

# Who Gains from Australian Generic Wine R&D and Promotion?\*

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## *Abstract*

A multi-sectoral partial equilibrium model of the markets for two types of Australian grapes and wine (premium and non-premium) is developed to study the aggregate returns from different types of research and promotion investments by the industry and their distribution across actors in the market (grapegrowers, winemakers, wholesalers/retailers, domestic consumers, the tax office and foreign consumers). The distinction is made between premium and non-premium, since half the market is non-premium and yet virtually all the R&D and marketing efforts are focused on just premium products in an attempt to raise quality as consumers continue to move up-market. The results show that most of the gains from cost-reducing R&D go to producers, with wineries faring better than grapegrowers; that producers get a far larger share of the benefit from promotion when it is targeted abroad than when it focuses on domestic consumers; and that foreign consumers of Australian wine enjoy a small share of the benefits.

**Keywords:** Economics of R&D, promotion, wine, equilibrium displacement modelling

**JEL classification:** C69, O33, Q13, Q16

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## **Who Gains from Australian Generic Wine R&D and Promotion?**

During the latter half of the 20<sup>th</sup> century the wine industry in many parts of the world has gradually become more professional in its approach to investing both in research and development (R&D) and in promotion. This has been particularly pronounced in the New World as the industry has corporatized and large firms have emerged,<sup>1</sup> and as export-oriented output has expanded.<sup>2</sup> Brand-level promotion can be and is undertaken by large firms, but since the vast majority of firms are tiny, even in the United States and Australia, many cannot afford mass media promotion campaigns. They therefore depend on generic promotion of their nation and region of origin. With respect to R&D, even large firms, let alone small ones, cannot on their own justify undertaking much large-scale research. As well, the public-good nature of both research and generic promotion is such that they are underinvested in unless done collectively. Hence grapegrowers and winemakers in countries such as Australia agree to pay a production-based annual levy to fund both of those activities. The Australian Government supplements those funds, matching them in the case of R&D on a dollar-for-dollar basis up to 0.5 per cent of the value of production (Brennan and Mullen 2002).

Who benefits from the investment of those funds? Does the distribution of benefits from R&D differ from that for promotion? To what extent do premium producers benefit relative to producers of lower-quality product? How do these outcomes change as the industry become more export-oriented? This paper outlines a methodology for addressing those questions. It then applies the model to Australian grape and wine industry data. The Australian case study is particularly timely at the moment for two reasons: because producers are contemplating raising the R&D levy they pay so as to at least reach the Federal Government's 0.5% matching funding threshold; and because the industry has recently launched a major new marketing drive (WFA and AWBC 2000). As recent modelling results demonstrate (Anderson 2001; Anderson, Norman and Wittwer 2001), the latter is going to be essential if producer prices are not to decline over the next few years as the recent boom in plantings translates into ever-greater supplies of premium wines on the international market.

Specifically, R&D via Australia's Grape and Wine Research and Development Corporation (GWRDC) is currently funded by a levy of \$5 per tonne of grapes (\$2 per tonne from grapegrowers on grapes received by wineries, and \$3 per tonne from wineries on the weight of grapes crushed for wine), which is matched by a similar grant from the Federal Government. As can be seen from Figure 1, there has been a significant increase in real dollar terms in the grape and wine R&D expenditure since early 1980s as a result of industry expansion and past increases in the levy rate. The annual R&D expenditure for 2000-01 reached \$11.3 million in nominal terms. However, the producer proportion of that represents only about 0.3% of the value of production, well below the 0.5% limit to which matching government funding applies. Proposals are currently being considered by producers to raise the industry R&D levy and possibly to move to an ad valorem levy system so as to ensure funding moves with the product price as quality rises over time and/or supply growth depresses some prices. The support for such a rise has been boosted by a recent benefit-cost study suggesting that the current portfolio of GWRDC research projects is expected to yield a 9:1 benefit/cost ratio and that a sample of past projects yielded ratios ranging from 7:1 to 76:1 (McLeod 2002).

Generic national promotion abroad is funded by a Federal Government grant plus a compulsory wine export levy based on the f.o.b. value of wine exported (0.2% of an exporter's first \$10 million of sales, 0.1% for the next \$40 million, and 0.05% for sales beyond \$50 million per year). The manager of those funds is the Australian Wine and Brandy Corporation (AWBC). Generic regional promotion is funded by voluntary membership of regional associations. State governments have supplemented the federal contributions from time to time (GWRDC 2001; AWBC 2001; Brennan and Mullen 2001).

The two producer groups and the government (on behalf of taxpayers and domestic consumers) are interested in maximizing the pay-offs from the investment for those funds. The government is also concerned about any spillovers to other producer groups, and any additional environmental and/or social outcomes generated from the expenditure of those public funds. There is also the issue of how much of the research

outcome benefits wine consumers and producers in other countries, both gross and net of benefits to Australia from similar activities abroad.

Issues of interest include, among others, the returns from research investments versus those from promotion, the returns from R&D for grapes versus for wine, the returns from cost-reducing R&D versus those from quality-enhancing R&D, and the returns from domestic promotion versus those from export promotion. Both the aggregate returns of these broad types of investments, and the distribution of total returns among groups such as premium and non-premium grape growers, premium and non-premium winemakers, domestic retailers, taxpayers, and domestic and overseas consumers are of interest. The distributional issue relates to the question of who should pay for what types of investments: not only as between consumers (including as taxpayers) and producers, but also as between grape growers and wineries (given that much of the quality of a wine is determined in the vineyard prior to crushing). In addition, knowledge on the impact on the government treasury via both the wholesale sales tax (now called a Wine Equalization Tax (WET)) and the Goods and Services Tax (GST) will also be useful.

The returns from the various parts of this investment portfolio need to be analysed within a comprehensive, internally consistent framework. Just measuring the direct effect of, say, a new cost-reducing viticultural technology on grape growers' costs per tonne is insufficient, for it does not take into account the indirect flow-on effects to those further down the supply chain and the associated changes in prices and quantities. Determining the net economic welfare benefits for growers, winemakers and consumers requires an economic model that identifies explicitly the multi-stage production process involved.<sup>3</sup> Even that leaves unmeasured any economic spillovers to other Australian industries or the grape and wine industries of other countries, and any social and environmental spillovers (both positive and negative).

There is a rapidly growing literature on the economic evaluation of research and promotion expenditures (see Alston, Norton and Pardey 1995). One of the approaches has been the use of a partial equilibrium, comparative static framework to measure effects on economic welfare within an industry or sector (Freebairn, Davis and Edwards 1982; Wohlgenant 1993; Alston and Chalfant (1999); Zhao *et al.* 2000). A

set of demand and supply equations with general functional form are used to describe the relationships among various industry links in the supply chain and consumer groups (see, for example, Alston and Wohgenant 1990; Zhao, Mullen and Griffith 1997). The impacts of alternative R&D and promotion investments are modelled as exogenous variables that shift the relevant supply or demand curves, and the changes in prices and quantities resulting from new technologies or promotion are then obtained to estimate the welfare implications for various industry groups.

In this paper, we use a multi-sectoral partial equilibrium model of the markets for two types of Australian grapes and wine (premium and non-premium) to study the aggregate returns and their distributions from different types of research and promotion investments in the industry. The distinction between premium and non-premium is crucial, since half the market is non-premium and yet virtually all the R&D and marketing efforts are focused on just premium products in an attempt to raise quality as consumers continue to move up-market. The model is presented first, and the data and market parameters are described next. Results are then presented, before drawing out their implication in the final section of the paper.

### **The model**

The structure of the model of the Australian wine industry is provided in Figure 1, where each rectangle represents a production function and each arrowed straight line the market for a product, with the arrowed end being the demand and the non-arrowed end being the supply of the product. Each oval represents a supply or demand schedule where an exogenous shift may occur.

Horizontally, the industry is disaggregated into premium and non-premium wine sectors. Vertically, the industry is separated into the following sectors: grape production, wine making, wine marketing and final consumption. This enables us to study implications of R&D and promotion investments in individual parts of the wine production and marketing chain.

We assume that participants in all sectors are profit-maximizers and the technologies are characterised by constant returns to scale. The economic equilibrium among

sectors of the Australian wine industry is modelled with general functional forms by Equations (1)-(36). Fifteen exogenous shifter variables are incorporated in the model. Variable notation is also shown in Figure 2.

**Input supply to the premium and non-premium wine sectors:**

- (1)  $X_p = X_p(w_p, w_{mp}, T_{Xp}, T_{Xmp})$  *supply of premium grapes*
- (2)  $X_p = X_{p1} + X_{np1}$  *destinations for premium grapes*
- (3)  $X_{p2} = X_{p2}(w_{p2}, T_{Xp2})$  *supply of premium wine specific inputs*
- (4)  $X_{p3} = X_{p3}(w_{p3}, T_{Xp3})$  *supply of other premium winemaking inputs*

Equation (1) is the supply function for premium wine grapes, relating total quantity supplied  $X_p$  to own price  $w_p$  and the price of multi-purpose grapes  $w_{mp}$ . In other words, it is assumed that the premium grape growers can shift some of the production to multi-purpose grapes, through grafting for example, in response to changes in the relative prices of the two types of grapes.  $T_{Xp}$  and  $T_{Xmp}$  are the supply shifters representing the impacts of new technologies that reduce the costs of producing premium and non-premium grapes respectively. The identity given in Equation (2) shows that the premium grapes can be used for producing either premium wine ( $X_{p1}$ ) or non-premium wine ( $X_{np1}$ ). Less than 5% of premium grapes are used for non-premium wine production. Equations (3) and (4) are supply functions for two other aggregated inputs to premium wine production.  $X_{p2}$  represents fixed capital, human capital and other inputs that are specific to premium wine making. These are relatively inelasticly supplied.  $X_{p3}$  represents mobile factors such as labour, chemical and other factor inputs that are non-specific to premium wine making. Supplies of these inputs are elastic.  $T_{Xp2}$  and  $T_{Xp3}$  are supply shifters for  $X_{p2}$  and  $X_{p3}$  respectively.  $T_{p2}$  can be used to represent technical changes in the premium wine making sector.

