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DAIRY POLICY ISSUES AND OPTIONS
FOR THE 1990 FARM BILL

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Preface

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This paper was presented at the Southern Dairy Conference, held in Atlanta, Georgia, on February 13-14, 1990. In part, it draws on a series of leaflets entitled Dairy Policy Issues and Options for the 1990 Farm Bill. The nineteen leaflets in this series cover topics relating to options for new approaches to dairy policy, modifications to existing programs, and background issues. The leaflets were written by a national group of dairy economists, under the auspices of the National Institute for Livestock and dairy Policy. The paper here represents the views of the author. For further information on the leaflet series, please contact Andrew Novakovic at the address listed below.

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Introduction

The remarks presented below begin with a discussion of what has been occurring in national dairy markets and the factors that are likely to be important as we enter the new decade. Dairy policy options and issues will be reviewed in light of these expectations and the objectives of dairy policy.

Where Are We and Where Are We Going?

The status of dairy markets and dairy farmers influences the decisions of policymakers and policy advocates. If we think production is too high, or that surpluses are a problem, programs will be targeted to change that. In the mid and late 1970s, we were concerned about adequate prices and farm incomes and not terribly concerned about production growth or surpluses. In that environment, policies were adopted which increased support prices rather significantly (80% of parity) and frequently (semiannual adjustments). What will policymakers and others think that the dairy situation is when the time comes to make decisions on the 1990 farm bill? If they are thinking about 1989, we may get a different answer than if they are thinking about 1990 and beyond.

The U.S. Dairy Situation in 1989

Several factors about national dairy markets were distinctive and notable last year:

1. Milk production declines as the year progresses.
2. Farm prices move to record highs.
3. Nonfat dry milk is exported commercially, then wholesale prices move to unthinkable levels due to intense domestic demand.
4. Cheese prices at wholesale hit records levels, largely to keep competitive with nonfat dry milk.
5. Net removals of butter reached record levels, but this is almost the only product sold to the USDA under the price support program.
6. People begin saying we have a milkfat surplus, not a milk surplus.
7. Commercial disappearance of all dairy products is down; or is it?

Some of these interpretations of 1989 are indisputable; others require a few caveats. Year-end estimates definitely show production and commercial disappearance down, and net removals unchanged, compared to 1988. Two factors significantly alter how we interpret these apparent facts.

First, 1988 was a leap year. Because milk and dairy products are "harvested" and consumed daily, the one extra day makes 1988 numbers a little higher. If we compare 1989 to 1988 on a daily average basis, production is actually up 0.2% and commercial disappearance is basically unchanged. This does not change the fact that 1989 started with strong monthly production growth but ended with lower monthly production.

The second factor further affects how we interpret commercial disappearance, and also net removals. This is the fact that dairy product accounting is done by USDA with milkfat based milk equivalents. In other words, when we want to know how much milk is represented by the amount of cheese, butter, and nonfat dry milk sold to USDA under the price support program, USDA has traditionally given us a milk equivalent number that actually is the amount of average test milk required to provide the milkfat contained in the butter and cheese purchased by USDA. When, as in 1989, USDA sales are lopsided in favor of butter, the traditional measure conveys a distorted sense of how much "milk" USDA is buying.

Commercial disappearance is the flip side of this coin. If we overestimate USDA net removals because of our accounting system, then, for the same reason, we underestimate commercial disappearance. In today's market, milkfat based accounting biases the milk equivalent measure of net removals upward and the milk equivalent measure of commercial disappearance downward. On a product basis, lower fat products and cheeses are selling very well; traditional, whole milk formulations are not. On a dollar basis, sales are certainly up.

In fairness to USDA, it should be recognized that 1989 was a very unusual year in this regard. The traditional milkfat based milk equivalent was never perfect, but it usually gave us a reasonable enough picture of what was going on in the aggregate. Expectations today are that declining sales of "whole milk" products in favor of lower fat products will only make current distortions even worse.

