

TESTIMONY ON FEDERAL DAIRY POLICY

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by

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Introduction

Congressman Gunderson and other distinguished members of the House of Representatives, I welcome you to New York. I am appearing before the Subcommittee today to offer my views on federal dairy policy and share relevant insights from the research we have done at Cornell. These views do not represent an official statement by Cornell University.

I wish to make five major points which I hope will be useful to you as you fashion the dairy title of the 1995 farm bill.

1. Efforts to promote long-term competitiveness in world markets offer the best hope for growth in the dairy sector.
2. Given the current budget environment and prospects for trade liberalization, the time may well have come to eliminate the dairy price support program.
3. Absent their own expressed desire to pay for federal programs, assessments levied on dairy farmers simply for the purpose of helping to balance the budget should be eliminated as price supports are eliminated.
4. Programs to protect dairy farmers from less than perfect conditions of competition continue to be warranted. The chief federal program of this type is the Federal Milk Marketing Order system.
5. Decisions relative to food assistance and environmental programs can and should be made with an eye toward minimizing detrimental impacts on agriculture.

Changing Times--Changing Needs

Federal dairy policies, beginning with Federal Milk Marketing Orders (FMMOs) in the 1930s and ending with dairy import quotas in the 1950s, were initiated because it was felt that dairy farmers weren't getting a fair deal in the marketplace. Initially, government programs had a "self-help" orientation. For example, the Capper-Volstead Act of 1922 sought to empower farmers so as to increase their bargaining power in the selling of their products or the purchasing of inputs. The FMMO program added a more formal role for government in establishing rules for certain conditions and terms of trade in milk markets, but it left a considerable role for farmers and market mechanisms in the overall setting of milk prices. The fact that FMMOs were and are voluntary is another indication of their "self-help" orientation.

When the Dairy Price Support Program (DPSP) became a permanent fixture after World War II, milk markets were severely depressed. Farmers had been complaining for

decades about their seeming inability to get a fair price out of the marketplace, even with FMMOs. Congress finally reached a point where more direct action to support prices seemed warranted. The establishment of permanent dairy import quotas in the early 1950s capped off the total package. One result was that the DPSP more or less ensured that the US would not be a major exporter and import quotas protected us from being a major importer.

It appears that today we are seriously looking at taking federal dairy programs apart in reverse order. In fact, with the declines in the support price beginning in 1984 and the implementation of the General Agreement on Tariffs and Trade (GATT) this year, the process is already underway. To a large degree, the 104th Congress will decide how much farther down that path we will go.

More Open World Markets

GATT has eliminated section 22 import quotas and guaranteed the rest of the world greater access to our domestic markets. Tariffs will limit the incursion, but imports will about double in the next five years. Corresponding changes in other countries create opportunities for us to increase our exports but this will be difficult in the short run and long run growth hinges on factors outside the control of the dairy industry.

In the short run, export market share will be hard to take from low cost products made in New Zealand and Australia and low priced products from Europe, where subsidization will be reduced but still remain large. Indeed, the increase in our imports will certainly come from these two areas of the world. Our prospects for increased exports are far less certain for several reasons.

1. New Zealand and Australia have real cost advantages with which no other supplier can compete without special help.
2. Although the US is very cost competitive with Europe, the continuation of European subsidies makes it difficult for us to compete with Europe as an exporter.
3. Dairy products, when compared to all foods worldwide, are high value foods (in both a nutritional and financial sense). Though desired, they are not as affordable as other foods in low income countries. Most high income countries are net exporters or self-sufficient in dairy products. The major exceptions are the developed and newly industrialized countries of East Asia.

When we take into account the purchasing power of the traditional importers of dairy products and add in the fact that lower European subsidies mean higher buying prices, I conclude that in the short run world trade in dairy products will shrink. I also suspect that New Zealand and Australia will get an increasing share of this shrinking pie at the expense of Europe. Increased market access provisions in high-income countries is the only factor I see to offset this phenomenon in the short run.

Thus, longer run growth in world dairy trade will hinge on two factors: 1) greater access to markets in high income countries and 2) economic growth in low income countries. Neither are a sure bet. For examples of the importance of this to the US, we need do little more than look north and south. I might point out that the recent huge devaluation of the Canadian dollar relative to the US dollar has done much to equalize US and Canadian dairy prices. This reduces our competitive advantage, but, if this relationship

persists, it will make it easier for Canada to envision freer trade in dairy products. The devaluation of the US dollar relative to other currencies improves our export competitiveness considerably and is, on net, good for US farmers, dairy and otherwise.

