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**Income Contingent Loans for Drought Relief:
Delivering better outcomes for farmers and taxpayers**

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Abstract

Australia's National Drought Policy is considered to be one of the most advanced in the world, recognising as it does the reality of climate and focusing on adapting farm management to climatic uncertainty rather than simply subsidising agriculture in low rainfall areas. But while the underlying principles of the Policy seem to be sound, after nearly two decades of implementation and incremental changes to the instruments applied under the policy have resulted in the loss of the risk management message, ongoing use of the exceptional circumstances provisions and growing inequities between farmers, and between farmers and non-farmers. In this paper we argue that the objectives of the Policy need to be reaffirmed and key policy changes made to ensure the outcomes of the policy more closely align with its intentions. We analyse financing policy issues and propose the introduction of an income contingent loan (ICL) for drought relief as an equitable and efficient policy instrument for delivering relief to farm businesses experiencing drought, and perhaps for other adverse circumstances. It is argued that such a policy reform would allow farm businesses to take advantage of ICL insurance benefits associated with default protection and income smoothing, while at the same time minimising taxpayer contributions to drought relief.

JEL Codes: N57, R11, Q14

Keywords: drought relief; income contingent loans; rural policy

1 Introduction

An early report on the state of agriculture and trade in New South Wales noted that the ‘uncertain climate’ of the colony was ‘not generally favourable to the growth of European grains’ (Bigge, 1966 [1823], p.18) and suggested that the future of agricultural production

will be that of pasture rather than tillage, and the purchase of land will be made with a view to the maintenance of large flocks of fine-woolled sheep; the richer lands, which will generally be found on the banks of the rivers, being devoted to the production of corn, maize and vegetables (Bigge, 1966 [1823], p.92)

In spite of this advice, Australian agriculture developed beyond the confines of the river banks to become one of the most efficient and productive agricultural sectors in the world. Australian farmers have an unenviable record of ongoing productivity improvement and have been highly innovative in adapting European farming practices to Australian conditions. The uncertain climate of which Bigge wrote however, continues to cause hardship and the Bureau of Meteorology has reported that recent droughts have been accompanied by hotter temperatures (Hennessy *et al.*, 2008, p.3) and the effects of climate change are likely to include a warmer and drier future for Australia (Hennessy *et al.*, 2008, p.12). This prognosis raises important policy questions about the provision of government drought relief: how it should be delivered, to whom, and how it should be financed.

This paper proposes the introduction of an income contingent loan (ICL) for drought relief as an equitable and efficient policy instrument for delivering relief to farm businesses experiencing drought, and perhaps for other adverse circumstances. The article is set out as follow. It begins with a brief history of Australia's National Drought Policy, which was introduced in 1992 and is considered to be world's best practice with its focus on risk management. This is followed by a discussion of the shortcomings of the policy and the problems that have arisen with its implementation, including consideration of the 2008 policy review initiated by the Commonwealth government. The third section of the paper contains our proposal for the introduction of an ICL as an effective and equitable way to deliver drought relief. We outline the arguments for the use of this policy instrument, how it might be constructed to accommodate the features of farm financing, and how it might be combined with an existing program, Farm Management Deposits, to deliver an effective risk management tool for farmers across the climate cycle.

2 The National Drought Policy

Brief history

Until 1989 drought was part of Australia's natural disaster relief arrangements (NDRA), a standing Commonwealth-State agreement which sets out the funding responsibilities of the Commonwealth, State and Territory governments in the event of a natural disaster. These arrangements are triggered by a State or Territory government's declaration that a natural disaster has occurred, and provide a

framework for the delivery of short-term aid to families and communities, support for the restoration of private assets and funding for the long term rebuilding of public assets and infrastructure. In 1989 the Commonwealth government decided that drought was no longer to be included in the events covered by these arrangements. There were two key reasons for this decision.