Market Factors in 1990

Some aspects of dairy markets in 1990 will look similar to last year; however many key aspects will be quite different. Compared to last year, market factors in 1990 will likely be as follows:

1. Milk production improves as the year progresses.
2. Farm prices fall.
3. Nonfat dry milk prices plummet to (or nearly to) USDA purchase price levels early in the year.
4. Cheese prices fall substantially from their 1989 record high, but remain stronger than prices for other dairy commodities.
5. Net removals continue to be dominated by butter (another record year). After 1-1/2 years, price support sales of nonfat dry milk resume. Net removals of nonfat dry milk and cheese are modest by historical standards.
6. We have a milkfat surplus, but do we also have the beginnings of another milk surplus?
7. Commercial sales of dairy products continue to be strong, although it's hard to tell from traditional USDA measures of commercial disappearance.

The reversals in production and price trends speak for themselves and are the cause of considerable concern. Will production growth usher in another bout of milk surpluses and high sales to the USDA? Will farm prices fall so low as to put farmers under severe financial pressure? Anything is possible, but most analysts are not subscribing to the disaster scenario. By the same token, the possibility of serious problems later in the year or in 1991 is not

taken lightly. Price and sales strength in dairy product markets are no easier to analyze, but this story should be more positive. Regardless of what the milk equivalent data imply, dairy product sales should continue to be good. With a little more milk available, dairy product sales should show greater gains than last year. Dairy commodity prices will not be as high as last year, but the changes should be healthy. Dairy products prices in 1990 will reflect more the strength of demand; in 1989 we saw more the weakness of supply.

So Where Are We?

History demonstrates that Congress has a tendency to pass legislation that is more influenced by past events than future needs. The aggressive price support legislation of the late 1970s was inspired by the financial difficulties of dairy farmers that began in 1973. The surplus cutting measures contained in 1983 and 1985 legislation were passed because of surpluses that became serious in 1981. Already we are seeing proposals for the 1990 farm bill that clearly have been inspired by the events of 1989. Some of these changes may well be needed, but if they are it is because some of the events of 1989 will become the trends of the 1990s. When policymakers sit down to put together a 1990 farm bill, the first challenge they will face is to keep focused on what needs to be done for the next five years, not some past period. What can we say about requirements based on likely market conditions?

First, the milkfat issue is real. Continuing changes in consumer preferences toward lower fat dairy foods and even away from dairy foods must be expected. This is not to say that the dairy industry cannot make adjustments to minimize the effects on them of these changing demands. The more pressing question will be how and to what extent does the dairy industry adapt.

A second major market factor for the 1990s has to be the possibility of developing true milk surpluses, not just a milkfat surplus. Although the word surplus has not been applicable to dairy markets since the summer of 1988, it would be a mistake to think that surpluses have been repealed or solved once and for all. It would be prudent to factor the possibility of that event into the design for a new dairy policy. There is a great underlying potential to increase milk production in the U.S. From the standpoint of long term food needs, this is exceedingly good news. For the time being it could present difficulties.

The fourth and last major factor mentioned here relates to issues that are not dairy issues; rather they are larger issues that could have very important implications for dairy farming, dairy markets, and dairy policy. Rural development, conservation of soil and water resources, environmentally friendly management practices, the globalization of dairy and other food markets, and other similarly large issues have impacted how we talk about dairy policy, and they have had already had some impact on agricultural policy choices. These factors and issues will become increasingly important. It would be prudent for the dairy industry and those who are concerned for it to begin thinking more seriously how the industry and policy needs to grow to deal with such issues.

Directions for Dairy Policy in the 1990 Farm Bill

Numerous proposals were discussed prior to passage of the last farm bill in 1985. Many of the proposals for 1990 are the same as or similar to ones proposed before; some are new. There are as many objectives behind these proposals as there are proposals. Three key objectives might be to:

1. stay with the program represented by the 1985 farm bill, but make some "fine-tuning" adjustments.
2. avoid further price cuts.
3. more selectively target the benefits (or penalties) of dairy policy, either on a regional or individual basis.

Objectives such as these will inspire proposals for all of the major components of dairy policy. The discussion below is divided into four parts: butterfat issues, the dairy price support program, federal milk marketing orders, and international trade.

Milkfat Issues

Policy choices that are inspired by growing surpluses of butter and other related issues include:

1. changing the price of butter relative to the price of nonfat dry milk,
2. measuring net removals differently, most likely using a whole milk equivalent that is some kind of weighted average of a milkfat equivalent and a nonfat solids equivalent,
3. changing the price trigger from milk equivalent net removals to:
 - a. product or component based triggers
 - b. a dollar based cost trigger
4. encouraging the more widespread or systematic use of multiple component pricing, particularly in federal milk marketing orders,
5. a supply control program just on milkfat.

