GRAPE GRUBBERS: THE CASE AGAINST WINE INDUSTRY REREGULATION

The success of the free market Australian wine industry is threatened by renewed industry-demands for government assistance argue **Jeffrey Gow** and **Bligh Grant**

Where there is plenty of wine,
sorrow and worry take wing.
—Anonymous

The Australian wine industry has been one of the most celebrated economic success stories in recent history. From 1990–91 to 2007–08, the total vine bearing area of grapes increased from some 61,000 hectares to 166,000 hectares, with production expanding from 346 million litres to 1.3 billion litres. Export volume increased from 57 million litres to a little over 714 million litres in the same time period, with the value of exports rising from $180 million to $2.7 billion. And most of us have been drinking for Australia, with per capita domestic consumption increasing from 18 litres to 29 litres per annum.[1]

Nor has this been merely a quantum expansion in industry size. Yes, the number of wineries increased from some 600 in 1990–91 to almost 1,900 in 2004–05.[2] More importantly, both grape growing and wine production are now dispersed across a broad area of the country, with the Australian Bureau of Agricultural Economics recently listing no fewer than 86 wine producing regions and as many subregions.[3] This stands in stark contrast to the malaise often presented as typical of rural and regional Australia, of struggling and dying communities, of family farms collapsing, and of under-funded government services. This latter portrait does have some credibility statistically—for example, between 1970 and 1996, the number of farms in Australia decreased from approximately 250,000 to 140,000.[4] Further, the mean size of the remaining farms increased from approximately 1,858 hectares in 1960 to 2,834 hectares in 1996.[5] Both grape growing and wine making have bucked these trends, but the boom has led to a new set of problems for the wine industry.

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The wine bust? And the proposed solution

Although the wine crush continued to increase from 2006–07 to 2007–08, the value of wine sold domestically declined by 4% in the same year. At the same time, the figures for exports became increasingly worrying, with overall quantity dropping 9.2% over the same year, and the unit value decreasing from $5.17 per litre in 2000–01 to a projected $3.51 for 2010–11. And yes, we are drinking a lot more New Zealand Sauvignon Blanc (and other imported wines), with the value of imported wine increasing by 40.8% from 2006–07 to 2007–08, with imported wine projected to reach 18% of domestic consumption by 2013–14.[6]

The Australian Bureau of Agricultural and Resource Economics (ABARE) has recognised the multi-dimensional nature of the problem. Several reports over a number of years cite an increase in global competition, changing drinking patterns in major export markets, and a strong Australian currency as contributing factors. The industry's response has been somewhat shrill. For example, in the Summer 2009-10 issue of the Winemakers' Federation of Australia (WFA) newsletter *Winescope*, WFA CEO Stephen Strachan stated that the industry had to address three problems:

1. to protect the fundamental strength of the Australian wine industry—the ability of industry to make choices and be innovative

2. to protect and enhance what has been left to us by generations of winemakers, vignerons, researchers and entrepreneurs, and

3. to protect the natural assets that we have been left.[7]

However, Strachan also called for increased government regulation of the industry, stating that the ability to sell an alcoholic product is a privilege, not a right, and that two of the most heavily regulated markets in the world—Canada and Sweden—are also the most profitable. He believes that it is time to install barriers that protect profit maximisers and avoid the 'white shoe brigade' while fostering true industry innovators.[8]

This pro-regulatory sentiment echoed previous calls by key industry players—including Doug Lehmann of Peter Lehmann Wines—for a vine pull scheme (VPS) of 20,000–40,000 hectares of vines, equating to 270,000 to 500,000 tonnes of grapes (amounting to 20 million–40 million cases of wine).[9]

In line with this pro-regulatory sentiment, on 10 November 2009 four pivotal institutions of the Australian wine industry—the Winemakers' Federation of Australia (WFA) the Wine Grape Growers' Association (WGGA), the Australian Wine and Brandy Corporation (AWBC) and the Grape and Wine Research and Development Corporation (GWRDC)—released two documents, a joint statement 'Wine industry must confront the reality of oversupply,' which outlined a Wine Restructuring Action Agenda (WRAA),[10] and a *Supporting Report*, which contained an analysis of the industry. Specifically, the *Supporting Report* identified six 'key drivers' behind the WRAA:

1. Australia's wine oversupply exceeds 100 million cases and at the current production rate this will more than double in three years.