First, in many years, drought relief was dominating the NDRA Budget and there was suspicion that the program was being manipulated for political purposes by the Queensland government. Second, scientific understanding of the drivers of Australia's climate was improving with increasing knowledge of the influence of the El Niño-Southern Oscillation on drought conditions, particularly in the eastern states. This suggested that drought was not an unpredictable event of the nature of other natural disasters such as cyclones, bushfires or earthquakes; rather it was a normal part of the Australian climate. Following the removal of drought from NRDA, the Commonwealth government set up a Drought Policy Review Task Force which reported in 1990 (DPRTF, 1990) recommending against the reinstatement of drought within the NDRA and suggesting that a National Drought Policy be developed based on principles of farmer self-reliance and risk management. The report recognised that Australia's climate is highly variable and that climate risk is one of a number of uncertainties to be managed by the farm business.

The 1992 National Drought Policy was negotiated through the relevant Commonwealth-State ministerial council, the Agriculture Council of Australia and New Zealand (ACANZ), and was broadly consistent with the recommendations of the Review. Ministers agreed that the policy would be 'based on principles of sustainable

development, risk management, productivity growth and structural adjustment in the farm sector' (ACANZ, 1992, p.13). The policy included an important caveat relating to 'severe downturns' during which support would be provided to 'those with sound prospects who are temporarily in difficulty' (ACANZ, 1992, p.13). This response to severe events was given effect in the exceptional circumstances (EC) provisions of the *Rural Adjustment Act 1992* which provided eligible farmers with interest rate subsidies of up to 100 percent on commercial borrowings. A welfare component was introduced into the drought policy in 1994 in the form of the Drought Relief Payment (later the Exceptional Circumstances Relief Payment). The Rural Adjustment Scheme was wound up in 1997 but both the interest rate subsidies and the welfare payment were retained for farmers experiencing exceptional circumstances.

The EC provisions were triggered almost immediately that the *Rural Adjustment Act 1992* came into effect in January 1993; ironically for excessive rain in South Australia and Victoria. They were also triggered the same year following a collapse in wool prices, and to support farmers affected by worsening drought in the eastern states. Since that time there have been EC declarations in place almost constantly, with some areas experiencing multiple years of declarations and, therefore, government assistance. The conditions under which EC declarations have been made have not been consistent and it is arguable that some areas that have been receiving support have not been experiencing rainfall deficits of an 'exceptional' nature; rather they have experienced the normal variability of the Australian climate. For a more detailed account of the history and development of the National Drought Policy, see Botterill(2003).

Forms of government support

One of the difficulties associated with the delivery of assistance to farm businesses is the 'unity of business and household' (Mauldon and Schapper, 1974, p.65) that comprises the family farm. The problem this poses for policy makers is ensuring farm welfare needs are met in way that does not provide a *de facto* subsidy for an otherwise unviable business. Similarly there has been concern that linking farm welfare support to business objectives is inappropriate and inequitable. A review of the Rural Adjustment Scheme in 1997 pointed to the problem of linking welfare and business support when it argued 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' (McColl *et al.*, 1997, p.38). The current drought policy nominally separates the two areas of support but there remain equity problems associated with linking welfare payments to the declaration of an EC drought.

Under the 1992 policy, the main mechanism for supporting drought-affected farm businesses was an interest rate subsidy, i.e. a grant in the form of a subsidy on the interest paid on commercial finance. Interest rate subsidies have been available in Australia as part of rural adjustment programs for decades, in spite of a number of reviews suggesting that they are an ineffective and inequitable means for delivering support (for example McColl *et al.*, 1997, Synapse Consulting (Aust) Pty Ltd, 1992, Freebairn, 1983). Interest rate subsidies can result in substantial transfers of public money to individual farmers. The current guidelines allow for payments to an

individual farm business of up to \$100,000 per year or \$500,000 over five years, although it is unlikely that many farmers are in receipt of such large payments. Interest rate subsidies are only available to farmers who 'are considered profitable in the long term but who, due to EC, are experiencing financial difficulties and are in need of assistance to achieve long-term profitability and sustainability' (Department of Agriculture Fisheries and Forestry, 2008, p.17). Freebairn has suggested that, drought interest rate subsidies '[encourage] lenders to substitute higher interest charges for less expenditure on loan assessment and management advice' (Freebairn, 1983, p.193). Interest rate subsidies also have potential to be regressive as larger farms with higher incomes and more debt attract greater subsidies.