Policy choices have already been made to reduce the price of butter relative to nonfat dry milk. Practical questions exist as to how far this process can go. For any given milk value, placing a lower value on the milkfat component means a higher value must be placed on the nonfat component. Nonfat dry milk prices have fallen to, or nearly to, USDA support levels. Further reductions in butter prices may need to be accompanied by corresponding cuts in milk prices, a prospect that is obviously not popular among dairy farmers.

On January 1, 1990, the support price was cut because USDA estimated that milk equivalent net removals will exceed the trigger of 5 billion pounds. This may have been the right reason but the wrong answer. In other words, USDA is most likely correct in its estimate of net removals; however milkfat based milk equivalents will likely continue to give us a distorted view of aggregate sales of dairy products to USDA. Critics have been arguing that we need to change how we measure net removals or otherwise change the price trigger mechanism to better reflect surplus levels.

Multiple component pricing seems like an idea whose time has finally come. Although there is substantial support for doing something to get

producers to think about enhancing the nonfat solids component of their milk supply, component pricing still presents some stormy questions. Key among these are how fluid milk processors are treated, what components are priced and at what level, and do processors pay into a marketwide price pool the same way that farmers are paid out of the pool. Chances are component pricing will not be addressed in legislation, but it may well be approached administratively through the federal order system.

Programs to manage the supply of milkfat may be the new idea for the 1990s. For some it is a way to begin down the path of supply control programs for milk. For others it is an expedient and direct way to deal with surplus milkfat. The major option will likely be an adaptation of the two-tier pricing concept, used on a standby basis when a component surplus surpassed a high trigger level. In this case, producers would establish production records on milkfat and would receive differential prices based on how their current milkfat production compared to their milkfat quota.

Dairy Price Support Program

Most of the options discussed above apply to the dairy price support program (DPSP). Other options range from further fine-tuning to more fundamental changes.

Fine tuning options include:

1. how the net removals trigger is measured, e.g. milk equivalents, product or component triggers (as the Milk Industry Foundation has proposed), etc.
2. what the trigger levels are, e.g. 2.5 to 5.0 billion pounds vs. 2% to 4% of commercial use (as the National Milk Producers Federation has proposed)
3. what the triggered price changes are, e.g. 50¢ (as under current law), 5% of the support price (as NMPF proposed last year), or a discretionary range (as proposed by the Secretary of Agriculture)

More fundamental changes involve supply oriented programs of one type or another, e.g.:

1. a two-tier pricing plan on just milkfat
2. inventory management on milk, i.e. pricing the surplus to facilitate its disposal, probably on world markets
3. supply management on milk, i.e. pricing milk in such a way as to avoid creating a surplus

Discussion about dairy for the 1990 farm bill is paralleling the debates in 1985 and 1983. Adjusting support prices according to anticipated net removals is the cornerstone of the Administration's dairy policy proposal. This basic approach has also gained grudging acceptance among mainline dairy organizations, although all producers groups would like to see something in addition that would mitigate future cuts. Thus, there appears to be broad, albeit not enthusiastic, support for maintaining the triggered price change procedures that are the basic framework of the dairy title of the FSA.

The National Commission on Dairy Policy and, several prominent producer organizations have supported various forms of supply controls to eliminate

price cuts or allow prices to rise. The more modest proposals would require the use of supply controls when modest price cuts prove inadequate and estimated surplus production exceeds a certain trigger level. More radical proposals call for cost based milk prices in exchange for strict production quotas. While there is rather broad support among producers for some kind of supply management approach, there is widespread disagreement among producers and their organizations about the form it should take.

Alternatives to the price support program range from fine-tuning efforts to radical departures from the current program. Almost all of the options have been discussed many times since the inception of the current dairy price support program in 1949. Of the many options, almost all could be designed to improve the surplus problem or achieve some other objective. Some are less well-suited to specific tasks than others, but few can be dismissed out of hand as unworkable.