- (5)  $X_{mp} = X_{mp}(w_{mp}, w_p, T_{Xp}, T_{Xmp})$  *supply of multipurpose grapes*
- (6)  $X_{mp} = X_{np2} + X_{dtd} + X_{dte}$  *destinations for multipurpose grapes*
- (7)  $X_{np3} = X_{np3}(w_{np3}, T_{Xnp3})$  *supply of non-premium wine specific inputs*
- (8)  $X_{np4} = X_{np4}(w_{np4}, T_{Xnp4})$  *supply of other non-premium wine making inputs*

Equation (5) is the supply of multi-purpose grapes relating the quantity supplied to own price and the price of premium grapes, with  $T_{Xp}$  and  $T_{Xmp}$  as the supply shifters. Equation (6) shows that multi-purpose grapes can be used either for non-premium wine production (32%) or as dried and table grapes for domestic or export market. Equations (7) and (8) are supply functions for capital inputs ( $X_{np3}$ ) and mobile inputs ( $X_{np4}$ ) respectively into non-premium wine production, with  $T_{Xnp3}$  and  $T_{Xnp4}$  as supply shifters.

### **Demand for table grapes**

$$(9) \quad X_{dtd} = X_{dtd}(w_{mp}, N_{Xdtd}) \quad \text{domestic demand for drying/table grapes}$$

$$(10) \quad X_{dte} = X_{dte}(w_{mp}, N_{Xdte}) \quad \text{overseas demand for drying table grapes}$$

Equations (9) and (10) are demand schedules for dried and table grapes for domestic ( $X_{dtd}$ ) and export ( $X_{dte}$ ) markets respectively.  $N_{Xdtd}$  and  $N_{Xdte}$  are the respective demand shifters.

### **Output-constrained input demand of the premium wine sector**

$$(11) \quad X_{p1} = Y_p * c'_{Yp,1}(w_p, w_{p2}, w_{p3}) \quad \text{demand for premium grapes}$$

$$(12) \quad X_{p2} = Y_p * c'_{Yp,2}(w_p, w_{p2}, w_{p3}) \quad \text{demand for specific inputs}$$

$$(13) \quad X_{p3} = Y_p * c'_{Yp,3}(w_p, w_{p2}, w_{p3}) \quad \text{demand for other inputs}$$

The above three equations are the output-constrained input demand for  $X_{p1}$ ,  $X_{p2}$  and  $X_{p3}$ , derived using Shephard's Lemma.  $c'_{Yp,i}(w_p, w_{p2}, w_{p3})$  ( $i=1, 2, 3$ ) are partial derivatives of the unit cost functions  $c_{Yp}(w_p, w_{p2}, w_{p3})$  ( $i=1, 2, 3$ ).

### **Output-constrained input demand of the non-premium wine sector**

$$(14) \quad X_{np1} = Y_{np} * c'_{Ynp,1}(w_p, w_{mp}, w_{np3}, w_{np4}) \quad \text{demand for premium grapes}$$

$$(15) \quad X_{np2} = Y_{np} * c'_{Ynp,2}(w_p, w_{mp}, w_{np3}, w_{np4}) \quad \text{demand for non- premium grapes}$$

$$(16) \quad X_{np3} = Y_{np} * c'_{Ynp,3}(w_p, w_{mp}, w_{np3}, w_{np4}) \quad \text{demand for specific inputs}$$

$$(17) \quad X_{np4} = Y_{np} * c'_{Ynp,4}(w_p, w_{mp}, w_{np3}, w_{np4}) \quad \text{demand for other inputs}$$

Equations (14)-(17) are the output-constrained input demand for non-premium wine production, also derived using Shephard's Lemma.  $c'_{Ynp,i}(w_p, w_{mp}, w_{np3}, w_{np4})$  ( $i=1,$

..., 4) are partial derivatives of the unit cost functions  $c_{Y_{np}}(w_p, w_{mp}, w_{np3}, w_{np4})$  ( $i=1, \dots, 4$ ).

**Market-clearing condition/supply of premium and non-premium wholesale wine:**

(18)  $v_p = c_{Y_p}(w_p, w_{p2}, w_{p3})$  *supply of premium wine*

(19)  $v_{np} = c_{Y_{np}}(w_p, w_{mp}, w_{np3}, w_{np4})$  *supply of non-premium wine*

The above market-clearing conditions specify that unit prices for outputs equal the unit costs of production.

**Destination of wine at the cellar door:**

(20)  $Y_p = Y_{pd1} + Y_{pe1}$  *premium wine destinations*

(21)  $Y_{np} = Y_{npd1} + Y_{npe}$  *non-premium wine destinations*

Equations (20) and (21) show that both premium and non-premium producer wines are destined for either domestic and export markets.

**Supply of wine marketing inputs:**

(22)  $Y_{pd2} = Y_{pd2}(v_{pd2}, T_{Y_{pd2}})$  *supply of domestic premium wine marketing inputs*

(23)  $Y_{pe2} = Y_{pe2}(v_{pe2}, T_{Y_{pe2}})$  *supply of export premium wine marketing inputs*

(24)  $Y_{npd2} = Y_{npd2}(v_{npd2}, T_{Y_{npd2}})$  *supply of domestic non-premium wine marketing inputs*

Equations (22)-(24) show that the supplies of marketing inputs ( $Y_{pd2}$ ,  $Y_{pe2}$  and  $Y_{npd2}$ ) relate to own prices ( $v_{pd2}$ ,  $v_{pe2}$  and  $v_{npd2}$ ), with impacts of marketing R&D represented by the shifters ( $T_{Y_{pd2}}$ ,  $T_{Y_{pe2}}$  and  $T_{Y_{npd2}}$ ).

**Output-constrained input demand of the wine marketing sectors:**

(25)  $Y_{pd1} = Q_{pd} * c'_{Q_{pd},1}(v_p, v_{pd2})$  *for premium wine -- domestic*

(26)  $Y_{pd2} = Q_{pd} * c'_{Q_{pd},2}(v_p, v_{pd2})$  *for premium wine marketing inputs – domestic*

(27)  $Y_{pe1} = Q_{pe} * c'_{Q_{pe},1}(v_p, v_{pe2})$  *for premium wine -- export*

(28)  $Y_{pe2} = Q_{pe} * c'_{Q_{pe},2}(v_p, v_{pe2})$  *for premium wine marketing inputs – export*

(29)  $Y_{npd1} = Q_{npd} * c'_{Q_{npd},1}(v_{np}, v_{npd2})$  *for non-premium wine -- domestic*

$$(30) \quad Y_{npd2} = Q_{npd} * c'_{Qnpd,2}(v_{np}, v_{npd2}) \quad \text{for non-premium wine marketing inputs -- domestic}$$

These are the output-constrained input demand for the three marketing sectors based on Shephard's Lemma.

**Market-clearing condition for the marketing sectors:**

$$(31) \quad p_{pd} = c(v_p, v_{pd2}) \quad \text{premium wine domestic marketing}$$

$$(32) \quad p_{pe} = c(v_p, v_{pe2}) \quad \text{premium wine export marketing}$$

$$(33) \quad p_{npd} = c(v_{np}, v_{npd2}) \quad \text{non-premium wine domestic marketing}$$

These specify that the unit output price for each of the three marketing sectors is equal to the unit cost.

**Final demand for wine:**

$$(34) \quad Y_{npe} = Y_{npe}(v_{np}, N_{Ynpe}) \quad \text{overseas demand for non-premium wine}$$

$$(35) \quad Q_{pd} = Q_{pd}(p_{pd}, p_{npd}, N_{Qpd}, N_{Qnpd}) \quad \text{domestic demand for premium wine}$$

$$(36) \quad Q_{pe} = Q_{pe}(p_{pe}, N_{Qpe}) \quad \text{overseas demand for premium wine}$$

$$(37) \quad Q_{npd} = Q_{npd}(p_{pd}, p_{npd}, N_{Qpd}, N_{Qnpd}) \quad \text{domestic demand for non-premium wine}$$

These are the demand functions for the four final wine products/markets. The N's are demand shifters representing impacts of promotion or increase in product quality in individual markets. As can be seen from Equations (35) and (37), the premium and non-premium wines are assumed substitutes in the domestic market.

The above structural model defines an equilibrium status in all markets involved. When a new technology or promotion disturbs the system through an exogenous shock, a displacement from the base equilibrium results. By totally differentiating the system of equations at the initial equilibrium points, the displacement model that relates changes of endogenous variables to changes in exogenous shifters can be derived as follows, where  $E(.) = \Delta(.) / (.)$  represents a small relative change of a variable (.). Definitions of all market parameters are given in Table 1. They refer to values at the initial equilibrium points. Integrability conditions such as symmetry and homogeneity conditions are imposed implicitly.