In addition to the interest rate subsidy program, farm businesses have access to a tax-effective income smoothing instrument, Farm Management Deposits (FMDs). FMDs were developed as part of the National Drought Policy to encourage farmers to build cash reserves during high income years on which they could draw during downturns. They were seen as an important risk management tool. However, in recent years FMDs have been exempted from eligibility criteria for EC support – in other words farmers holding substantial reserves of cash in these deposits have been eligible for both interest rate subsidies and welfare payments without first drawing down their cash reserves. This effectively undermines the purpose of the program as a cash flow management tool and is contrary to the principle applying to other forms of government support which generally require that recipients exhaust their own reserves before drawing on the public purse

The second component of the EC drought relief is a welfare payment, the Exceptional Circumstances Relief Payment. The welfare component of the drought program was introduced in 1994 following reports of welfare problems in many drought affected areas, and was set up to provide farmers in EC areas with access to welfare payments on an equivalent basis to other groups in the community. The major exception was the exclusion of farm assets from the assets test for the new payment. Otherwise, the payment was offered on the same terms as the unemployment benefit.

Importantly, this payment was not dependent on the prospects of the farm business. Where the interest rate subsidies were only accessible by farm businesses with a long term sustainable future in agriculture, the welfare payment was available to all eligible farmers in an EC area. This raised concerns about inequities between those in difficulty inside the EC areas and those suffering income stress who had not been declared to be experiencing EC. The introduction of the welfare payment also made the achievement of an EC declaration considerably more attractive as all eligible farmers in a declared area could access the support, irrespective of the health of their farm businesses.

In 2005 the Commonwealth government announced changes to the eligibility criteria the effect of which was to allow farmers in receipt of an EC welfare payment to earn two and a half times as much per fortnight as a recipient of other forms of welfare (Botterill, 2006). This gap was widened significantly in September 2007, when the income test was further relaxed (Howard, 2007); resulting in a \$20,000 gap between the exempt earnings of farmers and those of other welfare recipients. This change was justified by the then Minister on the grounds that ‘Given the length and severity

of the drought, we now link off-farm income to the farm business itself. After all, these farm businesses are earning no income themselves, and yet they've got costs such as fixed water charges, local government rates, or lease payments on machinery or the like' (ABC Radio, 2007). In essence, this means the original intention that drought policy should only support those with a long-term sustainable future in farming had been abandoned, and the welfare system was being used to subsidise farm business operations, confusing the risk management message of the National Drought Policy.

Farm poverty has not been measured systematically in Australia since the Henderson Inquiry of the 1970s. The EC Relief Payment and related programs have been based on assumptions about the existence of farm poverty, its nature and causes. In essence, the key assumption is that farm poverty is the result of sub-optimal levels of structural adjustment in agriculture. Accordingly, programs have been developed to facilitate structural adjustment, including easing poorer farmers out of agriculture through income support measures tied to exit grants. There is a clear need for an inquiry into farm poverty to determine the nature and extent of the problem and to develop appropriate programs which respond to the welfare needs of poor farm families in a manner which is equitable with the rest of the community.

Shortcomings

There were two key problems with the delivery of drought relief in the period prior to the 2008 review. First, EC declarations are based on geographical boundaries that bear little relationship to biophysical or climatic regions. Declarations are made on

the basis of administrative boundaries, for example the old Rural Lands Protection Board districts in NSW. The inequities arising from defining drought on the basis of these largely arbitrary boundaries has become known as the ‘lines on maps’ problem and attempts have been made to address it through the creation of ‘buffer zones’ within the vicinity of declared areas. While support is based on geographical regions, governments will face difficulties in defining EC in a manner which is scientifically justifiable across time and space. A drought in east Gippsland is different in nature from one on the edge of the arid zone, which is different again from a drought in north Queensland or the Pilbara.

In addition, separating drought conditions from other agricultural factors is difficult. As Heathcote observed, ‘the same rainfall which gave a bonanza wheat crop [...] in the 1880s, would be classed as a drought in the 1980s’ (Heathcote, 1994, p.100). Developing a definition which is meaningful in terms of temporal and spatial difference, and which is consistent with an underlying principle of understanding and living with the challenges of the Australian climate, is highly problematic. The international water resources literature confirms the challenges of defining drought (see for example Dracup *et al.*, 1980, Wilhite, 2000, Wilhite and Glantz, 1985). Further differentiating between ‘normal’ and ‘exceptional’ drought compounds the problem.