Tighter Federal Budgets

It goes without saying that the taxpayer dollars that can be allocated to dairy programs are shrinking. In the early 1980s, taxpayers financed surpluses equal to 12% of the US milk supply. At today's support price, if expenditures need to be limited to, say, \$250 million, we can only afford a surplus of about 1%. This obviously limits our ability to support farm prices.

Congressman Gunderson and others have asked whether this is the best way to spend \$250 million for the benefit of dairy farmers. My opinion is that it is not. I believe the money would be better spent on export subsidies for as long as the GATT allows. As direct subsidies are reduced, any such money might be better diverted to assist farmers 1) in becoming more competitive, 2) in complying with environmental regulations or 3) to assist low income consumers purchase dairy products, at home or abroad.

I would hope it would also go without saying that if the support program is eliminated, budget motivated assessments on dairy farmers should also be eliminated. Farmers may desire the option of paying an assessment in return for some beneficial program. For example, they might choose to kick in some money to finance an export program. As is the case with promotion assessments, I would favor a system which required mandatory participation if the majority approved a program and also allowed for periodic referenda. However, in the absence of clear support for such an assessment, the default should be no assessment.

Dairy Price Supports

The current support price is close to meaningless. Under the DPSP, farm milk price goals are achieved by the government support of wholesale prices for cheese, butter, and nonfat dry milk. The wholesale price of cheese has fluctuated well above the federal purchase price since about 1988. Market prices for butter and nonfat dry milk hover close to the federal purchase prices, but these markets are at least close to natural market clearing levels if not there already.

In my view, the DPSP has reached the point where it is more of a security blanket than a safety net. In fact, it is a security blanket that most manufacturers have already put aside. The only manufacturers for whom the program has some appeal are those who operate in areas of the country where milk supplies are growing very rapidly and the processing and marketing of this milk is a physical challenge.

If we take as given the facts that 1) we can't afford more price support and 2) freer trade requires us to be price competitive or lose market share, then I find it quite easy to say the time has come to eliminate the program.

The primary worthwhile argument against this is that even a modest program may have price stabilization effects which exceed the cost of the program. I accept this as a legitimate argument, but I believe the benefits would not exceed the cost.

We have done research on prices in dairy product markets which validates the conventional view that retail prices move up more easily than they move down, in response

to changes in wholesale or farm prices. Thus, when milk prices are highly volatile, as they were in the late-1980s, consumer prices will tend to be higher than when milk prices are extremely stable, as they were in early 1980s. This is true even when the annual average milk price is the same. Our results show that the consumer price response varies from product to product, but it can be large enough that one could argue that what is spent in stabilizing farm price is more than offset by the reduction in consumer expenditures associated with lower retail prices. Thus, the theory of the benefit to consumers of farm price stabilization is not frivolous. The relevant issue now is whether or not the benefit of stabilizing prices under late 1990s conditions would exceed the cost.

With limited federal budgets, we simply cannot afford the high degree of price stabilization that was achieved through high farm prices and large surpluses in the early 1980s. In addition, the extreme volatility of the late 1980s, when the support price was first moved to its current level of \$10.10, has moderated in the 1990s. Although still more volatile than any historical average, the gains from further stabilizing milk prices, particularly to the limited degree we can afford, simply aren't worth the taxpayer and farmer dollars that now go into the DPSP.

One could approach this as a proposition to be tested by implementing a phased withdrawal of price supports. For example, one might begin by eliminating the purchase of cheese. Cheese is the most vigorous of the supported markets. There is sufficient capacity in butter and nonfat dry milk plants to process all the surplus we could afford. One could even replace the purchase price for cheese with a -recourse loan program on cheese, along the lines Congressman Gunderson has suggested in the past, to see if the industry found that alternative to be useful. If, after a couple of years, the elimination of cheese from the price support program seemed workable, one could then more comfortably eliminate the rest of the program.

If it were my choice I would get rid of it all at once. On the other hand, I certainly would not object if the industry showed a clear preference for a more gradual approach.

Dairy Export Incentives

Every dollar freed from the DPSP should be used to fund the Dairy Export Incentive Program (DEIP) to the maximum allowed under GATT. This is desirable for several reasons.