### *The model in equilibrium displacement format*

#### **Input supply to premium wine and non-premium wine sectors:**

$$(1)' \quad EX_p = \varepsilon_{(X_p, w_p)}(EW_p - t_{X_p}) + \varepsilon_{(X_p, w_{mp})}(EW_{mp} - t_{X_{mp}}) \quad \text{supply of premium grapes}$$

$$(2)' \quad EX_p = \rho_{X_{p1}}EX_{p1} + \rho_{X_{np1}}EX_{np1} \quad \text{destinations for premium grapes}$$

where  $\rho_{X_{p1}}=X_{p1}/(X_{p1}+X_{np1})$  and  $\rho_{X_{np1}}=X_{np1}/(X_{p1}+X_{np1})$  are quantity shares.

$$(3)' \quad EX_{p2} = \varepsilon_{(X_{p2}, w_{p2})}(EW_{p2} - t_{X_{p2}}) \quad \text{supply of premium wine specific inputs}$$

$$(4)' \quad EX_{p3} = \varepsilon_{(X_{p3}, w_{p3})}(EW_{p3} - t_{X_{p3}}) \quad \text{supply of other premium wine making inputs}$$

$$(5)' \quad EX_{mp} = \varepsilon_{(X_{mp}, w_{mp})}(EW_{mp} - t_{X_{mp}}) + \varepsilon_{(X_{mp}, w_p)}(EW_p - t_{X_p}) \quad \text{supply of multipurpose grapes}$$

$$(6)' \quad EX_{mp} = \rho_{X_{np2}}EX_{np2} + \rho_{X_{dtd}}EX_{dtd} + \rho_{X_{dte}}EX_{dte} \quad \text{destinations for multipurpose grapes}$$

where  $\rho_{X_{np2}}=X_{np2}/(X_{np2}+X_{dt})$  and  $\rho_{X_{dte}}=X_{dte}/(X_{np2}+X_{dt})$  are quantity shares.

$$(7)' \quad EX_{np3} = \varepsilon_{(X_{np3}, w_{np3})}(EW_{np3} - t_{X_{np3}}) \quad \text{supply of non-premium wine specific inputs}$$

$$(8)' \quad EX_{np4} = \varepsilon_{(X_{np4}, w_{np4})}(EW_{np4} - t_{X_{np4}}) \quad \text{supply of other non-premium wine making inputs}$$

#### **Demand for drying and table grapes:**

$$(9)' \quad EX_{dtd} = \eta_{(X_{dtd}, w_{mp})}(EW_{mp} - n_{X_{dtd}}) \quad \text{domestic demand for drying/table grapes}$$

$$(10)' \quad EX_{dte} = \eta_{(X_{dte}, w_{dte})}(EW_{mp} - n_{X_{dte}}) \quad \text{overseas demand for drying/table grapes}$$

#### **Output-constrained input demand of the premium wine sector:**

$$(11)' \quad EX_{p1} = -(\kappa_{p2}\sigma_{(X_{p1}, X_{p2})} + \kappa_{p3}\sigma_{(X_{p1}, X_{p3})})EW_p + \kappa_{p2}\sigma_{(X_{p1}, X_{p2})}EW_{p2} + \kappa_{p3}\sigma_{(X_{p1}, X_{p3})}EW_{p3} + EY_p \quad \text{demand for premium grapes}$$

$$(12)' \quad EX_{p2} = \kappa_{p1}\sigma_{(X_{p1}, X_{p2})}EW_p - (\kappa_{p1}\sigma_{(X_{p1}, X_{p2})} + \kappa_{p3}\sigma_{(X_{p2}, X_{p3})})EW_{p2} + \kappa_{p3}\sigma_{(X_{p2}, X_{p3})}EW_{p3} + EY_p \quad \text{demand for specific inputs}$$

$$(13)' \quad EX_{p3} = \kappa_{p1}\sigma_{(X_{p1}, X_{p3})}EW_p + \kappa_{p2}\sigma_{(X_{p2}, X_{p3})}EW_{p2} - (\kappa_{p1}\sigma_{(X_{p1}, X_{p3})} + \kappa_{p2}\sigma_{(X_{p2}, X_{p3})})EW_{p3} + EY_p \quad \text{demand for other inputs}$$

#### **Output-constrained input demand of the non-premium wine sector:**

$$(14)' \quad EX_{np1} = -(\kappa_{np2}\sigma_{(X_{np1}, X_{np2})} + \kappa_{np3}\sigma_{(X_{np1}, X_{np3})} + \kappa_{np4}\sigma_{(X_{np1}, X_{np4})})EW_p$$

$$+ \kappa_{np2}\sigma_{(Xnp1, Xnp2)}W_{mp} + \kappa_{np3}\sigma_{(Xnp1, Xnp3)}E_{Wnp3} + \kappa_{np4}\sigma_{(Xnp1, Xnp4)}E_{Wnp4} + EY_{np}$$

*demand for premium grapes*

$$(15)' \quad EX_{np2} = -(\kappa_{np1}\sigma_{(Xnp1, Xnp2)} + \kappa_{np3}\sigma_{(Xnp2, Xnp3)} + \kappa_{np4}\sigma_{(Xnp2, Xnp4)})E_{Wmp}$$

$$+ \kappa_{np1}\sigma_{(Xnp1, Xnp2)}W_p + \kappa_{np3}\sigma_{(Xnp2, Xnp3)}E_{Wnp3} + \kappa_{np4}\sigma_{(Xnp2, Xnp4)}E_{Wnp4} + EY_{np}$$

*demand for non- premium grapes*

$$(16)' \quad EX_{np3} = -(\kappa_{np1}\sigma_{(Xnp1, Xnp3)} + \kappa_{np2}\sigma_{(Xnp2, Xnp3)} + \kappa_{np4}\sigma_{(Xnp3, Xnp4)})E_{Wnp3}$$

$$+ \kappa_{np1}\sigma_{(Xnp1, Xnp3)}W_p + \kappa_{np2}\sigma_{(Xnp2, Xnp3)}E_{Wmp} + \kappa_{np4}\sigma_{(Xnp3, Xnp4)}E_{Wnp4} + EY_{np}$$

*demand for specific inputs*

$$(17)' \quad EX_{np4} = -(\kappa_{np1}\sigma_{(Xnp1, Xnp4)} + \kappa_{np2}\sigma_{(Xnp2, Xnp4)} + \kappa_{np3}\sigma_{(Xnp3, Xnp4)})E_{Wnp4}$$

$$+ \kappa_{np1}\sigma_{(Xnp1, Xnp4)}W_p + \kappa_{np2}\sigma_{(Xnp2, Xnp4)}E_{Wmp} + \kappa_{np3}\sigma_{(Xnp3, Xnp4)}E_{Wnp3} + EY_{np}$$

*demand for other inputs*

**Market-clearing condition/supply of premium and non-premium wholesale wine:**

$$(18)' \quad EV_p = \kappa_{p1}E_{Wp} + \kappa_{p2}E_{Wp2} + \kappa_{p3}E_{Wp3} \quad \text{supply of premium wine}$$

$$(19)' \quad EV_{np} = \kappa_{np1}E_{Wp} + \kappa_{np2}E_{Wmp} + \kappa_{np3}E_{Wnp3} + \kappa_{np4}E_{Wnp4}$$

*supply of non- premium wine*

**Destination of wine at the cellar door:**

$$(20)' \quad EY_p = \theta_{pd}EY_{pd1} + \theta_{pe}EY_{pe1} \quad \text{premium wine destinations}$$

$$(21)' \quad EY_{np} = \theta_{npd}EY_{npd1} + \theta_{npe}EY_{npe} \quad \text{non-premium wine destinations}$$

**Supply of wine marketing inputs:**

$$(22)' \quad EY_{pd2} = \varepsilon_{(Ypd2, vpd2)}(EV_{pd2} - t_{Ypd2}) \quad \text{supply of domestic premium wine marketing inputs}$$

$$(23)' \quad EY_{pe2} = \varepsilon_{(Ype2, vpe2)}(EV_{pe2} - t_{Ype2}) \quad \text{supply of export premium wine marketing inputs}$$

$$(24)' \quad EY_{npd2} = \varepsilon_{(Ynpd2, vnpd2)}(EV_{npd2} - t_{Ynpd2})$$

*supply of domestic non-premium wine marketing inputs*

**Output-constrained input demand of the wine marketing sectors:**

$$(25)' \quad EY_{pd1} = -\lambda_{pd2}\sigma_{(Ypd1, Ypd2)}EV_p + \lambda_{pd2}\sigma_{(Ypd1, Ypd2)}EV_{pd2} + EQ_{pd}$$

*for premium wine -- domestic*

$$(26)' \quad EY_{pd2} = \lambda_{pd1}\sigma_{(Ypd1, Ypd2)}EV_p - \lambda_{pd1}\sigma_{(Ypd1, Ypd2)}EV_{pd2} + EQ_{pd}$$

*for premium wine marketing inputs – domestic*

$$(27)' \quad EY_{pe1} = -\lambda_{pe2}\sigma_{(Ype1, Ype2)}EV_p + \lambda_{pe2}\sigma_{(Ype1, Ype2)}EV_{pe2} + EQ_{pe}$$

*for premium wine -- export*

$$(28)' \quad EY_{pe2} = \lambda_{pe1}\sigma_{(Ype1, Ype2)}EV_p - \lambda_{pe1}\sigma_{(Ype1, Ype2)}EV_{pe2} + EQ_{pe}$$

*for premium wine marketing inputs – export*

$$(29)' \quad EY_{npd1} = -\lambda_{npd2}\sigma_{(Y_{npd1}, Y_{npd2})}EV_{np} + \lambda_{npd2}\sigma_{(Y_{npd1}, Y_{npd2})}EV_{npd2} + EQ_{npd}$$

*for non-premium wine -- domestic*

$$(30)' \quad EY_{npd2} = \lambda_{npd1}\sigma_{(Y_{npd1}, Y_{npd2})}EV_{np} - \lambda_{npd1}\sigma_{(Y_{npd1}, Y_{npd2})}EV_{npd2} + EQ_{npd}$$

