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Concerning the Final Report of the National Commission on Dairy Policy: Statement to the U.S. House Subcommittee on Livestock, Dairy, and Poultry

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PREFACE

Andrew Novakovic is an Associate Professor in the Department of Agricultural Economics at Cornell University. This paper is his statement at a hearing of the U.S. House Subcommittee on Livestock, Dairy, and Poultry, held on June 17 in Burlington, Vermont. The purpose of the hearing was to hear comments on the final report of the National Commission on Dairy Policy.

The National Commission on Dairy Policy was established under the Food Security Act of 1985. The charge of the 18 dairy farmers appointed to the Commission was to study the development of new technologies and their impacts on dairy farming and dairy support programs. In particular, the Commission was asked to consider 1) how effective the current price support program will be in preventing significant surpluses of dairy products, 2) how well this program will respond to challenges technological changes will bring to small and medium sized family farms, and 3) whether or not a better response to those challenges could be achieved through a different policy. The Commission used its mandate to review and comment on a very broad set of issues ranging from basic federal price programs to food safety and promotion programs. A copy of their final report can be obtained from the U.S. Government Printing Office, Washington D.C. 20402 (ask for stock number 001-000-04516-4). There is a charge of $7 per copy.

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The final report of the National Commission on Dairy Policy discusses nine major topics relevant to its charge. All parts of the report are important and should be read. I will focus my comments on the two major dairy policies, i.e. the price support program and federal milk marketing orders. I will touch briefly on a couple of other topics that I would like to highlight.

How Should the Report Be Viewed Generally?

The question of "do we like what the report says" aside, is this a good report? Did the Commission live up to its charge? Obviously we each will come to our own conclusions on such questions, but in my opinion they have made a very honest effort and offered a good report. The report leaves some gaps in how certain policy approaches would be specifically structured and implemented, and some of us would have liked to see some empirical examples and projections to support their recommendations. But, in fairness to the Commission it must be recognized that they covered a very broad waterfront in the time they had. Their recommendations are no more lacking in specificity and empirical justification than some of the legislation USDA has had to implement over the last several years. It is now up to others to look at the specifics and conduct empirical analyses. Perhaps the major theme of my comments is that the Commission's explicit and implicit statements about the appropriate goals for dairy policy are more important than their recommendations for dairy programs.

Dairy Price Support Proposals

Initial reactions to the Commission's report have been largely shaped by its recommendations relative to dairy price supports. The approaches they recommend contain elements that are very familiar to students of dairy policy in the 1980s. Hence much has already been said about criteria for setting support prices, supply management programs, and so on, and many of us have already made up our minds on the acceptability or desirability of approaches that the Commission endorses. Their price support program recommendations do not include any totally new approaches to grab our imaginations; hence they must be judged on how well the case is made that this combination of suggestions is indeed the best course of action. I surmise that how we react to these suggestions is determined mostly by what we think the dairy price support program should do--what goals or objectives it should be judged by.

The program suggested by the Commission emphasizes a national orientation. They argue that each farmer's price should be affected about equally by the price support program. The procedures they suggest for setting and changing support prices derive from concerns about predictability in future pricing, and they try to balance a sense of fairness to individual farmers against the need to realistically assess marketwide supply/demand balances. Concerns for short-term stability are addressed by limiting annual price changes. Non-price solutions are suggested when constrained price changes are not expected to work fast enough or have a large enough short-term effect (particularly when markets are in surplus). In many ways the combination they suggest could be viewed as technical refinements to the basic approach laid out in current legislation.

Price Support Goals

More important than the mechanisms proposed by the Commission are the goals, objectives, and philosophy they discuss and espouse. Noteworthy is their treatment of the family farm issue, benefit targeting, and economic vs. social objectives.

Many readers have been surprised that the Commission decided it could not define a family farm. Far more significant than their refusal to adopt a definition according to size, income, or the use of family resources is their conclusion that defining a family farm serves no purpose, at least in the context of national dairy policy. They assert that almost all milk is produced by farm families; hence any good support policy will benefit family farms. They reject the argument that price support policy should be restructured so as to have benefits aimed more directly at family farms.

