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AN OVERVIEW OF DAIRY POLICY OPTIONS

by

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Preface

This paper was presented at the Dairy Economics Symposium held in Kansas City on March 22-23, 1982. Proceedings of the Symposium are available from the U.S. Department of Agriculture. Additional copies of this paper can be obtained by request from:

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AN OVERVIEW OF DAIRY POLICY OPTIONS

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It seems clear that there is little disagreement that the current surplus milk production and large USDA purchases of and expenditures on dairy products is a serious problem having important consequences for the price support program and the future of the dairy industry itself.

The basic issue for this conference and the issue facing all components of the dairy industry is what do we do about it? It is not my intention to tell you what should be done. Others will make specific proposals later. My purpose today is to:

- discuss some of the general alternatives,
- try to focus some of the advantages and disadvantages of these alternatives, and
- comment on why we have dairy programs in the first place and some of the conditions surrounding the current problem.

What are Some of the Alternatives?

Alternatives to the price support program have been discussed for the last 30 years. Many that we hear today have been kicking around for years. I don't want to dwell on a long list of alternatives, but I would like to point out the ones that come to mind and how I would characterize them. The alternatives range from fine-tuning efforts to radical departures from the current program. Many of these options do not relate to our current problems, but they are alternative ways of achieving price support policy objectives.

- I. Support farm prices by purchasing manufactured dairy products, as is currently done. The farm price goal is achieved by setting the purchase prices for dairy products at appropriate levels. Alternatives exist for the mechanisms used to establish the support price or purchase prices, such as:
 - A. Use parity as the pricing standard for the support price, but:
 1. update the base year for the prices paid and prices received indices from 1910-1914 to something more current. (1967 is often suggested; this is the base year used for the Consumer Price Index.)

2. the weights assigned to the components of the prices paid index could be changed to more accurately reflect the amount of each component used by dairy farmers, rather than the amounts of inputs used by all farmers as is currently the case. This is the so-called dairy parity approach.
3. the current parity formula uses the most recent monthly prices paid index and the most recent ten-year averages for the prices received index and the wholesale price of milk. Only the more current data on the prices received index and wholesale prices could be used to calculate a current parity price.

B. Replace parity as the pricing standard with:

1. cost of production, as calculated by USDA,
2. an economic formula that may take into account several factors such as dairy product prices, supply and demand balances, cost of production, and so on, or
3. prices determined by a public hearing, as is done with Class I prices in some State milk marketing orders.

C. Change other administrative procedures, such as:

1. tying changes of support prices to changes in or projections of price support purchases and/or expenditures. This is the so-called trigger mechanism. Quantity and dollar triggers are specified in the Agriculture and Food Act of 1981.
2. changing the date on which support prices must be announced or requiring more frequent revisions, such as the semiannual adjustment which was used from 1978 to 1980.
3. creating more formal procedures for calculating and updating purchase prices.

II. Support farm prices but not via dairy product purchases. There are a number of theoretical possibilities, many of which are fatuous. The two most likely options are:

- A. a direct payments plan that gives farmers a cash subsidy based on the quantity of milk sold. This is similar to the target price program used for grains.

