise, and thus to improve the capacity of the New Zealand industry to supply some of the more rapidly growing parts of the international market.

CHAPTER FIVE

CONCLUSIONS

The argument that the government should continue to grant the Dairy Board the privilege of an export monopoly because other countries adopt unfair trade policies has no more substance than the other arguments that have been advanced for its retention. The export monopoly of the Dairy Board should only be maintained if it provides a national benefit. It does not follow from the fact that other countries distort world trade in dairy products that it is in New Zealand's interests to also adopt a restrictive and distortive policy.

The Dairy Board's claim that the international market for dairy products consists of distinct individual markets that operate independently of each other is a gross exaggeration. Despite all the distortions in the international market, the returns per tonne of exports that New Zealand obtains in major markets are similar for all products except butter. Even if this were not the case, there would still be no automatic grounds for monopoly controls. Exporters are only able to benefit from the high domestic prices in markets protected by import barriers when they are granted preferential access to those markets.

The import quota allocated to New Zealand by the European Union enables a substantial premium to be obtained (estimated to be worth $118 million per annum in 1995/96) on sales of butter to that market. Although import quotas have also been allocated to New Zealand for particular products in some other markets, any benefits derived from these arrangements are much smaller.

Continuing to grant an export monopoly to the Dairy Board is a very costly way of ensuring that New Zealand obtains the benefits of preferential access to the EU butter market. The export monopoly is acting as a virtual prohibition on the attraction of outside capital to the New Zealand dairy industry and is hindering the growth of the industry in areas such as specialist processing. It suppresses innovation and the development of international market linkages. These costs are shared by all New Zealanders, but are borne most heavily by dairy farmers.

The best way to ensure that New Zealand dairy farmers obtain the benefits of the premiums that are available in the EU butter market would be for the government to sell the right to export to this market to exporters through a form of competitive bidding or tendering and to return the proceeds to farmers. The option of preserving the EU butter market for the Dairy Board would be less satisfactory but nevertheless superior to the retention of the existing monopoly covering all dairy products in all export markets.

New Zealand can and should attempt to modify policies of foreign governments which damage its interests through persuasion and negotiation. However, in general, policy-induced effects on world markets are no more relevant than the natural economic and commercial advantages or disadvantages of New Zealand's trading partners in determining the nature of domestic regulations governing exports or the commercial strategies of New Zealand firms.

The Dairy Board's export monopoly is thus an anachronism. It does not serve any legitimate objective that cannot be achieved at less cost by other means. The sole justification advanced by the Dairy Board for its retention does not withstand scrutiny. The issue of regulatory privileges for any industry is a matter for the government not the industry to decide. The Minister of Agriculture, Dr Lockwood Smith, has stated that the removal of the monopoly controls is "inevitable". The government, which has the responsibility for taking into account the interests of the wider community, should remove them without delay.

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