1. When the federal government buys surplus product it pays for all of it and often ends up giving the product away six to 18 months later, thereby incurring some holding and distribution costs as well as the purchase cost. When the federal government subsidizes exports, the importer pays at least some of the cost of the product. Thus, the export approach obviously lets the same dollars move more product.
2. Subsidization allows US exporters to penetrate markets with which they are unfamiliar and would otherwise be unable to enter. There are no guarantees, but the strategic use of DEIP may help exporters to gain the expertise they will need if they are to be competitive marketers when subsidies are eliminated.

The logic of the latter suggests that subsidy dollars should target the lower income countries in which the US has the best long run potential as an exporter. I believe these are the countries of Latin America, first, and the Asian Pacific Rim, second.

The use of taxpayer dollars to subsidize exports is clearly to the advantage of the dairy industry. Whether it is worthwhile for producers to use their own dollars for this purpose is less certain but worth discussing. An approach of this type has sometimes been referred to as a class IV export program. This or a similarly structured program would allow manufacturers a lower, more competitive price for the milk used to make exported dairy products.

The class IV approach is similar to the FMMO class IIIa price which allows manufacturers a cost of milk that is calculated to be in line with the wholesale price of nonfat dry milk. The lower class price in either case is reflected in a lower blend price for farmers. Thus, all farmers pay a little so that the total size of the market can be larger. To the extent that export demand is more price elastic than domestic demand, this improves producer income as well as allows more producers to survive. To the extent that exports are a small share of the total demand, the price impact on domestic producers and consumers is small.

A relevant question is how much export market can producers afford to buy. For example, if they accepted \$9 per cwt as a class IV price, they might increase marketings by three billion pounds of milk. If they accepted \$6 per cwt, they might double their marketings, but would that be worth the lower price? There are many elements to a class IV program that warrant careful consideration, should such a program reach a point of serious discussion. One item might be that setting a class price derived from a wholesale price, as in the case of class IIIa, may be too open ended. It might be better to allow producers to determine a minimum class IV price they are willing to accept, and let the market determine how much could be sold at that price.

Federal Milk Marketing Orders

In writing this testimony, I must confess that I found it more than usually difficult to keep it short. In my view, so much has been said about FMMOs based on misunderstandings about what they do, why they are set up as they are, and the underlying nature of milk markets. It is difficult for me to react to the many suggestions for changing federal orders without wanting to back up and say, let's review some of the basics. Having said that, let me try to mention some of these basics without dwelling on explanations.

1. Farm level milk markets are not models of perfect competition. They are inherently oligopsonistic in nature, meaning buyers generally have the ability to dictate price. Federal orders are a mechanism to mitigate this economic condition so as to make farm prices more like what one would expect under more perfect conditions. The idea is to mimic competitive markets not to distort what would have otherwise been a competitive market.
2. The Agricultural Marketing Agreement Act requires the Secretary of Agriculture to act in the public interest when establishing pricing rules under orders. He must strive to balance producer, processor, and consumer interests. If one accepts the premise that it is impossible to define one price that meets the criterion of being reasonable and fair, then it is not hard to understand that the department has generally followed this mandate by trying to find pricing rules that would give the farmer the best deal possible while still being within the bounds of reason and fairness.
3. The economic structure of marketing costs and the patterns of milk production and dairy product consumption result in natural differences in the value of milk across

uses and across regions. Even before there were regulated prices, markets naturally established a higher value for milk used for fluid products (class I). Similarly, they naturally established regional values wherein milk prices were lower in the Upper Midwest and the Far West and elsewhere tended to increase with distance from the Upper Midwest. The price incline is greater from north to south than it is going east or west.

4. The underlying economic justification for these regional differences in class I prices hinges on regional differences in the balance of production and consumption and the differences in distribution costs between fluid and manufactured products, not in assembly costs of raw milk.
5. Given these economic factors, a rationale can be developed for establishing regulated prices that is loosely based on the cost of transporting bulk milk. This rationale hinges on the notion that it is desirable to first use local milk in local processing and that we want to give local producers the best price possible within the constraints of reason. A minimum price calculated to be at or just below the price of milk from the next available source is deemed to be at that boundary of reasonableness. To pay less is to unnecessarily disadvantage the local producer, to pay more is to unnecessarily benefit the local producer and make processors long for distant milk.