2. The scale of the problem is such that we cannot expect normal market forces or external factors to solve it.

3. Even ambitious sales growth ambitions in new markets would eliminate less than a quarter of the oversupply.

4. The combined impact of drought, water shortages and climate change would over time eliminate less than one-tenth of the oversupply.

5. Too much current activity is not viable in terms of competitiveness, margins and target market demand and the problems relate both to demand and supply.[11]

Moreover, the *Supporting Report* claimed that market signals continued to be distorted in the Australian industry due to several factors, including multi-year set price contracts, high sunk-capital costs, the unintended application of the WET (Wine Equalisation Tax) rebate and unrealistic expectations of market growth.[12]

The Wine Restructuring Action Agenda (WRAA) contained four immediate recommendations:

1. From 23 November 2009, detailed and confidential supply data summaries will be provided to regional associations. These will examine each region in isolation and in relation to the national picture, with a focus on levels and patterns of viability.

2. From 30 January 2010, a package of tools will be available to help individual vineyard operators assess their performance and viability. This will include: a checklist; an upgraded Deloitte Ready Reckoner to assess winery profitability by market, channel and price point; and an upgraded Vinebiz program to assess vineyard profitability.

3. From early next year, briefings will be held in 14 regional centres (covering all states) to discuss regional data and issues and offer business stress testing to assist with decision making. The federal government has been approached to help facilitate this initiative, and state input is being sought.

4. WFA and WGGA will hold discussions with the federal government about improved exit packages for growers and small wineries seeking to leave the industry along the lines of drought and small block irrigator exit packages. Discussions also will be held with state government agencies with regard to alternative land use options in wine regions.[13]

As such, while the WRAA included recommendations for a region-based analysis of farm profitability for grape growers (points 1 to 3 above), it also explicitly included a call for government support in the form of exit strategies for grape-growers (point 4 above). This level of government intervention into agricultural commodity production is hardly without precedent but has been rare in the recent past. The broad theoretical reasons for removing the option of market intervention from the armoury of policy options are well documented. However, the immediate question is to what extent would we expect such a scheme to work? To answer this, we look at the last time government intervened in the wine industry with the Vine Pull Scheme (VPS) of 1985–87.

All that you can't leave behind: the 1985–87 VPS

Initially intended only for the dried fruit vine industry, the 1985–87 VPS spilled over into the wine-grape sector due to the McKay Inquiry into grape production, which had been conducted at the same time. The scheme was announced on 26 March 1985, with the then Commonwealth Minister for Primary Industry stating that there was a need for structural adjustment of the industry 'because of a massive over-supply on world markets and high domestic production'[14]—precisely the same core reasons identified by current industry players in the WRAA. Eventually, a total of approximately $8.8 million was spent by the Commonwealth and three state governments (South Australia, Victoria and Queensland) to implement the scheme, with the vast majority ($6.2 million) being spent on wine grape removal in South Australia. With the completion of the scheme, 2,700 hectares (or 8% of annual winery intake) was removed from the national crush. By contrast, 802 hectares (a mere 3%) of dried fruit vine was removed from production.

In their assessment of the scheme published in 1991, Jeff Gow, Geoff Kaine, and Warren Musgrave of the Rural Development Centre (RDC) at the University of New England were highly critical of the overall impact of the policy.[15] They argued that after taking into account the 'grubbings' (or the grapes removed because of vine age, changes in demand, etc.), 'the net effect of the scheme was at most to increase grubbings by only 400 hectares' or approximately 1.5% of annual winery intake. Further, they argued that 'it seems difficult to avoid drawing the conclusion that the primary impact of the scheme was to bring forward intended grubbings of aged vines which were nearing the end of their productive life.'[16] Moreover, while the VPS was designed to assist the dried fruit industry, only 22% of funds were directed to this goal, principally because of an upswing in global demand for dried fruits when the scheme commenced.