- B. Use federal milk marketing orders to support farm prices. Federal orders establish minimum Class and blend prices. The level of these prices is tied to the Minnesota-Wisconsin (M-W) price, which is influenced by the price support program. If the price support program did not exist, minimum order prices could be set in some other fashion; in fact any of the pricing standards discussed above could be used. Without government purchases, supply and demand would have to be kept in balance through price adjustments in manufactured milk markets. If Class III prices continue to be based on unregulated Grade B milk prices, Class I differentials could be adjusted to compensate for changes in Class III prices in order to achieve a blend price consistent with price "support" objectives. Establishing minimum prices in lower use classes in some other manner could become a problem if Class III prices became out-of-line with Grade B milk prices.
- III. A direct income subsidy could be given. This would be a cash payment of fixed amount not based on an individual's milk sales, as opposed to the direct payment alternative discussed earlier. This would be more of the nature of an income subsidy than a price subsidy.
- IV. Production control programs can result in higher prices or they can be used to limit milk surplus problems in conjunction with some kind of price support program. There are several types of production control or supply management programs including:
 - A. dairy product import restrictions, either tariffs, quotas, or other non-tariff barriers to trade,
 - B. culling incentives that subsidize, reward, or otherwise encourage culling beyond normal levels.
 - C. production or marketing quotas that establish price penalties for over-quota milk; these are often called base-excess plans, and
 - D. surplus pricing plans that work somewhat like a base-excess plan but without formal or complicated procedures for establishing a producer's base. In theory, a low, surplus-value price is paid for all milk estimated to be in excess of commercial needs with all producers sharing equally in the surplus price.
- V. Programs to stimulate demand can also be used to increase returns to producers; these demand side initiatives include:
 - A. promotion programs for milk and milk products,
 - B. marketing research and product development,

- C. consumption subsidies that enable people to buy dairy products who could or would not otherwise consume dairy products. Consumption subsidies can focus on either or both of the following:
 - 1. domestic markets, e.g. Special Milk, School Lunch, recent cheese distribution programs, military or other governmental use, or even broad price subsidies such as those commonly used for food in Second World countries, or
 - 2. export markets, e.g. P.L. 480, other international aid programs, or even price subsidies to exporters as are used by many exporting countries in world trade.
 - D. change product identity standards to require higher concentrations of nonfat solids and/or butterfat in milk or dairy products.
- VI. The final alternative to any public regulatory policy is deregulation. In this case that means abandoning the price support program altogether and perhaps milk marketing orders as well.

Another aspect of these alternatives is how these programs would be administered. In general, I think there are 3 types of administrative organizations:

- I. Direct and exclusive Government control such as exists for the current price support program, import quotas, School Lunch, Special Milk and export assistance programs.
- II. Indirect or shared government control, implying that the affected parties have some choice in participating in a program offered by the government and/or some opportunities for direct input into decision-making processes or the administration of a program. The chief characteristic of this type of institution is that nongovernment control is involved but the institution could not exist or survive without governmental assistance or authorization. Examples of this type of administrative organization are milk marketing orders, marketing boards, and some promotion programs.
- III. Voluntary private control, such as is the case when a cooperative initiates promotion programs, base-excess plans, and the like for its members.

It is possible for virtually any of the support program alternatives to be administered in any of these three ways; however, the administrative organization chosen to implement a program can profoundly effect the overall effectiveness of a program and the distribution of the benefits and costs of the program.

How Do we Evaluate These Options?

The current immediate imperative is to balance supply and demand and thereby minimize government purchases and expenditures. A corollary theme today is that deregulation in general is good and perhaps we should pay more attention to nonproducer interests.

If these are our only criteria then the deregulation alternative looks appealing. But, I think it should be recognized that our immediate concerns do not reflect some of the good reasons why we have programs and that some of the historical problems used to justify government intervention in and regulation of the marketplace are still relevant concerns.

I think there were three principal problems that led to the development of most agricultural policies in the first half of this century:

1. low farm income relative to nonfarm income
2. production and marketing risks were borne mostly by farmers
3. inequality in bargaining power.

These problems could very well re-emerge in a deregulated environment and thus merit our attention.

As the gap between farm and nonfarm incomes narrowed over time, interest in income enhancement has waned and rightly so. I am optimistic that low farm incomes and serious inequities with nonfarm incomes will not become a major problem again, but we have not reached a stage where that prospect can be totally ignored.

In recent years, price stability has clearly replaced income enhancement as the dominant public objective of the price support program. Prices can be stabilized above, at, or below market clearing levels. The remaining vestiges of the income enhancement objective led to a support program philosophy that preferred prices stabilized slightly above market clearing levels. The definition of acceptable price levels is changing as concerns for incomes decreases and program costs increases.

