

Rarity: An Economist batting for GlobalCo.

farming - 11 April 2001 By Gareth Morgan

It's been a long-held convention amongst the economics fraternity in New Zealand that the protectionism legislated to shelter the dairy industry has virtually no merit in economics and is nothing but raw political vested interest of the most avaricious kind. It is pretty easy to demonstrate the economic cost of this protectionism is substantial and has denied the industry reaching its potential. While apologists for the industry are prone to compare its success with the lesser lights on our agricultural stage, such as meat, wool and ferrets, they conveniently and consistently fail to benchmark the industry against the world's more successful dairy businesses.

Economists prepared to defend such a sham have historically been pretty thin on the ground in New Zealand. So it came as a bit of a shock/revelation last week when an economist actually put his hand up and went in to bat for the protectionists by launching an attack on the arguments against prolonging dairy protectionism. This is bold stuff - like a rugby player taking the field in a frock - not just embarrassing but potentially of frightening consequences.

Now Alex Sundakov (NZ Herald April 5) has declared that he is in the employ of the Dairy Board and of course in part that can explain his compunction to defend the protectionism and the crony politics that passes for management of that sector. Just as a lawyer has to defend the worst axe murderer if asked, so one might argue even the most retarded economic rationale deserves a fair defence. But Sundakov embraces his assignment with such unguarded enthusiasm, forwarding so few qualifications of his claims for the merits of GlobalCo, that his arguments cannot be simply dismissed as the logic-free lines Board apologists have trotted out over several decades. His sincerity in attacking those that would remove the industry's privileges, and his claims that the opponents case is based on 'misconceptions', deserve at least a decent burial. So let's look at the Sundakov case and see if it is indeed breaking new ground, and is not just more flim flam of an industry stooge hired to bring respectability to the bludging.

The first argument Alex trots out is that because some other dairy industries run a cooperative model it must be okay. He argues that the vertical integration of the cooperative structure where the farmer owns both milking and processing activities is necessary because milk is perishable and further this not sub-optimal because the farmer jointly maximises the returns from both activities.

Apart from the fact this is all assertion and there is no case a priori whether production of perishable products nor joint maximisation of returns necessitates a co-operative model, Sundakov conveniently overlooks the reality that the cooperative model we have, is a legislative contrivance. If it were the outcome of a situation where free entry and exit of capital had been possible, and this sort of conglomeration had occurred naturally, then his argument might have content. Where is the evidence that the following hold (a) it happens overseas therefore that must be right? (b) perishable products cannot have specialisation in their production (let's just ignore production of bread and vegetables sold in supermarkets) and (c) joint maximisation of returns must deliver higher overall economic returns than separate maximisation of milking and processing returns?

The tenor of the Sundakov argument appears to be that GlobalCo is better than the mess the industry is in now, therefore it should be accepted. It's the level of argument I'd expect from a well-intentioned but economically illiterate dairy farmer and again is simplistic assertion. Indeed there is a set of arguments that would hold that GlobalCo is much worse than we have now. Nevertheless proceeding from this baseless assumption he then flits on to argue that the 'fair value' exit ensures farmers can extract the value from their downstream investment. This is wrong. It's to be an administered process based on some assessment of the

value of a company constructed under a protected legislative umbrella. As such it doesn't even approach the value that could be generated if the sector was opened to competition and enabled to exploit profit maximising endeavours without the shackles of imposed ownership structures. It's precisely this counterfactual that Commerce Commission scrutiny would once again expose.

Which brings us quickly and mercifully to the last Sundakov argument. Apparently the transaction is so complex that the Commerce Commission isn't suited to comment on its economic impact. Politicians instead, he argues are better equipped. God help us if this is the level politically-inspired apologists for protectionism have sunk to.

The reality of this industry is clear - and it doesn't take too much effort to find it out. The profit margins are greatest in the downstream consumer products, marketing and pharmaceutical uses. This is where the equity amassed by the industry would most profitably be applied. Instead, via protection of bundling and non-separation of the farmers' income streams the profits are legislated to go back to the cowshed. Result? We get overproduction of raw milk (the value of which often falls below the cost of production) and under-exploitation of the considerable profits to be had from downstream activities. That is called resource misallocation - and it is due solely to a legislative construct. Without enabling capital to earn a return independent of supplying milk, this industry is bound to be economically inefficient.

One is left concluding Sundakov has really done little more than provide a superficial gloss to some non-economic rationale for continuing the protection of our cow-milking, cottage industry. The protectionism is no less than that pursued under the CAP which we are so prone to criticise. It's more than a little ambitious for an economist to even try to defend the position and while Alex has been sufficiently intoxicated by the opportunity to have a go, the defence he's amassed wouldn't pass a Stage I economics term test. It's curious that at the risk of such professional humiliation why one would bother.

Ironically the flam of the Sundakov defence fits like a glove the weight of economic logic applied by the current government to almost all it does. Without doubt we have a Cabinet interested more in the patronage sectors of self-interest can ascribe it than arguments of economic logic and net national benefit. There is a world of self-serving politics where appeasing sector interests is the route to political tenure and the economic logic underpinning policy options are of virtually no interest. How else could you justify the People's Bank, surrendering the dairy industry to agrarian political manipulation, eyeing for re-purchase Transrail and no doubt soon, Air New Zealand. None of these agendas are remotely linked to concerns of economic net benefit.

And National? Meekly, squeakily it nodded its approval of GlobalCo on the eve of its acceptance. With such profound contributions emanating from parliament one could be forgiven in believing that the deep thinking of the 'Think Big' era is back again.