The report offered several observations regarding why the scheme faltered, particularly in relation to the dried fruit vines. First, fruit production by vines is inherently unresponsive to market signals (despite the fickle nature of the market) because the planning horizon of production will always be some 40 years—the producing life of a vine. As such, producers are better off taking a reduced price—even a price that falls well below the cost of production—for several consecutive years because the term of investment is so long.

Second, this structure of inherent unresponsiveness was exacerbated due to government regulation at the time. This included an exemption from section 45 of the *Trade Practices Act 1974* (the section prohibiting price fixing, monopolisation, and exclusive dealing) such that a sophisticated two-price scheme could be put in place. The scheme was designed to equalise the price received from export and domestic markets via a levy on domestic sales of dried fruit, which was then redistributed to producers.

Third, grape growing was overseen by two separate bureaucracies (the Australian Dried Vine Fruits Association domestically and the Australian Dried Fruits Corporation for export sales and marketing, in 'single desk' mode). Further, sultana producers also benefited from federal government underwriting, which guaranteed a minimum return on dried sultana production equal to 80% of an estimated average of equalised returns over the previous three seasons. These extreme levels of protection significantly insulated growers from price signals.

Finally, the RDC report noted that, in contrast to the ineffectual result with respect to dried fruit, the scheme did result in some multi-purpose wine grapes being pulled that were used for wines that 'certainly appear[ed] to be in long term decline,' namely 'those varieties used in fortified and table red wines.'[17]

Yet it is not so much in the bottom-line assessment of the 1985–87 VPS that the lessons for today's wine industry lies; rather, it is in the unintended consequences of policy that marked this particular episode of government intervention into agricultural commodity production. The scheme was star-crossed from the outset. Both the NSW Department of Agriculture and the SA Department of Agriculture cautioned against the scheme's implementation, the former asserting that 'apart from the problems of distorting the use of resources in favour of the underwritten resource, there is no guarantee that assistance distributed on the basis of resource-use will correspond to the welfare objectives of the Government.' One of the main points to be derived from the RDC analysis is that in "picking losers" by way of a VPS confines the industry to the farms that remain, rather than taking the more considered approach of adjustment over time. The NSW Department of Agriculture realised that any VPS was in danger of damaging industry infrastructure, and this point is reinforced by experience overseas.[18]

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In offering an assessment of the adjustment (or welfare) objective of the 1985–87 VPS, the RDC report found that while many grape-growing enterprises were 'uneconomic' when assessed from the perspective of grape-growing only, this was a surprisingly small percentage of producers. For example, in their overview of Murray River irrigation published only two years before the VPS Scheme was initiated, Dwyer Leslie/Maunsell found that 37% of growers in the Riverland did not depend 'primarily on the farm for their income' and that these growers were 'identified as either salaried professionals (e.g. solicitors), retired and semi-retired individuals and hobby farmers.'[19] Moreover, equity levels of these farms was high, with only 4% having an equity level less than 50%, with an average of 77% for mediumsized grape blocks. They cited another study conducted by Menzies and Grey in 1984 that found that 40% of heads of households earned income from activities apart from their farming enterprises.[20] Dwyer Leslie/Maunsell concluded that the requirement for any type of welfare assistance for Riverland farmers was less than in other areas: Many producers effectively operated mixed businesses, with a variety of on-farm and off-farm income streams.

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The RDC report also illustrated how the 1985–87 VPS tripped up on its own methodology: A foundational element of the application of the scheme was land area—assistance payments were acreage-based. Yet two variables immediately confounded this seemingly obvious choice of definition so as to render it simplistic. The first was that yield per acre is variable by variety of grape: Muscat Gordo Blanco yielded approximately 40 tonnes per hectare compared to the Shiraz's six tonnes per hectare. Although the Shiraz brought a higher price per tonne as a varietal in its own right, this price would rarely exceed 50% more than the cheaper varieties. As such, 'an assistance differential of over 600% would be necessary to make them indifferent to pulling either variety.'[21]

Post-facto, a newly-elected Australian Labor government found itself giving money to commercial grape growers for doing what they were going to do anyway. Twenty-five years later the same mistake may be repeated. Because the VPS ended up being a blanket scheme, the Commonwealth was also subsidising the viticultural 'lifestyle' and 'hobby' farms of some urban and rural professionals.