The historical issues of risk-bearing and equality of bargaining power are related to the price stability objective. Dairy price supports have contributed to the solving or easing of these two problems by transferring most of the risk associated with seasonal or cyclical over production from producers to taxpayers. In so doing the bargaining position of cooperatives is strengthened; because manufacturing dairy products even in an oversupply situation is a viable, even good, alternative. Cooperatives have a manufacturing option when they deal and bargain with processors that they did not have prior to the 1930s.

Thus when we consider alternatives we must consider how well an alternative deals with the inherent problems of the market as well as its ability to satisfy our current short run desires. Although some would disagree, I think the fundamental problems of inequities in risk-bearing and bargaining power would re-emerge in a deregulated environment. I cannot say whether society would or should judge that as a fair risk for producers to take, but these are factors that should be considered.

Sorting Out the Options

It seems to me that the immediate need to reduce the over supply of milk has to be a dominant factor in selecting price support strategy. Nonetheless, my concern that some of the problems that led to the development of price supports would re-emerge and my feeling that those problems are real and probably merit some kind of government intervention, leads me to conclude that some type of program that addresses these fundamental problems is justified. Total deregulation is probably not desirable.

So what program is best for today? Among the alternatives I mentioned earlier, I think almost all could work. Many of the alternatives discussed in the past deal with problems that are not particularly relevant now, many never were relevant. For example, there has been much discussion about modifying the parity standard or replacing it altogether. Frankly, I don't think it makes that much difference, and that kind of "solution" misses the problem.

When it introduced the flexible parity concept in 1949, Congress recognized that no formula could establish support prices without help in the form of human judgement. Congress defined boundaries on the support price but left the specifics up to program administrators who are better able to respond to market situations in a timely fashion. As long as the principle of flexibility remains, and it should, I don't think it makes a great deal of difference what pricing standard is used. The boundaries set by Congress 32 years ago need to be changed and the current parity standard could be improved, but I do not think the current situation was caused because of the parity standard we use nor would our problem be solved by changing that price standard.

What of the options that do not involve product purchases? Direct payments in whatever form are expensive when applied to milk. For a given level of price or income support, the current program is cheaper.

Increased reliance on federal orders to support prices is certainly an option, but I am afraid that doing so would draw further critical attention to a program that is already controversial enough in today's political environment. Federal orders serve an important role in creating an orderly marketing environment and should not, in my opinion, be used to enhance or overly distort prices. It should also be recognized that doing so would not necessarily solve the current problem, it could simply transfer the cost of the problem from taxpayers to consumers and processors.

Various production control alternatives are often espoused in times of oversupply, but they repeatedly have failed to be endorsed. Cow culling is too expensive and impractical as a long run replacement of price supports. Tighter import quotas imply tricky and undesirable conflicts with our trade policy and would not be enough to offset more than 15 percent of the total oversupply now anyway.

Production or marketing quotas have not been popular with producers in the past and are not in vogue politically these days. Some have suggested that a base-excess plan having an excess price lower than direct costs of production would be more effective in reducing production in a timely manner than an equivalent drop in market prices. This may be true, but this advantage, if it exists, does not come cheaply. Base-excess plans (or surplus pricing plans) require complicated and elaborate systems for determining who gets paid what for how much milk. This is unavoidable in any plan that seeks to give clear incentives to contraction and disincentives to expansion. Thus a costly infrastructure is required for determining the rules of the game. Moreover, biblical wisdom and patience is required of those who must decide on how bases are apportioned and how allotments can be changed or traded.

Another important consideration is that the adjustment process that would take place with a base-excess plan is very different from what would occur with a simple price drop. With a base-excess plan, production is reduced everywhere with few farms going out of business because of the pricing system. With a simple price drop, production is more likely to be reduced by farms going out of business. Either plan can be tailored to achieve a comparable impact on total production, but they can have quite different implications for future production adjustments. It is much easier to increase production after a period of contraction with a base plan. This is good if increased production is needed but not so good if a longer term, more permanent reduction is required.