In policy terms, the existence of the EC provisions has set up perverse incentives for farmers experiencing a drying spell. Where the National Drought Policy was focused on managing dry periods as part of normal climate cycles, the existence of the EC program provides an incentive for farmers and their representatives to make the case

that they are experiencing particularly bad conditions as this provides access to interest rate subsidies and welfare payments. This has reinforced the perception that drought is a natural disaster, a concept that was rejected in policy terms with the removal of drought from the Natural Disaster Relief Arrangements in 1989.

As the Drought Policy Review Task Force recognised in 1990, variability is the norm for the Australian climate and a sensible drought policy will recognise that reality and develop programs that support farmers in the transition from a disaster response to risk management. The ideal policy would arguably be to end the declarations of exceptional circumstances drought altogether and have standing support arrangements for farm businesses and farm families based on individual need. In fact, the Productivity Commission (2008) recommended the ending of declarations in its draft report into drought support, as discussed below.

The second major issue with the drought response as it evolved between 1992 and 2008 relates to question of equity in the delivery of support to both farm businesses and farm families. Inequities arose between farmers, and between farmers and non-farmers. With respect to business support, interest rate subsidies only provide relief to farmers with debt or who are prepared to take on debt. For some farm businesses, this may constitute poor risk management, since farmers without debt who are unprepared to take on debt are excluded from support. As well, the magnitude of the interest rate subsidies is very likely to be regressive. Farmers often have substantial assets and over their life times are likely to be wealthier than the average taxpayer funding the grants. The rationale for providing interest rate subsidies was that market failure was occurring in the delivery of commercial finance to drought-

affect farmers who were in temporary difficulty but were viable over the long term. There is little evidence of the existence of this form of market failure.

With respect to the welfare payment, the linking of eligibility to an EC declaration is inequitable and is also inconsistent with the principles underpinning other forms of welfare available to the Australian community. The unemployment benefit is not only available to job seekers in suburbs with high unemployment – eligibility is based on personal circumstances and need. This should also be the case for farm welfare payments. At present, there is potential for farmers in genuine welfare need to be excluded from receiving government support because they are not in an area declared to be experiencing EC drought.

The 2008 Policy Review

In 2008, the Commonwealth government announced a review of Australia's National Drought Policy. The review comprised three related reports: a climate review undertaken by the Bureau of Meteorology and CSIRO, a review of the social impact of drought by an expert panel, and a review by the Productivity Commission which was tasked with reporting on the appropriateness, effectiveness and efficiency of existing drought relief programs. This is the first comprehensive review of the National Drought Policy since it was agreed by Commonwealth and State Ministers for Agriculture in July 1992. For the purpose of this paper, we are focusing on the PC's inquiry, although it is clear that the results of all three inquiries will inform the development of government policy (Burke, 2008). In summary, the PC's major recommendations of relevance to this discussion are:

- The two existing EC programs, the interest rate subsidies and the welfare payments, be terminated ‘with the last year of eligibility for those in EC areas being 2009-10’;
- Government programs be adjusted to support farmers in adapting to climate variability and climate change, and to encourage self reliance and risk management;
- Temporary income support be available which recognised ‘the special circumstances of farmers’, and that such support not be limited to farmers whose low incomes result from drought conditions;
- The Farm Management Deposits scheme should be retained; and
- EC declarations be terminated (Productivity Commission, 2008, pp. xlvii-xlix)

The principles underpinning the National Drought Policy remain sound. What is needed following the current review is a restatement of the self-reliance and risk management messages of the original policy and the development of programs that assist in achieving these objectives. Experience with the implementation of the National Drought Policy since it commenced on 1 January 1993 suggests the need for a major rethink of the programs of support on offer. While the underlying principle of climate as a risk of the farm business to be managed remains sound, the evolution of the policy has undermined that objective and turned the policy into little more than a subsidy program for Australian farmers.