The RDC Report summed up the 1985-87 intervention:

> In short, the Vine Pull Scheme was prompted by a temporary, albeit prolonged, decline in world prices ...
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> In these circumstances, the provision of assistance through the Scheme for the destruction of long term assets such as vine stocks appears to be an inappropriate policy ... The recovery in export prices in the season preceding the implementation of the scheme, and the resultant low participation rate in the Scheme could, perhaps, be fortuitous.[22]

Then and now

But to what extent are the two situations—then and now—comparable? And what lessons, if any, can be derived from the experience in the 1980s? Of course, the two schemes are different: in the 1985–87 VPS, the Commonwealth gave funds to the state governments to pay farmers to pull out vines (initially clear-fell, then selectively). On the other hand, the WRAA is a more sophisticated instrument of convincing people *out of* grape production, with the help of the upgraded Deloitte Ready Reckoner and Vinebiz accounting programs coupled with the proposed exit packages from government suggested as point 4 of the WRAA (above).

Despite this, the most immediate similarity between the two schemes is that as well as being aimed at restructuring the industry, they both have a welfare component. But the welfare component of 1985–87 VPS was aimed (although it did not eventually reach) those producers who relied solely upon grape production as their means of income—in fact, this cohort turned out to be relatively small. On the other hand, the welfare component of the current WRAA is clearly aimed at the financial sustainability of larger producers, against what the CEO of the WFA referred to as the 'white shoe brigade' of producers—who are by no means individuals who have retired to grape growing, they are just the smaller players in regions assessed as marginal on the basis of grape production only. These players may well have other sources of income (on-farm and off-farm) and may well be contributing to the overall economic regeneration of some marginal regions in the country. Nevertheless, the WRAA is clearly aimed at persuading them to stop growing grapes for wine production. Yet these individuals could simply be enjoying growing grapes, drinking their own booze, and selling a few bottles to their friends. Whatever they're doing, it really isn't the business of the WFA, the WGGA, the AWBC, or the GWRDC. Nor is it the role of taxpayers to assist them out of the industry if they choose to exit.

The second similarity is that the proposed WRAA is nothing short of radical government intervention into commodity production in Australia. Although the WFA spruiks the idea that the industry is helping itself, the reality is that both the AWBC and the GWRDC are statutory corporations of the Commonwealth. As such, it may not be Commonwealth or state ministry that is prescribing policy in this instance, but it is still these organisations designing and delivering the agenda, then informing elected governments (or 'brief[ing] Federal and State primary industry ministers … four days before the statement's release and the State associations since brief[ing] relevant authorities.'[23]

The third similarity follows from this. Just because it is a restructured regulatory environment does not entail that this kind of intervention into commodity production won't be subject to the systemic problems of intervention into the market. Nor does the proposed WRAA guarantee against different, although no less perverse, outcomes witnessed as a result of the 1985–87 VPS. These outcomes showed that assistance programs in agriculture are notoriously difficult to design and that particular attention needs to be paid to designing criteria and ease of implementation. Moreover, to implement the WRAA as envisioned by the WFA and others would negate the principle that has seen the growth of the industry for the last 20 years, namely, that of minimal government interference.

Market solutions

So what should be done about the industry's problems—particularly oversupply?

This question is pertinent not only to the larger (corporate) producers but also for the disparate regions around the country that now enjoy the benefits of wine production as part of their local milieu. In this regard, and contradicting the claims of the WRAA *Supporting Report*, the industry is responding to market signals. The same ABS category that witnessed the meteoric growth in the industry now records that the total grape crush for 2008–09 dropped by 5.4% on the previous year, coinciding with a 5.9% decrease in overall literage. Moreover, the sky hasn't fallen in on the export front: Sales rose by 5.2% and domestic sales also rose slightly.[24]

This does not deny that the wine industry faces the systemic problems noted earlier. It does, however, caution against clumsy intervention.

