

## TARGET PRICES AND DEFICIENCY PAYMENTS

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Since it began in 1949, the Dairy Price Support Program (DPSP) has worked smoothly enough in most years that we tend to forget that there are other ways of achieving dairy policy objectives. One alternative to purchasing manufactured products to support farm prices is a target price-deficiency payments program.

When farm support is based on the support of farm prices, then farm support benefits increase in proportion to farm production or sales. In recent years, various proposals have been advanced in agricultural policy that would disassociate farm income support from production decisions. Such proposals have been referred to as decoupling, i.e., the amount of support is decoupled from the level of production. In the current dairy price support purchase program, the total returns that come from a higher price increase in direct proportion to the quantity of milk marketed. The objective of decoupled support is to provide an acceptable or reasonable standard of living for farm families, while letting open market supply and demand forces establish the price levels that influence production decisions of farmers and the purchase decisions of buyers. The target price-deficiency payments approach represents a step in the direction of decoupling, especially if payment limits are specified in the program.

In early 1985, prior to passage of the Food Security Act of 1985, the Reagan Administration advanced a proposal that would have phased out the current DPSP effective October 1, 1987, and would have replaced it with a target price-deficiency payments program. The proposal did not go anywhere, but the idea did not die. Subsequently, for example, the Farmers Union Milk Marketing Cooperative has endorsed a deficiency payments approach.<sup>1</sup>

### ***What is a Target Price-Deficiency Payments Program?***

Target price-deficiency payments plans can take several different forms, but basically, they are distinguished by the fact that direct payments are made by government to milk producers. Although a program to purchase surplus butter, cheese, and nonfat dry milk might be a part of a target price program, the current purchase based program could be eliminated. If it were, wholesale product market prices would adjust to market-clearing levels (see Leaflet P-1 for a discussion of the implications of purchasing surplus dairy products). Producer milk prices would quickly reflect such adjustments. Unless market prices are above support prices expectation would be that market prices would fall when the purchase program was eliminated. Target prices would be pegged at a level near the current support price or maybe higher. In this case, the amount of payment is the difference between the target price and the prevailing market price for producer milk. If a purchase program were kept to support wholesale prices, the program would work similarly to loan rates for corn and other supported cash crops. In this case, market prices would fall somewhat as purchase prices for dairy products (like loan rates on corn) were lowered somewhat, but farm market prices would not fall as much as they would if there were no purchase program. If the target price is the same in either case, then the only difference is the size of the deficiency payment and how much farm support leans on direct cash payments versus price supports.

Let's look at an example of deficiency payments that emphasizes the contrast with the present CCC purchase program. Assume that the purchase program

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<sup>1</sup> Their specific proposal combined deficiency payments with supply management. Eligibility for deficiency payments would be tied to production disciplines. This variation is discussed further later in the paper.

is in operation; the support price for milk is \$10.00 (3.5% butterfat); and CCC purchase prices are 79¢ per pound for butter, \$1.12 for cheese, and \$1.034 for nonfat dry milk—the levels at which these prices have been set in 1993-94. Further assume, for the sake of discussion, that the Minnesota-Wisconsin (M-W) manufacturing milk price or its replacement is \$10.20 per cwt.

If the CCC purchase program is replaced by a deficiency payments program, let us *assume* the following occurs:

1. The \$10.00 support price now becomes a \$10.00 target price.
2. In the absence of a CCC purchase program, wholesale prices for dairy products would likely decline.
3. As a result of the price declines in product markets, the M-W price for the month falls to \$9.30, an amount that is 90¢ per cwt. lower than the \$10.20 reported with a purchase program, and 70¢ below the \$10.00 target price.
4. With the competitive market price at \$9.30 and a designated target price of \$10.00, a deficiency payment of 70¢ per cwt. would be made.

Consider the types of differences in the present CCC purchase approach and the target price-deficiency payments approach on the income level of a dairy farmer shipping 100,000 pounds of grade A milk a month. Assume that the dairy farmer is receiving a price that is \$2.00 per cwt. above the M-W price. Also assume that market prices for manufactured products are not the same as CCC purchase prices. Butter is a very weak market. Cheese and nonfat dry milk are strong. The prices established in the previous section are used in the comparison in Table 1.

The price and income levels reflected in the comparison are there to illustrate differences in the programs. Cash receipts in this example are less under the deficiency payments program when compared to the price support program because the M-W price of \$10.20 is higher than the support price of \$10.00. If the M-W price had been less than the support price (\$9.90, for example), then cash receipts under the deficiency payments program would have exceeded those under the price support program.