One last caveat about base-excess plans is in order. Such plans may result in inequities between buyers, depending on how the plan is designed. If the plan is such that one group reaps most of the benefits of paying the lower excess price, there is clearly an inequity. This is not uncommon and ironically it is often world importers that benefit from lower prices at the expense of domestic consumers.

Consumption subsidies, whether domestic or external, are expensive, and when they apply to exports only, it is easy to see that they also are controversial.

Other demand side approaches are less controversial but have other limitations. Promotion programs alone are highly unlikely to solve the current problems. Research and product development suggest some hope for future increases in the use of milk but such efforts clearly pay off in the long run and do not address the immediate problem. Changing product identity standards may increase milk sales, but they restrict

the range of products available to consumers. This approach must be justified at the farm. In any case, efforts on the demand side should not be discouraged, but it is highly unlikely that they alone will solve the problem.

Finally there is the straightforward objective of reducing prices. Frankly, it is not clear to me that any plan is uniformly superior to another for an equivalent price reduction. No plan offers a magical or easy solution. Simple price reductions are the easiest administratively but may take a while to take effect and do not address program defects. Changes in parity, trigger mechanism and the like aren't likely to work any better in the short run and may or may not be any better or less mischevious in the future than the current program.

The problem of oversupply will not disappear overnight under any plan yet there are those who want a plan that will quickly reduce government expenditures. Frankly, I can see no easy way to avoid \$2 billion of government expenditures in 1982 and about the same amount in 1983 short of a budget ceiling or refusing to buy dairy products, which is tantamount to deregulation. Whatever specific form it took, deregulation would not solve the problem of oversupply in 1982; it would only transfer the cost of the problem from taxpayers to the dairy industry--mostly producers. Maybe taxpayers should be relieved of this burden, but deregulation would be a shortsighted solution.

Predictions for 1983 are difficult to make, but a simple price drop alone is not likely to make a large dent in production next year. Production adjustments will depend at least as much on corn prices, beef prices, and the strength of the overall economy. Without help on those fronts, milk prices would have to drop precipitously to eliminate overproduction by next year, and the havoc that would follow would be worse than another \$2 billion year for USDA dairy expenditures.

Three Final Comments

First, whatever change in policy is ultimately sought, careful consideration should be given to the adjustment process. For every proposal that is made someone should ask who will survive under this program and who won't. The answer is not always the same.

Second, I am fearful that the frenzy for action-now and short run solutions will result in a less desirable long run situation than a more gradual approach. This relates to the adjustment process and who will survive. What will the dairy industry look like 5 to 10 years from now after we fix it today? Another aspect of this problem of long and short run is that we should avoid locking ourselves into programs that are complicated, messy and may have adverse long run implications simply because they achieve short run objectives. The idea that we could do something in the short run and then phase it out as it becomes less useful is tempting but may be wishful thinking. Radical changes in the

current program should not be adopted unless they have clear long term advantages or the cost of eliminating short run changes once they have served their purpose is very low.

My third and final remark follows up on this theme; that is, don't panic. The dairy industry has faced similar problems before and survived. Overproduction problems in the fifties and early sixties were a little easier to handle, but we will survive this one also. This is not to say that we can go blithely along ignoring the problem; obviously a response is in order. But neither do I think it is time to plunge wildly into unknown and untested waters; we are not that desperate. This is a time for action but not rash action.

Although the dairy industry has survived similar trauma, the fact that these problems reoccur is also a lesson. It points to the failure of the system to finally solve such problems. In my opinion our current situation reflects a failure in the political process for allowing the situation to develop. It was not totally unforeseen and could have been avoided in a less politicized environment. Perhaps we ought to also spend some time thinking how we could improve the political process and program administration so as to avoid such problems in the future or at least reduce their severity.