As well, other steps can be taken within a market framework. Even ABARE has made specific recommendations in this regard.[25] These include exploring different business models, recasting the relationships between grape growers and winemakers, additional investment in R&D, and market expansion via in-country promotion.

These solutions require a lot of hard work but are far better for the long term prospects of the industry and its consumers.

Endnotes

1. Figures for the industry 1990–91 to 2005 have been rounded and are derived from Glenn Banks, Steven Kelly, Nicholas Lewis, and Scott Sharpe, 'Place "From One Glance": the use of place in the marketing of New Zealand and Australian wines,' *Australian Geographer* 38:1 (2007), 17, and from Australian Bureau of Statistics Cat. No. 1329.0, 'Australian wine and grape industry' (2010).
2. As above, 17.
3. Thomas Jackson, 'Australian wine grape production projections to 2010–11,' Australian Bureau of Agricultural and Resource Economics (ABARE) Research Report 09.7 (March 2009), 18.
4. ABS Cat. No. 7106.0, 'Australian farming in brief' (2009).
5. Andrew Davidson and Bligh Grant, 'Rural Australia: neo-liberalism or a "new feudalism"?' *Journal of Contemporary Asia* 31:3 (2001), 296.
6. Projections for the industry are taken from Thomas Jackson, Tara Stokes, and Brenda Dyack, 'Wine and wine grapes: outlook to 2013–14,' *Australian Commodities* (March quarter) 16:1 (ABARE, 2009).
7. Stephen Strachan, 'Reform agenda looks beyond current problems,' *Winescope* (Winemakers' Federation of Australia, Summer 2009/10).
8. As above.
9. See, for example, Eli Greenblat, 'Rip out the vines, wine industry told,' *The Sydney Morning Herald*, Business Day (6 January 2010); Eli Greenblat, 'Casella adds voice to call for cull to vineyards,' The Land (12 January 2010).
10. Winemakers' Federation of Australia, Wine Grape Growers' Australia, Australian Wine and Brandy Corporation, and Grape and Wine Research Development Corporation, 'Wine industry must confront the reality of oversupply' (*Joint Statement*) (November 2009).
11. Winemakers' Federation of Australia, Wine Grape Growers' Australia, Australian Wine and Brandy Corporation, and Grape and Wine Research Development Corporation, 'Wine restructuring action agenda: Supporting Report' (*Supporting Report*) (November 2009), 1.
12. *Supporting Report*, as above, 1.
13. *Joint Statement*, as above, 3.
14. The (then) federal Minister for Primary Industry, cited in Jeff Gow, Geoff Kaine, and Warren Musgrave, *An Economic Evaluation of the Vine Pull Scheme 1985–87*, Publication No. 173 (Armidale: The Rural Development Centre, University of New England, 1991), 31.
15. Jeff Gow, et al., as above.
16. As above, 40.
17. As above, 58.
18. Gerard Boyd, 'The lowdown on Malbec,' www.winereviewonline.com (26 January 2010).
19. Dwyer Leslie/Maunsell, *River Murray Irrigation Overview Study—Final Report* (Canberra: 1983).
20. Bruce Menzies and Peter Gray, *Technological Change: Salinity and Irrigation Systems—The Responses of Fruit Growers in the South Australian Riverland*, Technical Paper No. 8 (Department of Agriculture, South Australia, 1984).
21. Jeff Gow, et al., as above, 72.
22. As above, 56.
23. Stephen Strachan, as above, 1.
24. ABS Cat. No. 1329.0, 'Australian wine and grape industry' (2010).
25. Terry Sheales, Stephen Apted, Andrew Dickson, Rohan Kendall, and Simon French, *Australian Wine Industry: Challenges for the Future*, ABARE Research Report 06.16 (October 2006).