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An Overview of Dairy Policy Options

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AN OVERVIEW OF DAIRY POLICY OPTIONS

Andrew Novakovic*

What are Some of the Alternatives?

Alternatives to the price support program have been discussed for the last 30 years. The alternatives range from fine-tuning efforts to radical departures from the current program. Many of these options do not relate to our the particular problems of the 1980s, 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. By creating a wholesale market demand for dairy products, the demand for farm milk is increased and farm prices are pulled up. 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. (1982-84 is the current 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 traditional 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 could be used to calculate a current parity price.

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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. Triggers specifically related to surplus levels may be called supply-demand adjusters.

2. adjusting the price standard for changes in production per cow

3. 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.

4. 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. 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; the amount might be based on a minimum income level. It might be limited to a maximum volume of sales but it would not be proportional to an individual's milk sales, as opposed to the direct

payment alternative discussed earlier. The income subsidy approach achieves the "decoupling" objective that many policy analysts find attractive today.

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. production or marketing quotas. Quota programs generally are tied to one of two price strategies, which I refer to as negative incentives or positive incentives. The negative incentive approach penalizes producers who sell milk in excess of their quota. The positive incentive approach rewards farmers who sell less than their base marketings.

1. Canadian or European style quotas and the so-called two-tier pricing approach advocated by some producer groups are example of the negative incentive approach. A quota plan that does not permit producers to build a new base every year and that had an excess price well below average variable costs would be a good example of the negative incentive approach to quota pricing. This type of plan would require mandatory participation. Seasonal base-excess (which are used in some federal orders and by some cooperatives) and Class I base plans (such as that used in California) are similar to the negative incentive approach but these plans are different in the important aspect that they are not intended to restrict total marketings.

2. The Milk Division Program is an example of the positive incentive approach (as was the refundable assessment in 1983). Under this type of quota pricing strategy, farmers receive a bonus payment if they reduce their marketings to a level below their base. This type of plan would be voluntary and is likely to have payment limitations and other restrictions on participants. The Dairy Termination Program is an example of a positive incentive program taken to the extreme, i.e. participants don't produce anything.

B. culling incentives that subsidize, reward, or otherwise encourage culling beyond normal levels.

C. dairy product import restrictions, either tariffs, quotas, or other non-tariff barriers to trade.

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, the more recent Temporary Emergency Food Assistance Program, 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. Government stocks of dairy products are typically disbursed in this manner and the Food Security Act created a Dairy Export Incentive Program to subsidize commercial trade.

D. change product identity standards to require policy higher concentrations of nonfat solids and/or butterfat in milk or dairy products.

VI. Direct assessments on dairy farmers were very strongly opposed when they were first introduced in 1983; however they have shown themselves to be a very quick way to reduce government costs. (The total cost doesn't go away of course; it just gets shifted from taxpayers to producers.) Farmers also appear to have realized that assessments are easier on them than price cuts which are intended to have equivalent budget outlay effects.

VII. 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 and import quotas as well.

Another aspect of these alternatives is how these programs would be administered. In general, I think there are three 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 imperative is to more nearly balance supply and demand and reduce 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. Things like the current GATT negotiations also force us to think about the relationship of the dairy sector to other sectors in the economy and parts of the world.

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 at the farm level.

These problems could very well reemerge 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 over-supply situation is a viable, even good, alternative. Cooperatives have a manufacturing option when they deal and bargain with processors that they did not have before.

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 reemerge 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 a price support strategy. Nonetheless, my concern that some of the problems that led to the development of price supports would reemerge 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 judgment. 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. For example, the current trigger mechanism approach simply uses last year's price as the standard and it has worked fairly well.

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 may be cheaper. Nevertheless, an income support approach probably deserves further consideration.

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 over-supply, but they repeatedly have failed to be endorsed by Congress and even among farmers support is very uneven. 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 offset only a small amount of the total over-supply now anyway.

Some have suggested that a two-tier pricing 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 is probably true, but this advantage, if it exists, does not come cheaply. Such quota 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 two-tier plan is very different from what would occur with a simple price drop. With a two-tier 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 quota plan. This is good if increased production is needed but not so good if a longer term, more permanent reduction is required.

The setting of prices under a two-tier plan is incredibly arbitrary, regardless of what formula or procedure is used. There is a built in tendency and risk of setting prices much higher than would occur in a deregulated environment. Of course, proponents of this approach regard this as one of the program's virtues.

One last caveat about two-tier 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 of buyers 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, although we must recognize that consumption increases following the creation of the National Dairy Promotion and Research Board has been extremely helpful in relieving the surplus situation in the 1980s. The only problem is that analysts are unsure how much of the recent consumption increase can be attributed to expanded promotion. 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. In any case, efforts on the demand side should not be discouraged, but it is highly unlikely that they alone will solve the problem.

Frankly, it is not clear to me that any plan is uniformly superior to another for an equivalent price or income effect. 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 mechanisms and the like aren't likely to work any better in the short run and may or may not be any better or less mischievous in the future than the current program.

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 desire for short-run solutions will result in a less desirable long run situation. 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 their short-run cost is very low.

The dairy industry has faced similar problems before and survived. Over-production problems in the fifties and early sixties proved 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. 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, and that is my third and final remark. 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.