Table 1. Example of Producer Receipts Under Support Price and Target Price-Deficiency Payments Program

	Support Price \$10.00	vs.	Target Price \$10.00
CCC purchase prices (#/lb.)			
Butter	\$0.65		---
Cheese	1.12		---
Nonfat dry milk	1.034		---
Wholesale product prices (\$/lb.)			
Butter	\$0.64		\$0.55
Cheese	1.30		1.27
Nonfat dry milk	1.06		1.02
Farm milk price (\$/cwt.; 3.5% BF)			
M-W	\$10.20		\$9.30
Grade A Blend	12.20		11.30
Monthly cash receipts to producer shipping 100,000 pounds	\$12,200		\$11,300
Deficiency payment (70¢/cut on 1,000 cwt.)	-0-		\$ 700
Gross cash receipts to producer	\$12,200		\$12,000

### ***Alternative Mechanisms for Implementing Deficiency Payments***

The target price for milk could be identical to the support price. Both could be established by any number of procedures, whether that be dairy parity, cost of production, or some other standard.

### **Production Controls**

Deficiency payments could be designed not just as a means of addressing farm income problems in the dairy sector, but also as a means of controlling milk production. In the feed grains program, for example, producers must participate in acreage reduction programs to qualify for deficiency payments. In dairy, deficiency payments could be made available only to those producers who voluntarily agree to reduce marketings a certain percentage from a base. In a mandatory program, payment could be refused to milk producers who fail to limit marketings to an amount below their base. Either assumes that the combination of market prices and deficiency payments continues to result in excess milk supplies. Some type of a deficiency payments-supply control program would probably allow higher target prices than deficiency payments without supply controls because program costs and effects could be controlled more tightly (see Leaflets P-7 and P-8 for discussions of supply management programs).

### Payment Limits

In a similar vein, deficiency payments could be limited or targeted to specific groups. Where deficiency payments have been used for other commodities, a \$50,000 payment limit per farm has been specified. With a payment limit, larger dairy operations with production levels that exceed the limit would receive a lower average benefit, i.e., in terms of \$/cwt. of milk sold. As a rule of thumb, deficiency payments of \$1/cwt. on all milk marketed would mean a farm of approximately 300 milk cows would be the smallest size to reach a \$50,000 limit. At the same time, milk production on smaller dairy farms who are below the payment ceiling might increase in response to the payments. The target price-deficiency payments approach can be designed more specifically to help smaller farms as compared to the present CCC purchase program. Of course, payment limits also invite larger operations to be creative in restructuring themselves so as to qualify more milk to receive payments.

Another possibility would be to extend deficiency payments only to milk used for manufacturing. Almost 35% of the U.S. milk supply is utilized in beverage milk products—in class I—so program cost savings would be proportional. class I prices in marketing orders could be established by adding class I differentials to the target price rather than the market-clearing M-W price (see Leaflet O-1 for a discussion of classified pricing under federal milk marketing orders). Thus, producers in federal order markets would receive deficiency payments only on class III milk and would get the class I price, including the built-in deficiency payment, from buyers of class I milk. This transfers part of the cost of farm income supports from taxpayers to fluid milk consumers. In this case, there could be periods when class I prices would be much higher than is currently the case relative to class III prices than now.

### ***Deficiency Payments with Price Support Purchases***

Another possibility would be to continue to operate a dairy price support purchase program in conjunction with the target price-deficiency payments approach. The reason for operating both programs would be to prevent market prices from getting so low that deficiency payments could be very high and therefore very costly. The purchase program would only be made operable at some defined price lower than the target price, just as loan rates for corn are below the target

price for corn. For example, if the target price was \$10.00 per cwt., a trigger support price to initiate CCC purchases could be established at \$9.50. With this procedure, the size of deficiency payments would be restrained. In effect, part of the weight of supporting farm incomes is transferred from taxpayers (lower deficiency payments) to consumers (higher prices).

In this example, the competitive M-W price presumably would not go below \$9.50 because CCC purchases would be intended to establish \$9.50 as a “floor.” If, as a result, the M-W did hold at \$9.50 instead of dropping to \$9.30, deficiency payments would only be 50 cents per cwt.—the difference between the market price of \$9.50 and the target price of \$10.00. Lower deficiency payments might mean lower overall dairy program costs, even though product purchase costs by the CCC obviously would be higher.