*for non-premium wine marketing inputs -- domestic*

**Market-clearing condition for the marketing sectors:**

$$(31)' \quad Ep_{pd} = \lambda_{pd1}EV_p + \lambda_{pd2}EV_{pd2} \quad \text{premium wine domestic marketing}$$

$$(32)' \quad Ep_{pe} = \lambda_{pe1}EV_p + \lambda_{pe2}EV_{pe2} \quad \text{premium wine export marketing}$$

$$(33)' \quad Ep_{npd} = \lambda_{npd1}EV_{np} + \lambda_{npd2}EV_{npd2} \quad \text{non-premium wine domestic marketing}$$

**Final demand for wine:**

$$(34)' \quad EY_{npe} = \eta_{(Y_{npe}, v_{npe})}(EV_{np} - n_{Y_{npe}}) \quad \text{overseas demand for non-premium wine}$$

$$(35)' \quad EQ_{pd} = \eta_{(Q_{pd}, ppd)}(Ep_{pd} - n_{Q_{pd}}) + \eta_{(Q_{pd}, pnpd)}(Ep_{npd} - n_{Q_{npd}})$$

*domestic demand for premium wine*

$$(36)' \quad EQ_{pe} = \eta_{(Q_{pe}, ppe)}(Ep_{pe} - n_{Q_{pe}}) \quad \text{overseas demand for premium wine}$$

$$(37)' \quad EQ_{npd} = \eta_{(Q_{npd}, ppd)}(Ep_{pd} - n_{Q_{pd}}) + \eta_{(Q_{npd}, pnpd)}(Ep_{npd} - n_{Q_{npd}})$$

*domestic demand for non-premium wine*

**The data**

The inputs required for the model in Equations (1)'-(36)' are in three parts: (i) base equilibrium values for all sectors and markets that summarize the industry prior to the shocks to be considered; (ii) market parameters that describe producer and consumer responsiveness to any price changes, and (iii) the values of exogenous variables that quantify the effects of R&D and promotion.

The database used for the base equilibrium for 1996 and 2005 is adapted from the model of global wine markets outlined in Anderson, Norman and Wittwer (2001) and Wittwer, Berger and Anderson (2002), which describe the sectoral disaggregation of the Australian wine industry as projected to 2005. As it often takes up to seven years before newly planted vines are fully bearing, the projection of production to 2005 based on planting areas up to 1999 is likely to be reasonably robust. The disaggregation between premium and non-premium wines is based on containers,

with premium wines referring to those in bottles of 1.5 litres or less and non-premium otherwise.

The input cost structures for industry sectors are adapted and reconstructed from the database in Wittwer, Berger and Anderson (2002). Inputs other than grapes to the two winemaking sectors are grouped into two aggregated inputs: capital inputs and mobile factors. The capital inputs refer to fixed capital, human capital and other inputs that are specific to wine making and that have relatively inelastic supplies. The mobile factor inputs include all other factors such as labour, chemicals and other mobile factors that are non-specific to the wine industry and that are more mobile. These therefore have relatively elastic supplies. The inputs to wine marketing sectors are grouped into wholesale wine inputs and other marketing inputs. The cost structures for marketing sectors are based in part on the margin information in Wittwer, Berger and Anderson (2002), as are the splits among domestic and export destinations for both premium and non-premium wines. The base values and the resulting cost shares are summarized in Table 1. We show them for both 2005 and, for comparative purposes, for 1996 before the recent dramatic increase in vine plantings.

The market elasticity values used are given in Table 2. On the supply side these relate to both a short-term (say two-year) and a longer-term (say seven-year) adjustment period, and are specified according to limited empirical studies and subjective judgement. On the demand side, in addition to including input substitution and own-price elasticities, we include a cross-price elasticity of final demand between premium and non-premium wine for the domestic market. Sensitivity analysis to changes of these parameter values is helpful in determining the relative importance of improving on those estimates.

There are fifteen exogenous variables in the model that can be used to shift the various demand and supply schedules and thus to model the impacts of various R&D and promotion investments on various industry sectors. In this study, we concentrate on estimating the impacts of five R&D and promotion scenarios:

- (1) Cost-reducing R&D in premium grape production ( $t_{xp}=-1\%$ );
- (2) Cost-reducing R&D in premium wine making ( $t_{xp2}=-1\%$ );
- (3) Quality-enhancing R&D for premium wine ( $n_{Qpd}=1\%$  and  $n_{Qpe}=1\%$ );

- (4) premium wine promotion in the domestic market ( $n_{Qpd}=1\%$ ); and
- (5) premium wine promotion in the export market ( $n_{Qpe}=1\%$ ).

In each case, a one per cent vertical parallel shift of the relevant supply or demand curve is assumed. In other words, we examine the impacts of a 1% cost reduction in the relevant sector in the case of cost-reducing R&D and a 1% increase in consumers' willingness to pay due to promotion or product quality improvement.

### **Results of the impacts of alternative R&D and promotion investments**

With specified values for the base equilibrium, market elasticities and exogenous shifters, the equilibrium displacement model in Equations (1)-(37) can be solved to obtain the percentage changes in all price and quantity variables for each policy scenario. Changes in economic surpluses are then calculated for each of the industry groups involved.

The economic welfare results for the five scenarios are summarised in Table 3 for the short run and in Table 4 for the longer run. For each case, total non-government economic welfare gains and wine tax revenue changes are shown in 2001 AUD (converted from 1999 \$US millions, the unit of measurement in the model from which the data are drawn, simply by multiplying by 2). Table 3 and 4 provide the proportional distribution of the welfare effects of each shock among grapegrowers, wineries, retailers, domestic and overseas consumers. They also show the effects on the two types of tax revenues collected from industry (the recently introduced Wine Equalization Tax and the Goods and Services Tax – see Wittwer and Anderson (2002) for an analysis of those tax changes). In the interest of brevity the price and quantity changes for each scenario are not presented, but they are available from the authors.

What do the results reveal, focusing on the 2005 projections (with the 1996 results being left until the end)? Consider the first column of Table 3. It shows how a 1% shift downwards in the premium grape supply curve because of productivity enhancing R&D would, in the short run, benefit mostly but not only premium producers: 44% of the non-government economic welfare gain would go to the grapegrowers and 36% to the makers of premium wine, while most of the rest is

shared with domestic and overseas consumers (7% and 8% respectively). The reason that some of the benefit goes to consumers is because, given the partial equilibrium setting, consumers enjoy a lower price and higher quantity as a result of lower production costs. The total gain is \$13.8 million per year, less a \$0.2 million loss in tax. This is roughly the budget of the Grape and Wine Research and Development Corporation for 2002-03. The ad valorem tax revenue from wine is reduced because the increased quantity cannot compensate the reduced price, due in part to the relatively low price elasticity of demand assumed, so the wholesale and retail values for wine are both reduced as a result of the cost reduction. In the longer term, as grapegrowers have more time to expand their plantings of premium grapes and reduce their planting of non-premium grapes in response to the new premium cost-reducing technologies, the net welfare gain does not change much<sup>4</sup> but a larger share of that benefit (almost one-third) goes to consumers at the expense of grapegrowers whose share falls from 44% to 35% -- yet the share to winemakers falls very little (compare column 1 in Tables 3 and 4).

If instead the cost-reducing R&D is directed toward premium wine (rather than grape) production, the majority of the short-run welfare gains (57%) go to premium wineries and only 24% goes to grapegrowers, with again 15% going to consumers. The net benefit of that shock would be \$21 million per year, of which 9% goes to consumers abroad.<sup>5</sup> This gain is greater than the short-run gain in the grape R&D scenario (\$14 million pa), even though it involved a similar 1% shock, because of the large additional value added in the supply chain by the winery. That 57% share of the gain to wineries is diminished over time and in the longer run scenario of Table 4 is only 45%, with the consumers' share rising from 15% to 24%, equalling the grapegrowers' share which hardly changes over that adjustment period.

If, as a result of quality-enhancing R&D anywhere along the chain of premium wine production, consumers are willing to pay more for a better Australian premium wine in both domestic and overseas markets, then grape producers (26%), wineries (39%) and domestic consumers (20%) all gain significant shares in the short run. This also holds in the longer run in Table 4, with some of the benefits shifting from grape and wine producers to overseas consumers, whose share rises from 7% to 12% of the total \$66 million per year gains.

Turning to domestic promotion of premium wine (see the 4<sup>th</sup> set of columns of Tables 3 and 4), only about one-tenth of the gains from such promotion would accrue to producers and retailers. About 90% of the welfare gains go to domestic consumers, in the sense that they are willing to pay more after the promotion.<sup>6</sup>

The final scenario is of particular interest to those engaged in the industry's efforts to boost marketing abroad of Australian premium wine (WFA and AWBC 2001), since it shows the distributional effects of such an initiative. They are very different from the effects of R&D and domestic promotion. Specifically, in the short run grapegrowers gain half the benefits and premium winemakers gain more than half of the benefits. Non-premium producers, on the other hand, lose slightly from such promotion. Certainly overseas consumers benefit in the willingness-to-pay sense, enjoying 20% of the total measured welfare gain in the short run. These percentages add to more than 100 because domestic consumers lose substantially from the price-raising effect of the promotion abroad, due to the reduced supply to the domestic market as more wine is going overseas. In the longer run (Table 4) the effects are similar but with somewhat more benefit/less loss to consumers and somewhat less benefit to both grapegrowers and winemakers.

