The Australian

Water plan will cost a tsunami

- **Henry Ergas**
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THE Murray-Darling Basin policy has so far lacked any rational economic foundations.

TRUTH in advertising: I detest greenies every bit as much as the next man. And any sensible person likes seeing the government cop a hiding. So watching our country cousins shred the Murray-Darling Basin Authority's draft plan put a spring in my step and a song in my heart.

But the irrigators are hardly all sweetness and light. Rather, these are rent-seekers extraordinaire. And the concessions they are likely to extract could make a bad situation worse. That those concessions will be accompanied by give-aways placating the Greens makes the prospects even grimmer. Start with the facts. Far from destroying irrigation communities, the commonwealth is spending $4.4 billion in so-called water-saving initiatives that will fund irrigation upgrades. That spending is remarkably inefficient. Estimates suggest the benefits, in terms of additional water available, amount to barely $1bn: so that of every dollar of expenditure spent, more than 75c is pure waste.

That the subsidies are so inefficient is unsurprising. These upgrades involve high capital costs while securing very little water: according to a forthcoming paper by Quinton Grafton in the Australian National University's journal Agenda, some 400 to 450 gigalitres basin wide. That works out at around $10,000 per megalitre, four times the price paid by the government for water entitlements to date.

Only a small share of those high capital outlays will ever be recovered, with the bulk of a farmer's payments covering operating costs. And with the improved irrigation system reducing irrigators' water costs, farmers will use more water generally and prefer more water-intensive crops. This means that more water, a subsidised, high cost input, will be used, replacing unsubsidised, lower cost inputs and so increasing costs overall. Moreover, the more marginal the land, the more water it likely requires, and the higher the cost of irrigation infrastructure to reach it.

Irrigation can, in other words, account for a high share of the cost of additional production, that is the marginal costs. Subsidies to irrigation will therefore induce farmers to expand production, and that additional production (taking the subsidy into account) will cost more than it is worth. That loss adds to the waste.

In most industries, such a subsidy, as well as being inefficient, would be politically ineffective.

To see why, consider a subsidy to truckers for petrol. As the subsidy reduced those costs, truckers would want to supply more services; but as the market adjusted to increased supply, prices would fall, with competition ultimately passing the entire cost saving on to buyers. Taxpayers would be subsidising the truckers' customers, not the truckers. Not so, however, with Australian producers of irrigated crops such as cotton. These producers (who already earn higher margins than producers of wheat and other less subsidised crops) face prices set in world markets, where their own supply has little impact on price. As a result, they can sell more without the price falling.

And with price largely fixed, any cost savings they make are not passed on to buyers but accrue to them as higher returns, or in economic terms, as a rent, and which will also be reflected in increased land values.

Subsidies for inputs (in this case, water) can thus be especially effective in transferring income from taxpayers to these producers. That the subsidies are opaque adds to their political attractiveness. And so does the fact that once the capital is sunk, the subsidy is history, protected from shifting political fortunes.

But this is not to say that the environmental zealots are any more worthy. Wasting a dollar of taxpayers' money building irrigation worth 25c is bad; but it is every bit as bad to spend that dollar buying water for environmental purposes that themselves yield benefits worth only a fraction of the amount spent. Rather, sensible use of water, and of taxpayers' money, requires ensuring that the benefits of increased environmental flows are at least equal to their costs, including the value of the water in alternative uses. This standard cannot be met simply by setting objectives for the river system in bio-physical terms, for instance, sediment content or water temperature. These are merely intermediate steps in securing outcomes people value, such as species diversity, physical beauty or the rivers' suitability for activities such as swimming and fishing. What matters is knowing how much people value those outcomes, and then spending no more than that amount.

The government's water purchases to date have been entirely unblemished by any such assessment. Nor has the MDBA, in deriving its estimates of the water farmers need to forgo, relied on any such valuation of the environmental consequences.

Rather, it too has set objectives purely in physical terms, as if each environmental outcome were worth achieving at any price.

The Murray-Darling Basin saga therefore now centres on the clash of two powerful logics.

Echoing the government's arguments in favour of the National Broadband Network, proponents of the first assert that country people "deserve" water, regardless of costs and benefits. Advocates of the second, harking back to the government's own language on climate change, treat environmental outcomes as moral imperatives, rather than as uses of scarce resources that need to be weighed against alternatives.

With a minority government dependent on both groups, and trapped in rhetoric it has done so much to endorse, it is taxpayers and the wider community that are likely to pay the price of keeping these veto players happy.

And what a high price that could be. Since 1992, more than $20bn has been allocated for the Murray-Darling. Even in the crowded field that is Australian public policy, rarely has so much been spent to achieve so little. No wonder, for the policy has lacked any rational economic foundation. Until that changes, expect a trickle of benefits from a tsunami of costs.