It has been argued that there is no case for government involvement in drought relief on economic grounds (see, for example Freebairn, 1983). If climate variability is a

business risk, it can be managed like any other risk. However, drought relief is not just an economic issue – there is a powerful political dimension as well. Leaving drought-affected farmers to manage without government support is politically unviable in a country which still regards farmers as an important part of its national identity (Botterill, 2006). As Heathcote has noted, ‘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’ (Heathcote, 1973, p.36). Given that governments will continue to want to respond when there is worsening drought, the challenge is to develop a policy response that is more equitable and effective than current arrangements. Removing farm welfare from drought relief can be seen to be a good start. In the area of farm business support, a combination of FMD and ICL is now discussed.

3 A Better Policy Approach Through Income Contingent Loans

In our submission to the Productivity Commission Inquiry (Botterill and Chapman, 2008) we advocated the introduction of an ICL as a replacement for interest rate subsidies and as a complement to the existing FMD scheme. The PC’s Draft Report argued that ‘the Commission is not convinced that there is a strong rationale for governments to provide ICLs to farmers’. It did not provide strong justification for this conclusion beyond referent to the submission by the Australian Bankers’ Association that there was no failure of credit markets for drought-affected farmers. (Productivity Commission, 2008, p.180), an analysis with which we tend to disagree.

It is arguable that there are special circumstances in farm financing that warrant government intervention but that that intervention should be structured in a manner that provides income smoothing and default protection without being particularly burdensome on taxpayers. ICLs satisfy these criteria.

Identifying and Addressing “Market Failure”: The Advantages of Income Contingent Loans for Farming

ICL have two important features which make them particularly well suited to the needs of farmers faced with fluctuating incomes; namely they provide default protection for the farmer and they are an income smoothing mechanism. These benefits are considered in turn, in the context of the financing of rural business activity.

It is sometimes argued that a so-called “market failure” does not exist for farm financing if it is the case that banks are generally willing to lend to farm businesses (Australian Bankers' Association, 2008). However, this analysis only addresses the supply side of credit provision and there is a case that there is a significant access issue on the demand side of this potential credit activity. This is that there seems to be compelling evidence of farmers' reluctance to take on high levels of credit. In the Productivity Commission's Draft Report for the *Inquiry into Government Drought Support*, 2008, evidence is offered concerning the experience of financial hardship in the farming sector, and this is now considered.

In a survey conducted in 2007 of regional and rural families by the Australian Institute of Family Studies respondents were asked to record whether or not they were experiencing financial hardship, and the results for farmers show that 45 percent in a drought area believed that they were. Indeed, even 35 percent of farmers living in an area of above average rainfall categorising themselves in the same way (Productivity Commission, 2008, p.57). The critical question arises, if the banks are willing to lend to farmers in times of hardship, why is it apparently the case that the farmers themselves are unwilling to take advantage of this available credit?

One potentially compelling reason is that a key problem with farm financing is that farmers are likely to value their farms far more highly than the dollar value placed on the property by the finance sector due to the level of ‘psychic income’ associated with farming as an occupation (Vincent, 1976, p.111).and the psychic losses associated with losing the family farm. In addition, individual risk perception discounts upside risk and overestimates downside risk (Margolis, 1996, p.93), which means that farmers will borrow less than the finance sector is willing to provide because of their high level of concern with the possible loss of the farm, which may have been in the family for generations. This promotes for consideration the very important issue of default risk, and it is completely consistent with the above-noted evidence. It implies that there is a form of “credit failure” that cannot be resolved with normal bank loans, since loans of this form cannot offer insurance against default, and thus cannot provide insurance against the potential for the loss of the property. ICL, because the repayments are based on capacity to pay, provide this type of insurance.

The second advantage of ICL is their income smoothing effect. This has two elements, both related to capacity to pay. First, and noting that ICLs can be seen to be a mirror image of FMDs, they effectively allow farmers to borrow from future good years to improve their financial position in contemporary poor circumstances. Second, as with all ICLs, only very small repayments are required in low income years, but these can increase significantly in years of high farm incomes. By contrast, a standard mortgage-style bank loan can usually require a fixed repayment which in low income years can amount to a very high proportion of the farm's income, potentially causing considerable hardship. It should be noted that the banks have shown some flexibility in their dealings with drought-affected farmers which would have some degree of income-smoothing effect (Australian Bankers' Association, 2008, p.3). However, this flexibility remains based on commercial imperatives and lacks the certainty that an ICL can offer.