How do the above results for 2005 compare with what they would have been in 1996? The differences are minor in terms of the distributional shares, despite the fact that in 2005, 70% of Australian premium wine is expected to be sold abroad whereas in 1996 that share was only 49% (see the data in Table 1). However, when expressed in terms of dollars, the differences between 1996 and 2005 are huge, thanks to the dramatic growth of the industry's plantings in the latter 1990s. For example, the aggregate estimated benefit from the same proportion of cost reduction in either grape or wine R&D in 1996 is only about two-fifths that of 2005, while the difference in the aggregate benefit from the same promotional effort in export markets is even greater. Table 5 summarizes these actual dollar benefits to various industry groups, drawn from the first and final sets of columns in Table 4.

It is interesting to compare our results for the wine industry to that of a similar study for the beef industry (Zhao 1999), not least because it indicates how sensitive the

welfare distribution results are to assumed values of market elasticities and model specification. Both industries are significant exporters; have differentiated products; and involve a vertical chain of farm production, post-farm processing, marketing, and domestic and export consumption. Details of the comparison are in the Appendix. Post-farm processors and marketers in the case of beef are found to benefit little from R&D and promotion because that study assumed high price elasticities of supply for those sectors. As a result, most of the welfare gains go to domestic consumers. In addition, due to the assumption also of joint processing (a feature not in the wine industry), domestic consumers gain from overseas promotion.

### **Implications and conclusions**

Numerous qualifications need to be kept in mind in interpreting the above results. Obviously the numbers depend heavily on the elasticities assumed (see Table 2). The comparison of the results in Table 3 with those in Table 4 provide a form of sensitivity analysis with respect to grape and wine supply elasticities. Systematic account for uncertainty in market parameters, as undertaken in Zhao *et. al.* (2000) and Griffiths and Zhao (2000), would add further insights.

The study has also ignored the impacts of any costs incurred in R&D and promotion. Both generic R&D and promotion are funded in part by producer levies, which in effect add to the production costs and shift the supply curves upwards. It is assumed that the magnitude of such shifts are small in comparison to the shifts resulted from R&D-induced productivity gains and the increases in willingness-to-pay due to quality-enhancing R&D or generic promotion. This assumption is supported by the estimated high cost-benefit ratios in GWRDC research programs (McLeod 2002). Similarly, costs in extending and adopting research outcomes are not considered. For example, in the case of implementing quality-enhancing technologies, there may be extra costs in switching to different vines or buying new equipments for wineries. The impact of such costs can be considered as upward shifts in the relevant supply curves in our model, and the burden of such costs will be redistributed along the industry chain in the same proportions as the distribution of benefits from cost-reducing R&D, which are estimated in the first two columns of Tables 3 and 4.

It also should be kept in mind that this model only captures partial equilibrium effects within the Australian industry and for overseas consumers, leaving unmeasured any economic spillovers to other industries (including the grape and wine industry abroad) and any social and environmental spillovers (both positive and negative).

As well, the economic surplus measure of consumer welfare is not without problems (see Just, Heuth and Schmitz 1982), particularly when used to measure gains from promotion (Alston and Chalfant 1999). The only sense in which it is used here is as a 'willingness-to-pay' measure.

It would seem, though, that the major direct gainers within the grape and wine industry from R&D will be producers, and more so as the industry becomes more and more export focused over the next decade. In addition, even though growers and winemakers contribute about 50% of the R&D funds in the form of statutory levies, they eventually off-load some of the burden to consumers through the incidence of levy, with the proportions as estimated in the first two columns of Tables 3 and 4. So their 'real' contribution/burden is less than 50%. Hence the justification for matching funding from the government for R&D will need to depend increasingly not just on the gains to domestic consumers but also on positive net spillovers to other sectors of the Australian economy, including through the value of the research to science generally. In the case of promotion abroad, the gains are even more concentrated on producers, with domestic consumers losing because of the price-raising effect such promotion has on the home market. In that case, the justification for government subsidization depends on spillovers in the form of in-bound tourism and the like.

Finally, with the industry re-considering the R&D levy in the light of the apparently high rewards from research to date (McLeod 2002) and the fact that the current levy is well below the 0.5% threshold that attracts maximum government matching funds, now is the time to question the method of levying in addition to raising its level. To date it has been a weight-based gravimetric measure, so research intensity has declined as a percent of the gross value of production over the past decade as the price of wine has risen with quality improvements and with increased demand in export markets. An easy way to prevent that continuing is to switch to a value-based ad valorem levy rate. That would have the additional effect of ensuring that higher-

quality producers pay more per tonne. Since most of the promotion and much of the R&D is focused on premium rather than non-premium products, that would also seem a more equitable way to levy producers.

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**Table 1(a): Base equilibrium values projected for 2005 (in 1999 \$US million)**

<p><b>Grapes</b></p>	<p><b><u>Premium Grapes</u></b></p> <p><i>Total value:</i> <math>TV_{Xp} = 675</math>  <i>Destinations:</i> <math>\rho_{Xp1}=0.96</math> (prem. wine), <math>\rho_{Xnp1}=0.04</math> (non-prem. wine)</p> <p><b><u>Multi-purpose Grapes</u></b></p> <p><i>Total value:</i> <math>TV_{Xmp} = 245</math>  <i>Destinations:</i> <math>\rho_{Xdtd}=0.26</math> (domestic fruit) <math>\rho_{Xdte}=0.42</math> (export fruit)  <math>\rho_{Xnp2}=0.32</math> (non-prem. wine making)</p>
<p><b>Wine Production</b></p>	<p><b><u>Premium Wine</u></b></p> <p><i>Total value:</i> <math>TV_{Yp} = 2,392</math>  <i>Cost Shares:</i> <math>\kappa_{p1}=0.27</math> (prem. grapes) <math>\kappa_{p2}=0.43</math> (fixed capitals)  <math>\kappa_{p3}=0.30</math> (other mobile)</p> <p><b><u>Non-premium Wine</u></b></p> <p><i>Total value:</i> <math>TV_{Ynp} = 326</math>  <i>Cost Shares:</i> <math>\kappa_{np1}=0.09</math> (prem. grapes) <math>\kappa_{np2}=0.24</math> (multi-purpose grapes)  <math>\kappa_{np3}=0.43</math> (fixed capitals) <math>\kappa_{np4}=0.24</math> (other mobile)</p>
<p><b>Marketing Sectors and Final Wines</b></p>	<p><b><u>Premium Wine</u></b></p> <p><i>Domestic:</i> <i>producer value before WET (tax):</i> <math>TV_{Ypd1} = 718</math>  <i>final wine value after GST:</i> <math>TV_{Qpd}^* = 1,726</math>  <i>cost shares for marketing:</i> <math>\lambda_{pd1}=0.59</math> (wine)  <math>\lambda_{pd2}=0.41</math> (retail marketing inputs)</p> <p><i>Export:</i> <i>producer value:</i> <math>TV_{Ype1} = 1,674</math>  <i>f.o.b. value:</i> <math>TV_{Qpe} = 1,840</math>  <i>cost shares for marketing:</i> <math>\lambda_{pe1}=0.91</math> (wine)  <math>\lambda_{pe2}=0.09</math> (marketing inputs)</p> <p><b><u>Non-premium Wine</u></b></p> <p><i>Domestic:</i> <i>producer value before WET (tax):</i> <math>TV_{Ynpd1} = 280</math>  <i>final wine value after GST:</i> <math>TV_{Qnpd}^* = 652</math>  <i>cost shares for marketing:</i> <math>\lambda_{npd1}=0.61</math> (wine)  <math>\lambda_{pd2}=0.39</math> (retail marketing inputs)</p> <p><i>Export:</i> <i>producer/f.o.b. value:</i> <math>TV_{Ynpe} = 46</math></p>

**Table 1(b): Base equilibrium values for 1996 (in 1999 \$US million)**

<p><b>Grapes</b></p>	<p><b><u>Premium Grapes</u></b></p> <p><i>Total value:</i> <math>TV_{Xp} = 272</math>  <i>Destinations:</i> <math>\rho_{Xp1}=0.86</math> (prem. wine), <math>\rho_{Xnp1}=0.14</math> (non-prem. wine)</p> <p><b><u>Multi-purpose Grapes</u></b></p> <p><i>Total value:</i> <math>TV_{Xmp} = 174</math>  <i>Destinations:</i> <math>\rho_{Xdtd}=0.21</math> (domestic fruit) <math>\rho_{Xdte}=0.29</math> (export fruit)  <math>\rho_{Xnp2}=0.50</math> (non-prem. wine making)</p>
<p><b>Wine Production</b></p>	<p><b><u>Premium Wine</u></b></p> <p><i>Total value:</i> <math>TV_{Yp} = 870</math>  <i>Cost Shares:</i> <math>\kappa_{p1}=0.27</math> (prem. grapes) <math>\kappa_{p2}=0.48</math> (fixed capitals)  <math>\kappa_{p3}=0.25</math> (other mobile)</p> <p><b><u>Non-premium Wine</u></b></p> <p><i>Total value:</i> <math>TV_{Ynp} = 414</math>  <i>Cost Shares:</i> <math>\kappa_{np1}=0.09</math> (prem. grapes) <math>\kappa_{np2}=0.21</math> (multi-purpose grapes)  <math>\kappa_{np3}=0.47</math> (fixed capitals) <math>\kappa_{np4}=0.23</math> (other mobile)</p>
<p><b>Marketing Sectors and Final Wines</b></p>	<p><b><u>Premium Wine</u></b></p> <p><i>Domestic:</i> <i>producer value before WST:</i> <math>TV_{Ypd1} = 427</math>  <i>retail value:</i> <math>TV_{Qpd} = 790</math>  <i>cost shares for marketing:</i> <math>\lambda_{pd1}=0.54</math> (wine)  <math>\lambda_{pd2}=0.46</math> (retail marketing inputs)</p> <p><i>Export:</i> <i>producer value:</i> <math>TV_{Ype1} = 444</math>  <i>f.o.b. value:</i> <math>TV_{Qpe} = 488</math>  <i>cost shares for marketing:</i> <math>\lambda_{pe1}=0.91</math> (wine)  <math>\lambda_{pe2}=0.09</math> (export marketing inputs)</p> <p><b><u>Non-premium Wine</u></b></p> <p><i>Domestic:</i> <i>producer value before WST:</i> <math>TV_{Ynpd1} = 331</math>  <i>retail value:</i> <math>TV_{Qnpd} = 495</math>  <i>cost shares for marketing:</i> <math>\lambda_{npd1}=0.67</math> (wine)  <math>\lambda_{pd2}=0.33</math> (retail marketing inputs)</p> <p><i>Export:</i> <i>producer/f.o.b. value:</i> <math>TV_{Ynpe} = 50</math></p>

