

Anderson, Bruce; Novakovic, Andrew; Henehan, Brian; Wasserman, Walter

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Testimony Concerning the Proposed Northeast Interstate Dairy Compact

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*Testimony Concerning the Proposed
Northeast Interstate Dairy Compact*

Bruce Anderson & *Brian Henahan*
Andrew Novakovic & *Walter Wasserman*

March 1989

No. 89-6

Department of Agricultural Economics/
Cornell University, Agricultural Experiment Station
New York State College of Agriculture and Life Sciences
A Statutory College of the State University
Cornell University, Ithaca, New York, 14853

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Preface

The following testimony was presented at a hearing convened by the New York State Legislative Commission on Dairy Industry Development in Cortland, New York, on 9 March 1989.

The following people contributed to the preparation of this statement.

From the Department of Agricultural Economics at Cornell University:

Bruce Anderson	Associate Professor
Brian Henehan	Extension Associate
Andrew Novakovic	Associate Professor

From Cornell Cooperative Extension:

Walter Wasserman	Statewide Extension Specialist
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The authors express their appreciation for the Commission's invitation to discuss the implications of national market performance and policy on the New York dairy industry, and other matters relevant to these hearings.

Additional copies of this statement can be obtained by request from the authors or the following:

Publications Office
Dept. of Agricultural Economics
Cornell University
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Ithaca, NY 14853-7801

TESTIMONY CONCERNING THE PROPOSED NORTHEAST INTERSTATE DAIRY COMPACT

Regulatory Uniformity, Simplicity and Interstate Cooperation

The Commission is to be commended for its leadership in encouraging interstate regulatory uniformity, simplicity and cooperation. This effort has the potential to truly reduce the barriers to trade and improve economic performance in Northeast markets for dairy products. This is an effort that is aimed at benefitting all parties: producers, processors, manufacturers and consumers. Consequently, we strongly encourage the pursuit of all the items listed under Paragraph 7, Article IV of the Compact.

While review of current state laws and regulations, development of model standards, study of the costs of milk marketing, examination of the economic forces impacting the industry, and dissemination of timely information do not guarantee their adoption, they are certainly important first steps.

The National Dairy Situation

Despite the worst widespread drought since the 1930s, U.S. milk production for 1988 exceeded 1987 by 2% or 3 billion pounds. For 1989, production could increase another 1%. Longer term prospects are for steady growth fueled by increases in production per cow. More rapid gains are possible, depending on the extent and impact of the use of bovine growth hormone.

Ten states account for two-thirds of the nation's milk production. but these states do not follow national growth trends equally. For example, throughout 1988 Texas production increased 13%. In the process, Texas replaced Ohio as the seventh largest milk producing state, and it is closing in on number six Michigan. California, the second largest milk producing state, grew over 3% in 1988, slowing down from the first to second half of the year largely due to higher feed prices. Nearby Washington, the ninth largest milk producing state, grew at about the same rate. Wisconsin, the nation's largest milk producer, was sharply affected by the summer drought, but its production ended up almost 2% in 1988. Other major milk producing states in the Midwest started out with slower growth than Wisconsin and tended to be more drought affected as well. The Northeast was less affected by the drought, yet production decreased 0.5% for the region and almost 4% in New England. Clearly, pressure on land use and other factors are establishing growth trends in the Northeast. The major milk producing states that produced less milk in 1988 than 1987 are New York, Minnesota, Michigan, and Vermont. In early 1989, all major states are showing increases over 1988 except Wisconsin and Michigan, and Texas is again increasing very rapidly.

There have been considerable annual increases in commercial disappearance (a measure of sales) of dairy products since 1983; however each year has shown slightly less growth. In 1988, total sales ended up about 1% above 1987. Sales in 1989 are expected to be as large or somewhat larger than in 1988. Longer term prospects for growth might be characterized as full of opportunity but few guarantees. Of particular note is the apparently accelerating shift toward dairy foods that have lower fat content than traditional formulations.

In this case, even when total sales increase, the dairy industry is left with a growing problem of how to cope with increasing surpluses of cream.

With production increasing faster than consumption, net removals of surplus dairy products under the price support program ended 1988 at 8.9 billion pounds, milk equivalent (m.e.). This represents about 6% of the milk produced in the U.S., compared to 4% in 1987. Net removals for 1989 are projected to be comparable to slightly lower. Although well below net removals during the rest of the 1980s, net removals at this level are still too high to take the budget and political pressure off of dairy programs.