Budgetary Factors

The impact of FMMOs on the federal budget is close to nil. Most of the administrative cost of the program is borne by regulated processors (at least some of which shows up in the price to consumers). The remaining \$4 to \$5 million that represents that cost of the Washington-based staff could easily be converted to user fee funding as well, if that were deemed important. At any rate, any concern about FMMOs has to be recognized as having a basis in something other than the federal budget.

The Process of Changing Orders

There are many voices calling for fundamental changes to federal orders, including voices in Congress and on this committee and its Senate counterpart. There are also voices to defend the status quo. Any changes that Congress might choose to make to federal orders directly or the legislation that provides the framework for the FMMO system should be made with careful consideration for the long term impacts. This is a complex system in a complex market. Seemingly simple changes may have unforeseen consequences which would be difficult to redress. Ideally Congress should clearly articulate the purpose and objectives of legislation, give the Department the regulatory and financial tools to meet the objectives, and let the Department work out the details.

Eliminating Orders

Despite my earlier willingness to dispense with the Dairy Price Support Program, I am less eager to eliminate marketing orders. In my opinion, the marketing order system still effectively addresses a legitimate need. I refer to the first premise I listed above. Federal orders do not necessarily guarantee each farmer a profitable return, but by establishing minimum prices and certain conditions of trade, they do mitigate the natural tendencies for lowering prices to producers.

One could argue that any move which improves prices to producers is necessarily at the expense of consumers and therefore suspect. However, if one accepts this argument that the results of a perfectly competitive market define a social optimum, then an argument can be made that price regulation in the form of marketing orders can work in the direction of correcting an imperfect market and therefore moves toward a social optimum. Obviously, one must study the specific outcomes to estimate whether or not the specific provisions of marketing orders go too far or far enough.

If one accepts the proposition that price regulation is better than no regulation, then the obvious question becomes what is the best form for that regulation to take. This is an exceedingly difficult question. If the model of perfect competition is accepted as the norm, then economic theory can be brought to bear to estimate what the outcome of perfect competition might look like. Price regulation can be used to move the market from where it is toward where it should be. Other guidelines can also be used to establish what the norm ought to be, and therein lies the source of a lot of arguments about the provisions of federal orders.

Let me also offer a cautionary observation about economic models used to analyze dairy markets. Economic models of dairy markets generally use the tools of supply and demand. Strictly speaking, these tools are valid only when one assumes markets are perfectly competitive. Economists generally assume that they remain valid if markets are reasonably competitive, even if they are not perfectly so. To the extent that price regulation in dairy markets promotes a more balanced competition, these tools should provide meaningful results; however their use must be modified if one wants to estimate the impact of deregulation. Hence one must be especially careful in using models drawn from data in an regulated market to estimate what an unregulated market would look like. Furthermore, many dairy sector models lack specificity in the product market structure and marketing cost detail that give rise to price differences in the real world. In many cases these models work on the basis of the price assumptions of the author; they lack the ability to predict market prices when regulated minimums are set too low.

Class Prices vs. Blend Prices

Class prices are the prices processors must pay for farm milk. Blend prices are the market-wide average of the class prices paid by each processor regulated in the market. They are the minimum prices farmers are to receive. The process of calculating a weighted average, market blend price is typically called pooling.

Economic analysis can estimate the differences in class values of milk under assumptions of competitive markets. I have done so in my 1991 paper "Geographic Price Relationships Under Federal Milk Marketing Orders." The tools of economics cannot estimate how milk should best be pooled. Pooling is about equity not efficiency, it is more of a social issue than an economic one.

The historical rule of thumb was that the distribution patterns for fluid milk would define a market. In other words, if a group of fluid milk plants tended to serve a certain area and compete with one another primarily in that area, to the general exclusion of another area, then that area constituted a geographic fluid milk market and those plants, wherever they might be physically located were a part of that market. Manufacturing plants were associated with that fluid market only if they played a role in balancing the seasonal ebb and flow of milk associated with one or more fluid processors in that market. On this basis, a group of fluid and manufacturing plants could be identified as part of a market and the values of their milk could be pooled across all farms which supplied those plants.

Over time, this rule was relaxed to the point that one way or another any grade A farmer can get his or her milk pooled under a federal order. Although this tends to undermine the historical concept of a market, it was done using the logic that it is good to share the benefits of marketing orders with as many farmers as want to use them. This has a certain appeal but it makes far more murky the rationale by which markets are identified. Should northern New York farmers have access to a fluid milk market that is predominantly in southeastern New York? If so, why not western New York farmers; or how about Ohio farmers? And if them, why not Indiana, Illinois, and Wisconsin farmers?