**Table 2: Market elasticity values assumed**

**Grape supply**

*Short-Run:*       $\epsilon_{(X_p, w_p)}=0.4$        $\epsilon_{(X_{mp}, w_{mp})}=0.5$        $\epsilon_{(X_{mp}, w_p)}=-0.2$

*Long-Run:*       $\epsilon_{(X_p, w_p)}=0.8$        $\epsilon_{(X_{mp}, w_{mp})}=1.0$        $\epsilon_{(X_{mp}, w_p)}=-0.6$

**Other wine-making input supply**

*Short-Run:*

*Premium:*       $\epsilon_{(X_{p2}, w_{p2})}=0.4$        $\epsilon_{(X_{p3}, w_{p3})}=5$   
*Non-Premium:*       $\epsilon_{(X_{np3}, w_{np3})}=0.5$        $\epsilon_{(X_{p3}, w_{p3})}=5$

*Long-Run:*

*Premium:*       $\epsilon_{(X_{p2}, w_{p2})}=0.8$        $\epsilon_{(X_{p3}, w_{p3})}=5$   
*Non-Premium:*       $\epsilon_{(X_{np3}, w_{np3})}=1.0$        $\epsilon_{(X_{p3}, w_{p3})}=5$

**Table grape demand**

$\eta_{(X_{dtd}, w_{dtd})} = -0.6$  ,       $\eta_{(X_{dte}, w_{dte})} = -5$ ,

**Input substitution for winemaking**

*Premium:*       $\sigma_{(X_{pi}, X_{pj})} = 0.1$  (i, j = 1, 2 and 3; i<j)  
*Non-Premium:*       $\sigma_{(X_{npi}, X_{npj})} = 0.1$  (i, j = 1, 2, 3 and 4; i<j)

**Wine marketing input supply**

*Premium:*       $\epsilon_{(Y_{pd2}, v_{pd2})}=2$        $\epsilon_{(Y_{pe2}, v_{pe2})}=2$   
*Non-Premium:*       $\epsilon_{(Y_{npd2}, v_{npd2})}=2$

**Input substitution for marketing**

*Premium:*       $\sigma_{(Y_{pd1}, Y_{pd2})} = 0.1$        $\sigma_{(Y_{pe1}, Y_{pe2})} = 0.1$   
*Non-Premium:*       $\sigma_{(Y_{npd1}, Y_{npd2})} = 0.1$

**Final wine demand**

*Premium:*       $\eta_{(Q_{pd}, p_{pd})} = -0.8$        $\eta_{(Q_{pe}, p_{pe})} = -5$   
*Non-Premium:*       $\eta_{(Q_{npd}, p_{npd})} = -0.9$        $\eta_{(Y_{npe}, v_{npe})} = -7.0$   
*Cross-price :*       $\eta_{(Q_{npd}, p_{pd})} = 0.3$

**Table 3: Total economic welfare changes (in 2001 AUD million), shares of total welfare changes (in %) to various groups, and tax revenue changes (in 2001 AUD million) from alternative investment scenarios: 2005 vs 1996 – short run**

<b>Non-Gov't Welfare Gains (% shares)</b>	<b>Scenario 1 Prem. Grape Cost-reducing R&amp;D</b>		<b>Scenario 2 Prem. Wine Cost-reducing R&amp;D</b>		<b>Scenario 3 Prem. wine quality-enhancing R&amp;D</b>		<b>Scenario 4 Prem. wine domestic promotion</b>		<b>Scenario 5 Prem. wine export promotion</b>	
	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>
$\Delta PS_{xp}$	42.4	40.5	23.5	21.9	25.2	22.2	2.5	4.2	48.8	50.8
$\Delta PS_{xmp}$	1.2	2.8	0.5	1.1	0.5	1.0	-0.2	-0.2	1.2	2.9
<b><math>\Delta PS_{xp} + \Delta PS_{xmp}</math> Grape producers Subtotal</b>	<b><u>43.6</u></b>	<b><u>43.3</u></b>	<b><u>24.0</u></b>	<b><u>23.0</u></b>	<b><u>25.7</u></b>	<b><u>23.2</u></b>	<b><u>2.3</u></b>	<b><u>4.0</u></b>	<b><u>50.0</u></b>	<b><u>53.7</u></b>
$\Delta PS_{xp2}$ Prem. Wineries	35.2	32.9	57.0	59.1	40.1	40.0	3.7	9.2	77.2	89.1
$\Delta PS_{xnp3}$ Non-prem. Wineries	0.9	2.9	-0.7	-2.0	-0.9	-2.8	-1.8	-3.7	-0.5	-1.4
<b><math>\Delta PS_{xp2} + \Delta PS_{xnp3}</math> Wineries Subtotal</b>	<b><u>36.1</u></b>	<b><u>35.8</u></b>	<b><u>56.3</u></b>	<b><u>57.1</u></b>	<b><u>39.2</u></b>	<b><u>37.2</u></b>	<b><u>1.9</u></b>	<b><u>5.5</u></b>	<b><u>76.7</u></b>	<b><u>87.7</u></b>
<b><math>\Delta PS_{xnp3} + \Delta PS_{xnp4}</math> Mobile Factors Gains</b>	<b><u>2.5</u></b>	<b><u>1.8</u></b>	<b><u>2.5</u></b>	<b><u>1.9</u></b>	<b><u>2.7</u></b>	<b><u>1.9</u></b>	<b><u>-0.1</u></b>	<b><u>0.3</u></b>	<b><u>5.3</u></b>	<b><u>4.5</u></b>
$\Delta PS_{ydp2}$	0.6	0.9	0.8	1.3	3.5	5.4	12.5	14.1	-5.8	-8.6
$\Delta PS_{ynpd2}$	0.1	0.2	-0.2	-0.3	-0.4	-0.7	-1.5	-1.8	0.5	0.9
$\Delta PS_{ype2}$	1.9	1.5	2.0	1.8	1.8	1.3	-1.3	-1.2	4.9	5.4
<b>Marketing Sector Subtotal</b>	<b><u>2.6</u></b>	<b><u>2.6</u></b>	<b><u>2.6</u></b>	<b><u>2.8</u></b>	<b><u>4.9</u></b>	<b><u>6.0</u></b>	<b><u>9.7</u></b>	<b><u>11.1</u></b>	<b><u>-0.4</u></b>	<b><u>-2.3</u></b>
$\Delta CS_{xdttd}$	-0.3	-0.6	-0.1	-0.2	-0.1	-0.2	0.1	0.1	-0.3	-0.6
$\Delta CS_{Qpd}$	5.8	7.4	6.0	8.4	20.3	26.4	88.9	79.6	-48.3	-58.6
$\Delta CS_{Qnpd}$	1.3	2.9	-0.4	-0.8	0.1	0.3	2.8	4.5	-3.0	-6.5
<b>Domestic Consumers Subtotal</b>	<b><u>6.8</u></b>	<b><u>9.7</u></b>	<b><u>5.5</u></b>	<b><u>7.4</u></b>	<b><u>20.3</u></b>	<b><u>26.5</u></b>	<b><u>91.8</u></b>	<b><u>84.2</u></b>	<b><u>-51.7</u></b>	<b><u>-65.7</u></b>
$\Delta CS_{xdte}$	-0.5	-0.8	-0.2	-0.3	-0.2	-0.3	0.1	0.1	-0.5	-0.8
$\Delta CS_{Qpe}$	8.7	7.2	9.4	8.3	7.5	5.6	-5.9	-5.6	20.9	23.7
$\Delta CS_{Ynpe}$	0.2	0.4	-0.1	-0.2	-0.1	-0.1	0.2	0.4	-0.3	-0.8
<b>Overseas Consumers Subtotal</b>	<b><u>8.4</u></b>	<b><u>6.8</u></b>	<b><u>9.1</u></b>	<b><u>7.8</u></b>	<b><u>7.2</u></b>	<b><u>5.2</u></b>	<b><u>-5.6</u></b>	<b><u>-5.1</u></b>	<b><u>20.1</u></b>	<b><u>22.1</u></b>
<b>Total, %</b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>
<b>Total, AUD million</b>	<b><u>13.8</u></b>	<b><u>5.4</u></b>	<b><u>21.0</u></b>	<b><u>8.4</u></b>	<b><u>65.7</u></b>	<b><u>25.6</u></b>	<b><u>32.7</u></b>	<b><u>15.8</u></b>	<b><u>31.8</u></b>	<b><u>9.9</u></b>
<b>Tax revenue changes (AUD million)</b>										
Wholesale sales tax	-0.14	-0.16	-0.16	-0.20	4.84	3.9	2.52	1.98	2.20	1.94
GST	-0.02		-0.04		2.76		2.24		0.46	
<b>Total</b>	<b><u>-0.2</u></b>	<b><u>-0.2</u></b>	<b><u>-0.2</u></b>	<b><u>-0.2</u></b>	<b><u>7.6</u></b>	<b><u>3.9</u></b>	<b><u>4.8</u></b>	<b><u>2.0</u></b>	<b><u>2.7</u></b>	<b><u>1.9</u></b>