Similarly they argue against the concept of targeting benefits to groups of farmers defined by any other criteria, including regional location or milk utilization. This in part reflects a philosophy of "we're all in this together." It also results from their coming to the conclusion that the underlying economics of milk production cannot be changed by dairy policy.

The Commission also reaches a strong conclusion on a large issue when it states that federal price supports should be operated according to basic economic criteria aimed at nationally balanced markets. They argue that concerns for farmers unable to survive the rigors of incremental but steady price reductions are largely of a social nature and should be addressed by broader social programs.

That 18 dairy farmer leaders from across the country would come to these basic conclusions about the objectives for dairy price supports is nothing less than stunning. It would surely not have occurred 5 or 10 years ago, before the industry went through the trauma of the 1980s.

Price Support Mechanisms - The Purchase Program

The practice of supporting prices by having USDA offer higher prices for storable dairy products than would otherwise prevail in the market place, i.e. the purchase program, is an efficient way to support farm prices; however it may deserve further review.

I am convinced that part of the difficulty farmers have had in understanding and coping with policy issues during the 1980s stems from the fact that the purchase program is a mechanism that has been totally transparent to them. Farmers are not aware of the benefits they receive from price supports because these benefits come indirectly through dairy processors and wholesale markets for dairy products. This has led to an overemphasis on who sells to the CCC and comments like "I don't sell my milk to the government" (no one does) and "how can there be a surplus if so many buyers want my milk." A seemingly obvious solution to this problem would be to switch to direct payments, as is done in the feed grains program. It can hardly be said that the feed grains program is without problems; however these problems are not due to grain farmers bickering about whose fault the surplus is or not recognizing that they receive benefits.

Another problematic characteristic of the purchase program is that this approach has no mechanism for discouraging plants from selling to the CCC. To do so would be counter to the objectives of supporting farm milk prices; yet in a large surplus market it seems strange that processors who sell to the CCC have no particular incentive to cultivate commercial sales. The net returns to serving commercial markets are not necessarily better, and processors who sell on commercial markets are not necessarily able to offer their farmers any more market security or higher prices.

With respect to the price support program there are three kinds of processing plants. Those who produce products that cannot be sold to the CCC, those who sell to the CCC primarily on a seasonal basis, and those who sell to the CCC on a more or less year around basis. Farm pricing programs that have enough bite to encourage dairy farmers to coordinate milk production with seasonal changes in dairy product sales are not given enough attention as a solution to the very real and costly problem of seasonal balancing and the dilemma faced by processors who fall primarily in the second group. Processors who fall in the third group present another dilemma. In some sense, having plants heavily oriented to CCC sales on a year around basis may be a very efficient way to implement a price support program, but their very existence implies that we are resigned to a program of endemic surpluses.

The Commission, as many others do, argues that the purchase mechanism should be retained. Perhaps it should, but the problems it brings with it probably ought to be given more consideration.

Price Support Mechanisms - Price Setting

The Commission calls for the use of a formula to establish a "first cut" at a support price. This formula price would then be subject to some discretionary adjustments within a plus or minus 50¢/cwt range. Given the impossibility of coming up with a perfect formula, some sort of supply/demand, productivity, and/or discretionary adjustments are inevitable. Perhaps it would be just as reasonable to simply decree that next year's price shall equal this year's price plus or minus no more than 50¢. Adjustments could still be made relative to a supply/demand adjuster or trigger mechanism, along the lines of current policy. Another approach might be to require that price adjustments be made subsequent to a collection of evidence at a hearing. This would allow for other factors to be considered and perhaps alleviate some concerns about giving the Secretary too much flexibility. Some might argue that a hearing process would be too cumbersome, but this needn't be the case. Allowing the dairy industry input into the price-setting decision could be a very positive step by projecting a sense of involvement and by explicitly recognizing that, with or without formula guidelines, prices are ultimately determined by judgment not arithmetic.