The Minnesota-Wisconsin price for manufacturing grade milk (M-W price) is an indicator of national prices and undergirds all federal order prices, including prices in the Northeast. Following the end of the phase-in period of the Dairy Termination Program, the M-W price fell toward support levels in the first half of 1988, but drought conditions resulted in an increase of \$1.93 per cwt. from July to December 1988. Although the M-W was higher in 1983, price premiums on top of federal order minimums resulted in farm prices that were probably at an all time high at the end of 1988 and the beginning of 1989. However, the M-W fell a total of 91¢/cwt. in January and February. Further drops of 30¢ to 80¢ will occur before prices strengthen again next Summer and Fall. It would now appear that the late 1988 price rise may have been largely an over-reaction to the summer drought. Prospects for farm prices in the 1990s still point to some further declines, if policy permits and feed prices return to lower levels.

If the Disaster Assistance Act of 1988 had not eliminated the possibility, the support price would surely have been reduced on January 1, 1989. On January 1, 1990, the support price will once again be subject to review and a possible 50¢ reduction, if net removals for 1990 are projected to exceed 5 billion pounds. A 1990 reduction seems probable at this point.

Major Dairy Policy Issues

Numerous proposals were discussed prior to passage of the last farm bill in 1985. All participants understand that the need for change is driven by high government costs associated with purchases of surplus dairy products under the price support program. Much progress has been made since (fiscal year) 1983, when net removals of dairy products equaled 16.6 billion pounds (m.e.) and net government expenditures peaked at \$2.6 billion. Today the surplus has been cut about in half and government expenditures have fallen by more than half. Yet, the problem is not solved.

Throughout the 1980s the focus of debates has been how to achieve these objectives, i.e. whether to treat dairy product surpluses with lower support prices or to use special production reducing incentives that are less financially hard on dairy farmers. Differences in the priority placed on the survival or prosperity of the greatest number of dairy farmers is probably the major reason for divergent proposals and points of view.

For many the rapid rebound in milk production after the Milk Diversion Program (MDP) expired in March 1985 generally discredited supply control approaches. Its adherents argued that a few technical adjustments would improve the MDP; others argued that firmer approaches would work better. One

could argue that the Dairy Termination Program (DTP), introduced in 1986, worked better than the MDP, but production also resumed growing after the DTP phase-in period expired in September 1987. Consequently, there is little support in Congress for repeating the MDP and not much more support for another DTP. Although these supply control programs have not had the desired permanent effect on milk production, successive cuts in the support price have not appeared to solve the problem either. Thus, those who favor price cuts also have had no strong evidence to support the efficacy of their approach.

Discussion about dairy for the 1990 farm bill can be expected to parallel the debates in 1985 and 1983. Dairy price support policy proposals will cover a wide range. There will be some support for maintaining the triggered price cut procedures and basic framework of the FSA. Another benchmark will be the proposals of the National Commission on Dairy Policy. This group of 18 dairy farmers from across the U.S. proposed 1) revisions to the price setting process intended to tie price changes to milk production cost changes and 2) adding a requirement to use supply controls when modest price cuts prove inadequate and estimated surplus production exceeds a certain trigger level. As in earlier debates, there may also be calls to go one step beyond the Commission's recommendation and have a more aggressive supply control program, sometimes referred to as two-tier pricing. In addition to proposed changes in the dairy price support program, federal milk marketing orders and dairy import quotas will probably receive considerably more discussion than they did during the last two farm bill debates.

The FSA resulted in a noticeably larger difference between minimum class I and blend prices across milk marketing order areas from North to South. Midwesterners have argued strongly that they are unfairly penalized by federal order provisions that, they claim, unduly stimulate milk production outside of the Midwest and make it difficult to supply distant markets with Midwestern milk. Northeastern and Southeastern producers generally believe that current federal provisions are reasonable and, if anything, class I differentials should be increased to more fully reflect interregional transportation costs.

Recent reports by the U.S. Government Accounting Office and, to a much lesser extent, the U.S. Department of Agriculture are critical of current federal order price structures and of the system itself. Other studies of so-called "mailbox prices" in Wisconsin and the South Central U.S. suggest that the regional prices actually received by farmers are much closer than is implied by a comparison of the minimum prices plants are required to pay under federal orders. In other words, non-order price premiums and marketing costs passed back to dairy farmers do more than federal order minimum plant prices to shape regional price differences.

A related topic that shaped much of the discussions on dairy policy in 1987 and early 1988 was regionalism, i.e., the view that dairy policy should discriminate between regions of the country according to the characteristics or performance of their dairy industry. The most prominent proposal would divide the U.S. into six to ten regions, establish a base level of surplus dairy product sales for each region, and charge dairy farmers in each region for the cost of surplus sales in excess of a regional quota.