**Table 4: Total economic welfare changes (in 2001 AUD million), shares of total welfare changes (in %) to various groups, and tax revenue changes (in 2001 AUD million) from alternative investment scenarios: 2005 vs 1996 – long run**

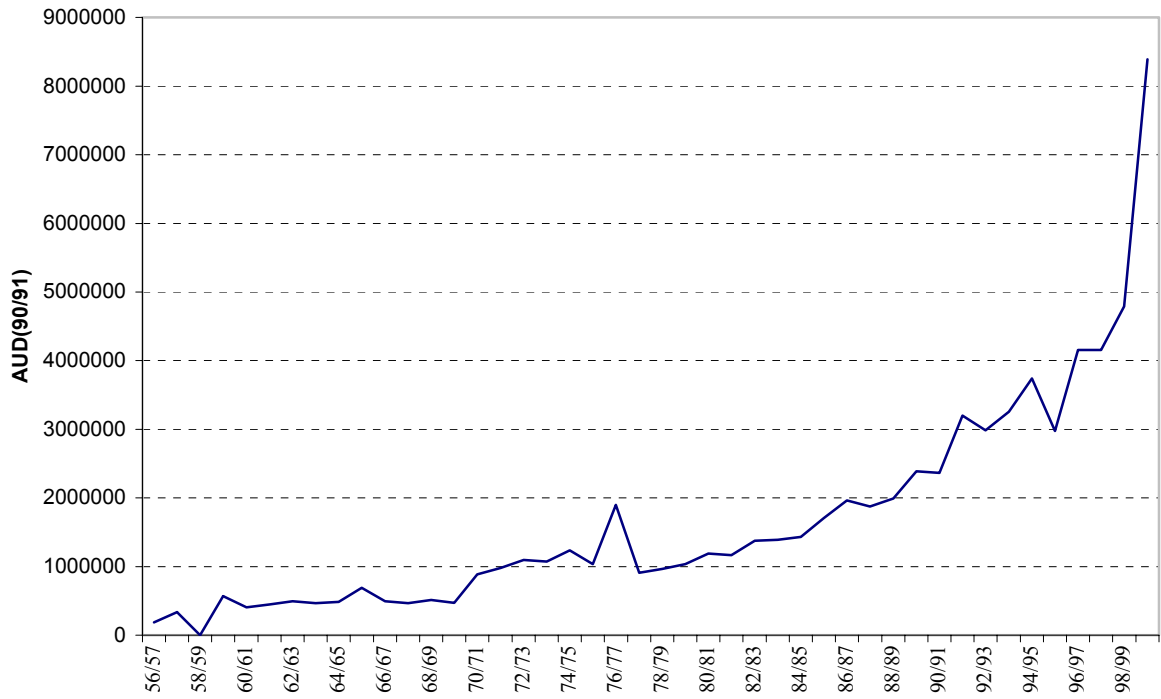
<b>Non-Gov't Welfare Gains (% shares)</b>	<b>Scenario 1 Prem. Grape Cost-reducing R&amp;D</b>		<b>Scenario 2 Prem. Wine Cost-reducing R&amp;D</b>		<b>Scenario 3 Prem. wine quality-enhancing R&amp;D</b>		<b>Scenario 4 Prem. wine domestic promotion</b>		<b>Scenario 5 Prem. wine export promotion</b>	
	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>	<b>1996</b>
$\Delta PS_{Xp}$	32.6	31.6	22.2	21.1	21.5	19.3	2.6	3.4	41.2	44.2
$\Delta PS_{Xmp}$	2.2	4.9	1.4	2.8	1.3	2.4	-0.003	-0.3	2.6	6.2
<b><math>\Delta PS_{Xp} + \Delta PS_{Xmp}</math> Grape producers Subtotal</b>	<b><u>34.8</u></b>	<b><u>36.5</u></b>	<b><u>23.6</u></b>	<b><u>23.9</u></b>	<b><u>22.8</u></b>	<b><u>21.7</u></b>	<b><u>2.6</u></b>	<b><u>3.1</u></b>	<b><u>43.8</u></b>	<b><u>50.4</u></b>
$\Delta PS_{Xp2}$ Prem. Wineries	32.1	29.4	45.0	46.2	33.1	32.4	4.4	7.3	63.0	72.0
$\Delta PS_{Xnp3}$ Non-prem. Wineries	0.6	1.9	-0.6	-1.8	-0.7	-2.2	-0.9	-3.9	-0.4	-1.5
<b><math>\Delta PS_{Xp2} + \Delta PS_{Xnp3}</math> Wineries Subtotal</b>	<b><u>32.7</u></b>	<b><u>31.3</u></b>	<b><u>44.4</u></b>	<b><u>44.4</u></b>	<b><u>32.4</u></b>	<b><u>30.2</u></b>	<b><u>3.5</u></b>	<b><u>3.4</u></b>	<b><u>62.6</u></b>	<b><u>70.5</u></b>
<b><math>\Delta PS_{Xp3} + \Delta PS_{Xnp4}</math> Mobile Factors Gains</b>	<b><u>4.0</u></b>	<b><u>2.9</u></b>	<b><u>4.1</u></b>	<b><u>3.0</u></b>	<b><u>4.0</u></b>	<b><u>2.7</u></b>	<b><u>0.4</u></b>	<b><u>0.1</u></b>	<b><u>7.7</u></b>	<b><u>6.5</u></b>
$\Delta PS_{Ypd2}$	1.1	1.6	1.3	2.2	3.8	6.0	12.2	14.4	-5.0	-7.2
$\Delta PS_{Ynpd2}$	0.1	0.1	-0.3	-0.6	-0.5	-0.9	-1.3	-2.3	0.4	0.6
$\Delta PS_{Ype2}$	3.0	2.4	3.2	2.9	2.9	2.2	-0.9	-1.0	6.8	7.2
<b>Marketing Sector Subtotal</b>	<b><u>4.2</u></b>	<b><u>4.1</u></b>	<b><u>4.2</u></b>	<b><u>4.5</u></b>	<b><u>6.2</u></b>	<b><u>7.3</u></b>	<b><u>10.0</u></b>	<b><u>11.1</u></b>	<b><u>2.2</u></b>	<b><u>0.6</u></b>
$\Delta CS_{Xdt}$	-0.6	-1.0	-0.4	-0.6	-0.3	-0.5	0.001	0.1	-0.7	-1.3
$\Delta CS_{Qpd}$	9.5	11.8	9.9	13.6	23.3	30.2	85.1	83.3	-41.2	-49.8
$\Delta CS_{Qnpd}$	1.7	3.7	-0.6	-1.3	-0.2	-0.2	2.5	3.3	-3.0	-6.6
<b>Domestic Consumers Subtotal</b>	<b><u>10.6</u></b>	<b><u>14.5</u></b>	<b><u>8.9</u></b>	<b><u>11.7</u></b>	<b><u>22.8</u></b>	<b><u>29.5</u></b>	<b><u>87.6</u></b>	<b><u>86.7</u></b>	<b><u>-44.9</u></b>	<b><u>-57.7</u></b>
$\Delta CS_{Xdte}$	-0.9	-1.4	-0.6	-0.8	-0.5	-0.7	0.001	0.1	-1.1	-1.8
$\Delta CS_{Qpe}$	14.4	11.5	15.5	13.6	12.4	9.5	-4.2	-4.9	30.0	32.4
$\Delta CS_{Ynpe}$	0.2	0.6	-0.1	-0.3	-0.1	-0.2	0.1	0.4	-0.3	-0.9
<b>Overseas Consumers Subtotal</b>	<b><u>13.7</u></b>	<b><u>10.7</u></b>	<b><u>14.8</u></b>	<b><u>12.5</u></b>	<b><u>11.8</u></b>	<b><u>8.6</u></b>	<b><u>-4.1</u></b>	<b><u>-4.4</u></b>	<b><u>28.6</u></b>	<b><u>29.7</u></b>
<b>Total</b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>
<b>Total (AUD million)</b>	<b><u>14.0</u></b>	<b><u>5.4</u></b>	<b><u>21.2</u></b>	<b><u>8.4</u></b>	<b><u>66.4</u></b>	<b><u>25.7</u></b>	<b><u>34.0</u></b>	<b><u>15.3</u></b>	<b><u>32.4</u></b>	<b><u>9.9</u></b>
<b>Tax revenue changes (AUD million)</b>										
Wholesale sales tax	-0.22	-0.24	-0.26	-0.32	4.58	3.66	2.62	1.76	1.94	1.68
GST	-0.04		-0.06		2.70		2.28		0.42	
<b>Total</b>	<b><u>-0.3</u></b>	<b><u>-0.2</u></b>	<b><u>-0.3</u></b>	<b><u>-0.3</u></b>	<b><u>7.3</u></b>	<b><u>3.7</u></b>	<b><u>4.9</u></b>	<b><u>1.8</u></b>	<b><u>2.5</u></b>	<b><u>1.7</u></b>