An understanding of farming credit problems in the above contexts offers a different perspective on the role of ICL as a supplementary financing instrument for times of rural hardship. This is because, unlike any other form of credit, the collection of an ICL is defined by capacity to pay, and thus it is impossible to default on this form of debt due to poor circumstances, and they also offer income smoothing. This is in essence why ICL are potentially such a significant rural financing instrument. As explained by Moss (2002), governments are in a unique position to provide insurance benefits of this type.

Features of an ICL for drought relief

We have discussed the possible features of an ICL elsewhere (Botterill *et al.*, 2004, Chapman *et al.*, 2004, Botterill and Chapman, 2004, Botterill and Chapman, 2006) and the scheme has been modelled using ABARE data and testing different scenarios for collection of the loan as well as the impact on both government revenue and on the financial position of different groups of farmers (Kelly *et al.*, 2004).

Structuring an ICL scheme for farmers raises some particular challenges. The unity of the farm family and the farm business discussed above and the array of tax deductions available for farmers raises the concern that farmers are tax minimisers and capable of ‘hiding’ income. The consequence of this is that an ICL along the lines of HECS-HELP and FEE-HELP (previously known as HECS), which calculates repayment obligations on the basis of personal taxable income, would not work as farmers would either never trigger the repayment threshold or would underpay due to understatement of their actual income position. Secondly, because the Commonwealth would have no claim over the farm asset, repayment of an ICL could be avoided through the sale of the farm, inheritance or changes to partnership arrangements. Simply replicating existing ICL schemes such as HECS for drought relief is clearly not an option; the ICL would need to be structured specifically to recognise the nature of farm businesses.

Although the Productivity Commission proposed, and we agree, that an improved National Drought Policy should end EC declarations, an ICL of the type outlined could be offered on the basis of existing EC declaration processes. In the event that declarations are ended, it could be structured to respond to individual farm circumstances. In administrative terms, the former would be quicker and easier to

implement and could be seen as an interim program in a transition to the ending of declarations for the reasons outlined above.

The collection of a drought relief ICL raises two main issues: the implementation of a threshold below which farmers are not required to repay and the repayment mechanism itself.

It is suggested that a drought ICL not include a repayment-free threshold. This is because farm receipts reflect to an important extent farm size which means that if repayments were not required for revenue below a certain level the policy might excuse all repayments from small farm units (even in periods in which a significant proportion of small establishments are not experiencing economic hardship). Having a revenue threshold for repayment would also have an unfortunate behavioural characteristic of systematically encouraging the participation in the scheme of those farms expecting to have relatively low gross revenue in the longer term, thus undermining the prospect for the government of high levels of collection. An ICL collected on the simple basis as a percentage of a measure of income would be the preferred arrangement.

In order to ensure that the loan is repaid, it is proposed that the debt be collected on the basis of gross revenue rather than taxable income. An important administrative issue is that gross revenue is already reported on the Business Activity Statement (BAS) which farm businesses complete for GST purposes. But because gross revenue is a relatively crude measure of farm welfare, it is proposed that the repayment rate be set at a very low level. In Kelly *et al.* (2004) we have modelled repayments at both 2

percent and 5 per cent of gross revenue, and our simulations show that the associated revenue streams for the government appear to be satisfactory for these repayment parameters.

In order to avoid the potential for farmers to circumvent repayment by holding an ICL against one ABN (Australian Business Number) and reporting their income against another, farm businesses with a drought ICL should be required to group their ABNs and report their activities on a single BAS. Many farm businesses are already grouping their ABNs on the advice of their accountants.

Attaching the ICL to an ABN has the further advantage of ensuring repayment should the ownership of the farm business be rearranged or changed entirely. On the sale of the farm there would be a requirement for the ICL to be paid in full. When a rural property is purchased, a number of searches are already undertaken – this would be extended to an ABN search to determine if there was an outstanding drought ICL on the property. The purchaser could then require that the loan be paid out or agree to take it on for an associated reduction in the purchase price of the property.