The debates about regional surpluses and federal order prices eventually merged. Charges that the Midwest sells a large quantity of surplus product were countered with charges that the Midwest wouldn't have to if not for the

fact that marketing orders inhibit their ability to compete for Southern and Eastern markets. Both points of view are likely to be reflected in the 1990 farm bill discussions. Opinions on these topics are widely divergent in the dairy industry, such that there is no obvious resolution.

Dairy import quotas, which help the U.S. maintain domestic price supports, are becoming a topic of discussion because the U.S. is in the middle of the so-called Uruguay Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT). As with earlier rounds, dairy quotas stand out as an exception to the philosophy and rules of the GATT.

Dairy import quotas will be staunchly defended by the U.S. dairy industry, which has successfully blunted forces for change in the past. Even the most ardent U.S. free-traders will not give up dairy product quotas without exacting major changes from other countries. The U.S. proposal calls for extensive changes in each country's domestic support policies as well as trade policies. Such changes will not come easily and may not be made at all; yet there is a strong desire on the part of all GATT participants to do something.

Implications for New York

Nationally, the dairy industry is still producing more dairy products than can find a home in commercial markets. Although the surplus situation is much less acute than it has been, it is still a problem. Not all regions, indeed not all farms have contributed to increased production equally. It would be surprising if they did. The fact that they don't tells us about the differences in profitability of milk production in different parts of the country and across farms.

Because we don't know what sort of farm bill will be passed in 1990, it is too early to say how policy changes will affect New York. If the policy of triggered price cuts is extended, New York will not be the only area of the country that is unhappy.

A recently released USDA study of costs of producing milk in 1987 estimates the pattern of returns illustrated in Table 1. Although net cash returns per herd in the Northeast are double those calculated for the Wisconsin/Minnesota/Michigan/South Dakota area, they are below the national average and far below levels estimated for areas of the country that have been experiencing considerable production growth. Differences in prices, cash expenses, herd size, and production per cow all contribute to the differences in net cash returns per herd. The most significant factor is herd size. We are not advocating large farms; nor do we suggest that increasing farm size is the only way, or even a sure way, to improve net farm income. Nevertheless, the USDA cost estimates speak plainly enough. The regions that have larger average farm sizes also have much greater total returns per farm.

What this means is that the traditional milk producing areas are much more vulnerable to price cuts. The following example oversimplifies how a price cut shows up in average cash returns because it assumes that farmers do not change their variable cash expenses. Nevertheless it illustrates the point. Suppose the price of milk is reduced \$1 per cwt. across the country and that this shows up as a reduction of \$1 per cwt. in average net cash returns in each region. Net cash returns per herd are recalculated as shown in Table 2.

Table 1. Net Cash Returns to Farms in Different Regions of the U.S., 1987

Region	Cows/Herd	Pounds/Cow	Net Cash Returns ^a	
			\$/cwt	\$/herd
Northeast ^b	57	14,321	2.72	22,203
WI/MN/MI/SD	49	13,475	1.50	9,904
Florida/Georgia	388	12,217	3.20	151,686
Texas	128	13,055	3.40	56,815
CA/WA/ID	322	16,821	2.20	119,160
United States	108	14,029	2.02	30,606

Source: Dairy Situation and Outlook Report, USDA, February 1989.

^a Value of milk and cull cows less variable and fixed cash expenses.

^b Includes Ohio.

Table 2. Net Cash Returns Per Herd in Different Regions of the U.S. When Average Returns Are Reduced by \$1 per Cwt.

Region	Net Cash Returns, 1987		Net Cash Returns, with \$1 Cut
	\$/cwt	\$/herd	\$/herd
Northeast	2.72	22,203	14,040
WI/MN/MI/SD	1.50	9,904	3,301
Florida/Georgia	3.20	151,686	104,284
Texas	3.40	56,815	40,105
CA/WA/ID	2.20	119,160	64,996
United States	2.02	30,606	15,454

The total dollar reduction in the Southeast, say, is much more than the reduction for the Wisconsin/Minnesota/Michigan/South Dakota area, but under these simple assumptions the large Southeastern farm is still making a large sum of money and the small Upper Midwestern farm is barely breaking even on a cash basis. If the USDA cost calculations are anywhere near the mark, small wonder that producers on small to medium size farms are concerned about price cuts, and this is undoubtedly true no matter what region of the country the farm happens to be in.