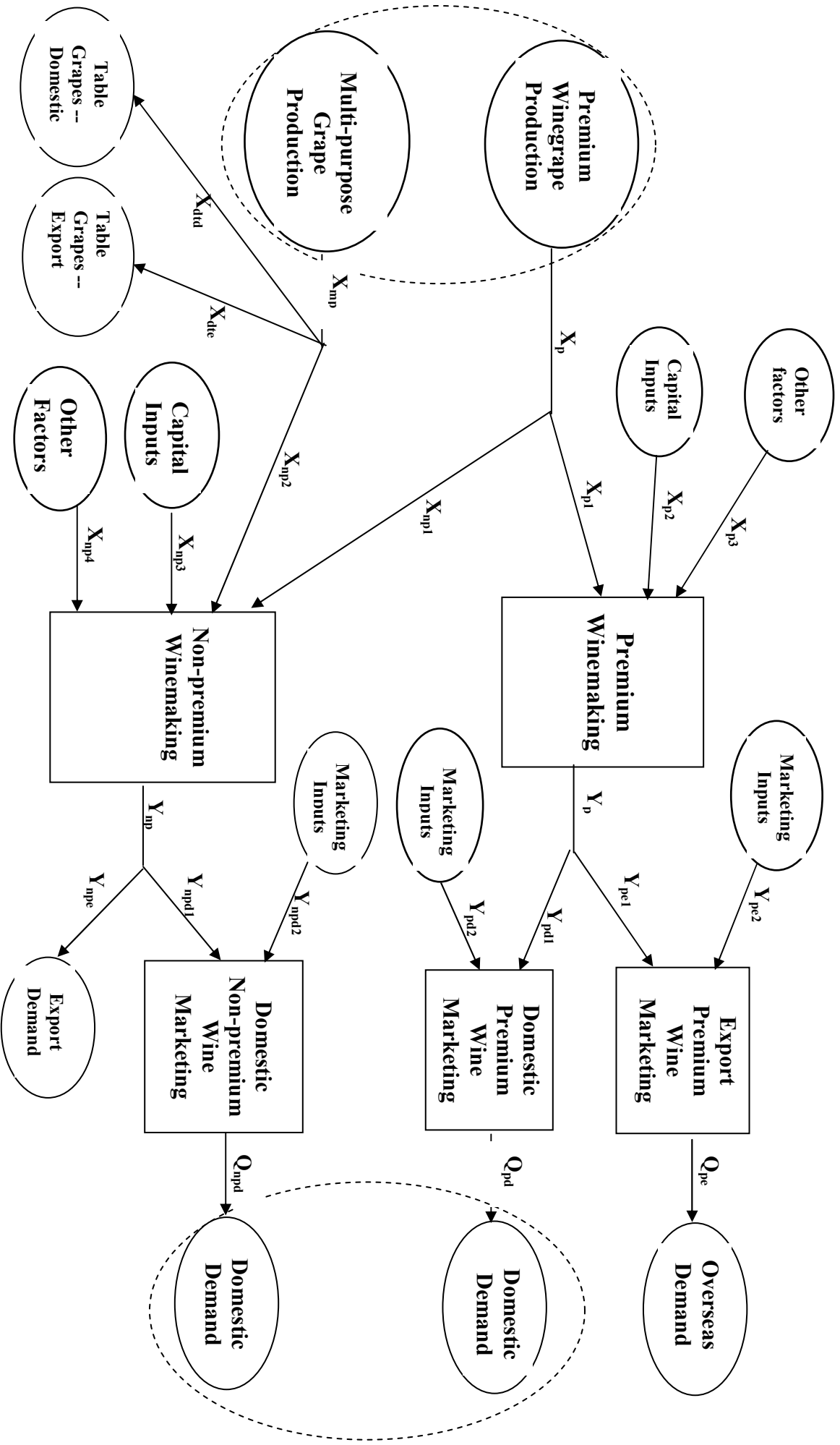
**Table 5: Changes in economic welfare to various groups and in tax revenue (in 2001 AUD million) from premium grape R&D and premium wine promotion abroad: 2005 vs 1996 – long run**

	Premium grape cost-reducing R&D		Premium wine promotion abroad	
	2005	1996	2005	1996
<b>Global total</b>	<b>13.7</b>	<b>5.2</b>	<b>34.9</b>	<b>11.6</b>
<i>of which</i>				
Overseas consumers	1.9	0.6	9.3	2.9
<b>Australian total</b>	<b>11.8</b>	<b>4.6</b>	<b>25.6</b>	<b>8.7</b>
<i>of which</i>				
Tax office	-0.3	-0.2	2.5	1.7
Domestic consumers	1.5	0.8	-14.5	-5.7
Wineries	4.6	1.7	20.3	7.0
<i>Premium</i>	4.5	1.6	20.4	7.1
<i>Non-premium</i>	0.1	0.1	-0.1	-0.1
Grapegrowers	4.9	2.0	14.2	5.0

Source: Estimates in first and final set of columns of Table 4.

Figure 1: Real expenditure on grape and wine research and development, 1956-57 to 1999-2000 (in 1990-91 Australian dollars)





**Figure 2: Structure of the Model**

## **Appendix: Comparison of results for Australia's wine and beef industries**

It is informative to compare the above wine industry study with a similar study for the beef industry in Zhao (1999) and Zhao, Griffith and Mullen (2001), since those industries share a number of common characteristics. Both industries export a significant share of their outputs (around 50% for wine and 60% for beef), and both have quality differentiated products (grain-fed and grass-fed beef, and premium and non-premium wine). In each case products are quality differentiated early in the production chain.

There are also the following differences between the two industries and the assumptions used in the two studies. First, all four products in the beef study, whether grain- or grass-fed and whether destined for the export or domestic market, are processed through a joint processing sector at the abattoirs, which is captured in the study by a joint production function. Marketing sectors are separate for export and domestic destinations but joint for each quality of grain- and grass-fed beef. The wineries, on the other hand, are more closely linked with the farm sector and thus the post-farm processing and marketing are separated by qualities and destinations.

Second, export and domestic beef are differentiated products early on in the production chain, unlike for wine where premium wine for both export and domestic consumption are assumed to be of the same quality up to the point of cellar door ( $Y_p$ ).

And third, factor supplies in the post-farm sectors for beef (feedlots, abattoirs, retailers, etc.) are assumed to be highly elastic ( $\epsilon=5$ ), while in the wine model some winery inputs are assumed to be specialised and so inelastic in supply ( $\epsilon=0.4$  to  $1.0$  for human and fixed capital and  $\epsilon=5$  for labour, etc.). Marketing inputs also are assumed to be less elastically supplied to the wine industry than that for beef ( $\epsilon=2$  for wine compared with  $5$  for beef).

The differences in the distribution of welfare results for the two industries (based on the 2005 results for wine) are summarised in the Table A.1. Due particularly to the difference explained in the third point above, post-farm sectors in the beef industries are unable to benefit greatly, leaving the welfare gains from R&D or promotion accruing to either farmers or consumers. In contrast, due to the assumed inelastic supply for wine-specific inputs, wineries are able to collect sizeable welfare gains from grape and wine R&D, and even to gain reasonably from marketing R&D and domestic promotion.

Another significant difference in the two sets of results relates to the case of export promotion, where domestic consumers gain significantly in the beef case and lose in the case of wine. This is due to the differences listed in the second and third points above. Premium wine for export and domestic is assumed to be the same product at cellar door ( $Y_p$ ). Export promotion shifts the supply of premium wine away from the domestic market, so the premium price for domestic sales increases, leaving domestic consumers worse off (with a lower quantity and higher price). For beef, export and domestic products are differentiated all the way back in the production chain, made possible via contracts through vertical integration, as exported beef has unique genetic

and nutritional specifications even before feedlot entry. They are then linked with joint production functions in processing and marketing. Due to this assumption of jointness, an increase in demand for one product will result in an increased supply of the joint inputs and thus increased supply of other products. As a result of an overall supply expansion, domestic consumers enjoy a price fall, and thus a gain in welfare.

**Table A.1: Comparison of welfare shares (%) from R&D and promotion for Australia's beef and wine industries**

	Farmers	Processors+Marketers (beef: feedlot+abattoir+ retailer wine: wineries+retailers+others)	Consumer	
			Domestic	Export
<b>Farm R&amp;D:</b>				
<i>Beef</i>	32	9	51	8
<i>Wine(s/l run)</i>	44/35	41/40	7/11	8/14
<b>Processing R&amp;D:</b>				
<i>Beef</i>	26	10	55	9
<i>Wine(s/l run)</i>	24/24	61/52	6/9	9/15
<b>Domestic Prom'n:</b>				
<i>Beef</i>	23	9	62	6
<i>Wine(s/l run)</i>	2/3	12/13	92/88	-6/-4
<b>Export Prom'n:</b>				
<i>Beef</i>	31	10	50	9
<i>Wine(s/l run)</i>	50/44	82/72	-52/-45	20/29

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<sup>1</sup> The shares of national wine production held by the top five firms in 2000 are as follows: Australia 68%, New Zealand 80%, United States 73%, Argentina 50%, and Chile 47%. By contrast, they are much lower in the Old World where small cooperatives still dominate: 13% in France (excluding Champagne), 10% in Spain and 5% in Italy (Anderson, Norman and Wittwer 2001).

<sup>2</sup> Between 1988 and 1999 wine production grew at 5.3 % per year in Australia, 2.8% in the United States, 2.4% in Chile and Uruguay, and 2.0% in New Zealand; and the share of global wine production that is exported rose from 15% to 25% (Anderson and Norman 2001, Tables 11 and 32).

<sup>3</sup> The global average cost of a bottle of wine is shared roughly as follows: 10% to the grapegrower, 30% to the winery, 37% to transporters, wholesalers and retailers, and 23% to tax collectors (Wittwer, Berger and Anderson 2002).

<sup>4</sup> For a given small exogenous change, total welfare gain only changes at the second-order magnitude for any changes in market elasticities (Zhao, Mullen and Griffith 1997).

<sup>5</sup> For simplicity we assume throughout that, in the time frame considered here, there are no beneficial spillovers to producers abroad in terms of the new technologies lowering their costs of production.

<sup>6</sup> Although see the important comments by Alston and Chalfant (1999) on the difficulties of inferring benefits to consumers from advertising.