### ***Arguments in Favor of Deficiency Payments***

There are several reasons why the target price-deficiency payments approach would be seriously considered. Easily the most important reason is that the market-clearing prices that are basic to this program would be demand sensitive, and lower prices could provide a significant boost to milk and dairy product sales in the long run. The deficiency payments program would permit products to move through markets on a supply-demand basis, whereas CCC purchase prices hold wholesale prices up and thereby weaken the demand for products (see Leaflet P-1). A critical element to this argument is the relationship between changes in farm prices and changes in wholesale or retail prices. If retail prices resist declines in farm prices, then the benefit of deficiency payments in promoting sales is diminished. If added sales are expected to come from the wholesale level, say as an export or for food processing, then one might have a more optimistic expectation of positive price responsiveness. Generally, wholesale price responds more closely to farm price changes.

Also, the price advantage that some substitutes for dairy products now enjoy would be reduced substantially. One might wonder what would have happened to butter prices versus margarine prices if there had been a deficiency payments program and no purchase program in the 1950s. Closely linked to the demand stimulus that market-clearing prices might generate would be new incentives to promote, merchandise, and market dairy products. The easy option of selling to the

CCC would no longer exist. Proprietary firms and dairy cooperatives who now rely on the CCC would be challenged to more aggressively seek sales in competitive markets. Without an automatic government market, energies would be directed at expanding commercial sales.

The deficiency payments approach would also link dairy price policy more closely to overall U.S. agricultural policy. Critics say the dairy program in recent years has gone its own way. Deficiency payments have been a basic tool for cotton, wheat, and feed grains since the early 1970s. When feed grain prices were moved to a market price orientation and milk prices stayed with parity in the early 1970s, overall U.S. farm policy was not consistent. By adopting deficiency payments, the dairy sector would become more integrated with agricultural price-income policy.

A third factor to recognize is that the target price-deficiency payments approach shifts the costs of the dairy program to the taxpayer. The CCC dairy product purchase program might be described as one of "double taxation." First, consumers pay more for dairy products because of the higher prices the program generates; and second, taxpayers must pay the costs of dairy products acquisition and disposition in the support program. The pure target price-deficiency payments approach reflects a "single taxation" approach, as the only costs incurred by the taxpayer are in funding the deficiency payments. What is not clear, and probably cannot be answered without making very specific assumptions, is which approach involves the lowest total cost for comparable levels of farm support.

A final consideration might be that target prices can achieve the price-income goals of the dairy program more reliably than CCC purchases. For example, in the 1981 through mid-1984 period, the competitive M-W price was usually below the support price by 20 to 30 cents per cwt. Following the 1988 drought, the M-W price surged more than \$4.00 per cwt. above the support price for a short period of time. A deficiency payments program would be less subject to these kinds of income fluctuations because the difference between the target

price and the market price would be measured directly and payments to farmers would be made accordingly.

### *Consequences of Deficiency Payments*

In the same way that CCC purchases ran into trouble because of high program costs in much of the 1980s, the deficiency payments approach is vulnerable on a cost basis too. For example, if 70 cents per cwt. payments were issued for milk marketings of 150 billion pounds, the dairy program would cost more than \$1 billion. When annual milk production is large, market-clearing prices would be pushed to lower levels and deficiency payments would mount to higher and more costly levels. As was discussed earlier, program costs can be reduced by limiting payments or by transferring some of the cost back to consumers.

A very important short-run concern has to do with the disruption of the manufactured dairy products industry. The CCC purchase program is so institutionalized that processors of cheddar cheese, butter, and nonfat dry milk would face major adjustments if purchases were abruptly terminated. The nonfat dry milk market, the butter market, and even the cheddar cheese market, on occasion, have been dependent on the CCC as a residual buyer. Dairy cooperatives have taken on much of the responsibility for handling excess milk supplies in recent years, so they would be challenged to move products commercially and obtain prices for these products that do not disadvantage their members. If a deficiency payments program were adopted, it might be desirable to phase out CCC purchases or to establish some kind of market-wide service payment mechanism for all dairy farmers so that an equal cost sharing of the adjustment away from government purchases might be effected.

Reduced milk production and increased exports of dairy products in 1993 resulted in very limited purchases of cheese and nonfat dry milk by the dairy price support program. Butter continued to be a surplus product, but to a lesser degree. Given the reduced surplus situation, a year like 1993 would be a good transition year to a target price-deficiency payments program.