In the face of declining national prices, what are the opportunities for compensating with higher, over-order prices in New York, either via cooperative action or government fiat? The success farmers have had in obtaining price premiums through RCMA and other organizations indicates that there is room to maneuver above federal order minimum prices. However, prices cannot be set in the Northeast without paying heed to prices elsewhere. Efforts to raise Northeastern prices, especially for milk used in manufacturing, confront a practical limit, beyond which the customers of Northeastern plants will buy products from other sources. Competition in manufactured product markets is already intense. Northeastern outlets are prized by manufacturers located in the Midwest and potentially as far away as California. If Northeastern farmers are unable to profitably supply milk to Northeastern manufacturers at prices that allow manufacturers to be competitive, then we can expect to lose those markets. This is not to say that it is impossible for manufacturers to pay prices greater than federal order minimums, in fact they already do. However, it must be recognized that there are limits.

What about federal policy options other than continued triggered price cuts? Some producers favor quota or two-tier pricing programs, like those used in Canada and Europe. No option can be dismissed at this stage, but the possibility that Congress will adopt this approach in the 1990 farm bill seems to be exceedingly low.

The 1990 farm bill could bring changes in federal milk marketing order pricing. This does not seem highly probable at this point, but it is possible. Specific changes could only be guessed now. Most of the changes that have been proposed by Midwestern activists would be somewhat detrimental to the Northeast. Inasmuch as the proposed changes almost all apply to class I prices, any such change in minimum order prices could be compensated by increases in over-order premiums. The net effect on farmers is not necessarily as large as a specific proposal may imply on the surface.

Changes in import quotas are possible as a result of the GATT negotiations. These trade negotiations are far from complete, and it is not at all clear what their outcome will be. However if import quotas are relaxed or phased out, New York will be affected in two ways. First, if the prices of imports of manufactured products are attractive to U.S. buyers, there will be pressure on all U.S. manufacturers to compete. New York's stake in manufactured product markets is large. Second, most imports enter the U.S. through the New York City and Philadelphia ports. Hence, this puts the Northeast at the front line of the attack. Again assuming imports are attractively priced, they could just as easily displace Midwestern products as Northeastern products. But, the major battle zone is likely to be Northeastern markets.

If federal policy moves in any of these directions, the Northeast will find itself in an increasingly challenging situation. The fact that it will have much company, particularly in the Upper Midwest, is probably not much comfort. It is overly simple to point to just one factor, but the biggest factor that will determine the future of the Northeast dairy industry will probably be the cost competitiveness of Northeastern dairy farms.

The Role Of Cooperatives

A few of the questions outlined in the notice of hearing related specifically to cooperatives. We would like to address the role of cooperatives in the context of a Northeast compact.

First, review and recommendation of a model cooperative corporation law is long overdue. As indicated in Baarda's State Incorporation Statutes for Farmer Cooperatives (Cooperative Information Report 30, Washington, D.C.: USDA, ACS, October 1982) there is a great deal of variation in cooperative corporation law, even across the Northeastern states. Over the years since their initial adoption, revisions and additions have been on an ad hoc basis by each state. The end result is that the cooperative laws of each state have become more and more different, despite the fact that most state laws stem from the same heritage. We highly encourage any new model law to address the structures, operations, and issues being used by or facing contemporary organizations.

Second, the notice of hearing spelled out several questions concerning the voting rights of cooperatives. Because these are questions of organizational and political concern, rather than economic issues, we do not feel that we are in a position to respond. At the same time, we would point out that block voting is an accepted and common practice when it comes to intra-industry efforts. In addition, it is most democratic for farmers to have the option to vote contrary to the block vote.

Finally, we would like to address the issue of the Compact being a possible substitute for group action in the form of cooperatives. In a market environment organizations should compete to provide the combination of goods and services people want. It is our opinion that a Compact should not usurp the market responsibilities currently assumed by dairy cooperatives. While we realize that this is certainly not the intent and the legislation almost suggests a desire to strengthen the role of cooperatives, the economic forces seem to indicate a different result. A legislatively authorized organization that assumes some of the market and industry-wide functions of dairy cooperatives is likely to have the upper hand in the marketplace. Consequently, the Northeast Compact may serve to weaken the role and attractiveness of dairy associations, and other market entities.

Issues For Additional Consideration

We feel there are several questions that deserve additional consideration. For example:

How should a Compact be structured to best mesh with current market institutions and regulatory bodies?

What are the implications of potential Compact pricing provisions on the ability of the Northeast to compete in the national market for dairy products?

Are current and expected future conditions, especially under a new farm bill, consistent with the original premises of the proposed Compact?

What other measures should be taken, either privately or publicly, to enhance and ensure the vitality and future of the New York dairy sector?

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