In the case of the death of the farmer the property is likely to either be sold, in which case the above scenario applies, or continue in operation in which case the ICL would continue to be paid out of the operations of the farm. Further, to insure against a different form of avoidance, we propose that the reconstitution of a partnership would require a new ABN in which case the ABNs of the former partnership would be required. This would alert the ATO to the existence of an ICL.

A further possible concern relates to bankruptcies and what this would mean for an ICL scheme design. It is important to note that bankruptcies are a rare occurrence in the rural sector as banks monitor their clients' financial positions and tend to encourage sale before bankruptcy occurs. That monitoring process would take account of the existence of an ICL as one of the obligations of the farm business.

Applying a real rate of interest to the ICL would further minimise the incentives for poorer operators to use the ICL scheme, as there would be no implicit subsidy that would benefit those who took longer to repay the loan, i.e. those with lower future revenue, over those who paid it off quickly. A different form of a real interest rate would be to impose a surcharge on the debt, as happens currently with the FEE-HELP scheme. However, while this approach reduces taxpayer interest rate subsidies it does not have the benefit of reducing potential adverse selection.

Advantages on an ICL-FMD combination for drought relief

ICLs are consistent with the principles of the National Drought Policy and offer a clear alternative to interest rate subsidies. ICLs mirror FMDs in that farmers essentially borrow from future good years rather than from past good performance. Income contingent loans could be combined with FMDs in a single farm business financial risk management program through which farmers draw down their FMDs and then have access to an ICL once their reserves are exhausted, possibly leaving a small amount of cash in the FMD for working capital. This would also address one of the limitations of FMDs, which is that new entrants may not have time to accumulate reserves before they encounter a downturn.

Any government support program is ultimately paid for with taxpayers' money. Under the current guidelines for interest rate subsidies, an individual farm business can receive a grant of \$100,000 or \$500,000 over five years. It is acknowledged that few, if any, farmers receive assistance of this magnitude, however the grants amount to substantial transfers between the taxpayer and the farmer. One of the characteristics of farming is that farm families are often income-poor and asset-rich. This means that, although farmers are in short term difficulty during drought, over their lifetimes they are likely to be wealthier than the average taxpayer who funds their drought relief. A properly designed ICLs would not have this regressive property.

It is important to note that both ICLs and FMDs have the effect of 'consumption (income) smoothing'. FMDs are accumulated during high income years and reserves are built up to be drawn down in low income years. Similarly, because an ICL is repaid on the basis of capacity to pay, repayments are sensitive to the farm's financial situation and avoid the problem of mortgage-type loans which are constant irrespective of the borrower's capacity to pay. Thus an ICL can be seen to protect borrowers against the financial hardships associated with normal borrowings.

4 Conclusion

Australia's National Drought Policy is considered to be one of the most advanced in the world, recognising as it does the reality of climate and focusing on adapting farm management to climatic uncertainty rather than simply subsidising agriculture in low

rainfall areas. The underlying principles of the Policy seem to be sound. However, nearly two decades of implementation and incremental changes to the instruments applied under the policy have resulted in the loss of the risk management message, ongoing use of the EC provisions and growing inequities between farmers, and between farmers and non-farmers. This paper argues that the objectives of the Policy need to be reaffirmed and key policy changes made to ensure the outcomes of the policy more closely align with its intentions.

Our analysis is consistent with the recommendation in the Productivity Commission's Draft report that interest rate subsidies should be abolished. We suggest that they be replaced with a Farm Risk Management Program that combines FMDs with ICL, a combination which would provide farm managers with mechanisms for managing their cash flow across the climate cycle. Ultimately this business support package could be made available on an individual farm basis, ending all need for EC declarations.

At the time of writing the Productivity Commission had not released its final report. We hope that the Commonwealth government takes the opportunity of the review process to renew the policy and refocus it on its original goal of supporting farmers in living with the reality of the Australian climate. An important part of such a policy renewal would be the introduction of an ICL for drought relief. This would allow farm businesses to take advantage of the insurance benefits associated with default protection and income smoothing, while at the same time minimising taxpayer contributions to drought relief.

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