The Commission makes one short recommendation that could easily go unnoticed, i.e. to return to the practice of making annual adjustments to the support price on October 1. This may seem like a small issue but it has considerable merit and is particularly appropriate when prices are declining.

Price Support Mechanisms - Standby Supply Management

The Commission recommends that supply controls be used to augment price cuts when CCC purchases are estimated to exceed certain levels. The decision rules would be much like those currently used to determine price cuts under current legislation; however they would have supply controls automatically come into play at a fairly moderate level of CCC purchases, i.e. before purchase levels became disastrously large. They suggest either of two mechanisms--a voluntary buyout program (like the recent Dairy Termination Program) or a mandatory "two-tier" price program (which is simply a euphemism for a quota program in my opinion).

In general I think the buyout approach has some merit, more for social considerations than economic reasons. The two-tier/quota approach is less appealing, primarily for economic reasons. In either case, I think many reviewers are not sure just how temporary such "standby" programs would really be after they are first used. This concern is especially acute in the case of the two-tier/quota program, but could be an issue for an ongoing buyout program as well. An important factor mitigating such concerns is that the Commission would keep pressure on prices for as long as CCC purchases were projected to exceed acceptable levels. This is necessary if one is to prevent supply controls from becoming a permanent fixture. I am simply uncertain as to whether or not it is also sufficient to insure that temporary measures do not become permanent.

I would also suggest that the level of price under a two-tier/quota plan needs to be clarified. Typically this approach implies an attractive price for quota milk, and large penalties or a low price for milk in excess of the quota. Yet the Commission presents the two-tier/quota option in conjunction with declining support prices. In the case of a large surplus, does this mean that producers would face a lower support price and mandatory production cuts (mandatory in the sense that everyone would automatically face very low net prices on "excess" milk)? If so, this would be a very severe program.

The Make-Allowance Issue

The intent of the Commission regarding the make-allowance used to calculate Class 4 prices in California is clear. However, there may be some confusion about how to best describe and eliminate the discrepancies between prices of milk used in manufacturing in California and other states. For example, on page 101 of their final report, the Commission speaks of equalizing the California make-allowance and the CCC make-allowance. On page 79, they speak of equalizing the California Class 4 price and the M-W price. This may look like the same thing but it is not. The pricing parity that the Commission argues for would exist if the California Class 4 price equaled Federal Milk Marketing Order Class III prices. Achieving this result would likely involve changing the California make-allowance, but the CCC make-allowance would not feature in the calculation and should not be the focus of the technical adjustment.

Federal Milk Marketing Orders

The Commission makes three suggestions upon which I would like to comment. First is their recommendation that the federal order hearing process be quickened. The Commission is appropriately retrospect in recognizing that order decisions should not be made hastily. While USDA probably does not need two years between an initial petition and a final decision, good decisions and an appropriate hearing and review process will not occur in a matter of a few weeks either. Undoubtedly some reduction in the hearing and decision process could be made, but in no case should we think that it could or should be a rapid process. It may also bear mentioning that an "emergency" procedure does exist for certain issues where a faster than normal, temporary response is indicated.

Two statements are made in the report that relate to this issue and also to the issue of how decisions should be made. On page 70 of the final report, it is stated: "Market administrators should ratify marketing order programs when requested by a majority of producers in the order." Page 71 adds: "administrative procedure [should be modified] to allow votes on individual amendments." These seemingly reasonable suggestions would prevent USDA from playing its role as an arbiter of farmer, processor, and consumer interests. Processors and consumers are clearly affected and interested parties; however they cannot vote on federal order changes. Some sort of checks and balances are needed. Adopting these recommendations would eliminate USDA's ability to administer the federal order program in the public interest and make them solely a tool for majority producer interests.