Price Leveling

Some critics of the current system, particularly in the Upper Midwest where order prices tend to be lowest, have suggested that it would be more fair to somehow equalize prices across regions. There are any number of methods that could be combined to move in this direction. The two basic concepts that have been most frequently discussed are 1) equalizing class I prices (other class prices are already equal across orders, with a few fairly minor exceptions) and 2) national pooling.

The attached table shows the current class I differential and the average blend price, average class I utilization, and total producer receipts for each federal order during the first 10 months of 1994. Pooling all receipts across the entire system would give each order the all order average blend price of \$13.19, assuming no other changes were made. This would raise the blend price in the Pacific Northwest by \$1.15 and reduce it by \$2.62 in Southeastern Florida. If California were included in the calculation, the national blend price would average \$12.85. National pooling would pull up the California average \$1.50 and lower the Southeastern Florida blend price almost \$3.00. It can be argued that if southern markets had a natural reason for higher prices, then over order premiums could come in to play to pull actual farm prices up above the low blend price. Unfortunately, no such mechanism can compensate for an excessively high minimum price. I conclude that national pooling which does not take into account the supply and demand conditions in regions would be a very costly mistake.

The alternative of leveling class I prices does not in fact equalize blend prices; because there would continue to be differences in class I utilization across markets. For example, if each federal order had the system average differential of \$2.57, then the blend price in the Pacific Northwest would increase 22¢ to \$12.26 and the Southeastern Florida price would decrease \$1.30 to \$14.51. This approach obviously narrows the range in blend prices but a considerable range would still exist.

In thinking about these approaches it is good to keep in mind which areas would get higher prices and which would get lower prices. Midwestern critics tend to think of their getting higher prices at the expense of southern producers. Other beneficiaries of these price leveling strategies include the states of the West. Thus, prices would increase in areas of the country where milk is plentiful and growing rapidly and decrease in areas which produce less than they consume. One must believe that the current system is seriously out of whack for this to make any sense.

Other Issues and Ideas

Numerous other ideas will be suggested for reforming federal orders, and there are important issues beyond the concept of price leveling. I hesitate to burden this testimony

further with a laundry list of options and issues; however, I wish you to know that I would be delighted to visit with you about them further at your request.

Related Policies

I would like to conclude my testimony with some very brief comments regarding federal policies that are presently under review and which have important implications for agriculture, including dairy.

Research and Extension

Dean Call has emphasized the value of public support for agricultural research and extension. At the risk of appearing self-serving, I would like to reiterate that point. Public support for research and extension is not about helping universities survive; it is about helping people survive. In a market that increasingly confronts US producers with marketers all over the world, our investment in educational programs and both short-term and long-term research is all the more crucial. I do not know what is the right mix between public and private investment. Nor would I argue that the current expansive land-grant system is necessarily required for today's needs. I do believe that some public investment more than pays for itself.

Food Assistance

Domestic and international food assistance programs have important implications for agriculture, to say nothing of the people for whom the programs are targeted. In the long run, policies should strive to help people help themselves, but in the short run hunger and poverty exist. Programs like WIC and School Lunch target infants and children who do not have a second chance to get off to the right start. Maintaining the integrity of these programs is a pay a little now and save more later strategy.

Environmental Policy and Animal Agriculture

Animals generate waste products that contain a lot of soil nutrients and small amounts of microorganisms, some of which are pathogenic. It is not inappropriate to have policies and regulations which ensure public safety and avoid long term harm to vital natural resources from nutrient overload or high levels of pathogens. What is needed is a sensible and coherent policy that simplifies the task of farmers who generally want to achieve the same environmental goals as the general public. This policy needs to recognize that regulations now derive from federal, state, and local sources. Achieving coordination is not a simple task. I urge this committee to carefully monitor environmental policies developed elsewhere in Congress and work with your colleagues to avoid unnecessary hardships on farmers, develop ways to assist farmers in meeting environmental objectives, and keep the overall system as uncomplicated as possible.

Conclusion

It has been my pleasure to speak to you this day. I look forward to your questions and stand ready to assist the efforts of the committee, now or in the future, in any way I can.