Page 70 also includes the statement: "Milk marketing orders should assure that Class I differentials meet Class I milk requirements without creating incentives for additional production for manufacturing purposes." This reminds one of a basic premise of the recent GAO report on federal orders, i.e. that class I differentials contributed to producer incentives to increase production between 1979 and 1986. It is beyond my capacity to understand how this could be, given that these differentials were constant during the 1970s and 1980s, until Congress raised them in 1986.

Certainly Class I differentials could be reduced as an alternative to reducing the support price, but that is a different issue. Moreover, eliminating Class I differentials wouldn't do much more than substitute for only one of the 50¢ cuts in the support price. And that requires one to believe that prices for milk used by fluid processors would actually follow the cuts in the federal order minimum price.

Probably the Commission had something in mind other than the basic GAO premise about causes of increases in total production. For example, since the 1960s or so some have argued that the large amount of milk used in manufacturing and priced under federal orders is inconsistent with the original intent of the federal order program. It is undeniable that several large marketing orders have more milk pooled as class III than class I; in some cases, considerably more. In fact, since 1980 less than half of farm milk priced under all federal orders has been used for fluid milk purposes.

Should class I differentials be reduced in Wisconsin, New York, and Minnesota to drive milk produced for manufacturing purposes down? Or, should federal and state impediments to the reconstitution of milk be removed so as to permit more milk from the North to compete with Southern milk for class I markets in the South? Just what is the appropriate posture of federal orders towards milk used in manufacturing? Should strict performance and qualification requirements be used to make it hard for manufacturers to qualify for pool status and the equalization payments that status gives them? Or, is it more important to promote producer pricing equity and maintain or expand the scope of federal orders?

The simple comment on class I prices in this report raises a host of very fundamental questions about the purposes of federal orders, the evolution of their use, and the role of an ever-expanding manufacturing sector in the federal order program. These types of questions have been kicking around for want of attention for quite some time. They deserve careful thought and analysis. Given the focus of this hearing, I will not belabor these issues now, but they deserve much more thoughtful attention than either the Commission or the GAO gives them.

Is the Technology Issue Adequately Addressed?

Clearly, one of the motivations for establishing the Commission was to begin thinking about whether or not federal programs are capable of dealing with the potentially dramatic increases in productivity that could result from new technologies that appear near on the horizon. The Food Security Act instructs the Commission to consider 1) how effective the current price support program will be in preventing significant surpluses of dairy products, 2) how well this program will respond to challenges technological changes will bring to small and medium sized family farms, and 3) whether or not a better response to those challenges could be achieved through a different policy. The Commission used its mandate to review and comment on a very broad set of issues ranging from basic federal price programs to food safety and promotion programs. The basic questions posed in the Food Security Act do not seem to be directly or adequately addressed in the Commission's report.

The report reviews new technologies and recommends 1) no unnecessary delays in federal approvals for safe technologies, 2) educational programs for users of production technologies and consumers of agricultural products produced with new techniques (biological or chemical), and 3) a greater emphasis on marketing research (as opposed to production research). These recommendations are fine as far as they go. But it seems to me that the question of whether federal policy is up to the task of dealing with the changes that new technologies may present is left hanging.

Dairy Product Trade

There has been considerable discussion within dairy industry circles about the opportunities for expanding export markets for U.S. dairy products. The Commission report conveys some of that, viz.:

> "Efforts to boost exports for market development should concentrate on low-income nations where markets do not now exist. Research should continue to develop products for foreign diets and lower-income nations."
>
> "There should be public and private funding of studies to ascertain which countries represent a potential market for U.S. dairy products and which countries are potentially self-sufficient...."
>
> "USDA should encourage the development of international markets ... by assisting industry-initiated activities through use of the Dairy Export Incentive Program, or by greater use of the Export Enhancement Program."

These are reasonably cautious statements. I would only add that I am doubtful that export markets can be profitably expanded to any significant degree. Any opportunities warrant careful study, and government encouragement in the short run may be justified. Nonetheless, I would opine that there is a tendency to underestimate the ability of third world countries to satisfy their own needs and overestimate our ability to develop profitable markets in low-income countries.