None of the basic approaches for supporting dairy farmers and markets is uniformly superior to another for an equivalent price or income effect. No plan offers an easy solution. Simple price reductions are the easiest administratively, but reasonable cuts take a while to have effect and do not accommodate farm income or other objectives. Production quota programs, new ways to administer support programs, and other such attempts to substantially change the dairy price support program may simply require a greater change than policymakers are willing to make, and even among farmers support for such major change is very uneven.

Federal Milk Marketing Orders

Leading options for changes to Federal Milk Marketing Orders (FMMO) include:

1. changing class I differentials,
 - a. by rolling them back to the levels they were before they were changed in 1986,
 - b. by using a multiple basing point concept to more drastically reshape and realign milk prices from one part of the country to another,
2. changing certain FMMO provisions so as to reduce disincentives on reconstituted milk,
3. revising the M-W or replacing it altogether as the basic formula price used in setting prices under FMMOs,
4. mandating administrative hearings to consider all or some of the above,
5. requiring USDA or some other agency to further study proposed changes,
6. not doing anything at all.

In an effort to accommodate the many needs and numerous contending proposals, a dairy title to the Food Security Act of 1985 (FSA) was passed which contained a whole herd buyout program, some assessments, triggered annual price changes starting one year after the bill was signed, and regional increases in class I differentials, as well as a number of lesser provisions.

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 southern markets with Midwestern milk. This has inspired proposals to 1) reduce federal order prices in markets distant from the Midwest, 2) increase class I prices in the Midwest, and 3) require the USDA to alter federal order provisions which discriminate against the use of concentrated milk components (shipped from the Midwest) as an alternative to (local) farm 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 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 much to shape regional price differences.

The 1990 farm bill may change the regional pattern of federal order prices. However, changes in minimum order prices can be offset by increases in over-order premiums. Thus, the net effect on farmers is not necessarily as large as a specific proposal may imply on the surface. Costs and benefits that might result from proposed changes have probably been overstated.

The Federal Milk Marketing Order Program is necessarily complex. The marketing of milk is not unusually complicated, but the FMMO program must contain provisions to cover the various situations and needs that arise in a complex environment. There is much more to FMMO than just Class I differentials. An overly simplistic understanding of FMMO provisions can lead to overly simplistic analyses and prescriptions for changes. Congress is not the right institution to deal with technical Federal Order issues, that is USDA's job. Certain reforms and modifications deserve serious study and consideration. Things more complex than simple class I differentials need to be studied. I am not convinced that the work done to date provides a sufficient basis for making some of the large changes that have been proposed.

Regardless of what I might think, changing federal orders has more industry opponents than proponents. It does not seem likely that a new farm bill will contain substantive revisions to federal order policy. If it does not, it should be recognized that criticisms of federal orders will continue.

International Trade and Dairy Import Quotas

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 in 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.

In any event, GATT negotiations will not be completed before the 1990 farm bill is passed. In fact, it is doubtful we will even have a good idea what the final GATT agreement is going to be before the end of the year. Hence, international trade and dairy import quotas are not likely to be seriously considered for changes in the 1990 farm bill.

Other Policy Issues That May Affect Dairy Markets

Dairy markets are most certainly affected by a myriad of things other than dairy policy. Non-dairy policy issues may lead to policy changes or regulations that have implications for dairy policy. Five major items are mentioned here:

1. the growing divergence between the haves and the have-nots in dairy farming
2. feed grain programs and the price of dairy feeds
3. conservation and environmental programs, which involve both compliance and "recoupling" issues
4. rural development and the role of agriculture
5. the globalization of food markets, including increased opportunities for international trade and for foreign ownership, in both directions.

Haves and Have-Nots

In the past, 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. These fundamental differences in profitability also have implications for how we draft federal dairy policy.

A recently released USDA study of costs of producing milk in 1987 estimates the pattern of returns illustrated in Table 1. Net cash returns per herd in the Northeast and the Wisconsin/Minnesota/Michigan/South Dakota area 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. This is not to 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.¹

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 when faced with lasting price shifts.

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

Nevertheless it illustrates the point. Suppose that somehow 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.

¹ A caveat about the USDA's Pacific region is in order. USDA puts California, Washington, and Idaho together in this region. The average herd size and production per cow reported for this grouping suggests that the USDA region is not typical or representative of any one of these states separately. The regional average herd size is much too small for California and too large for Washington or Idaho. Production per cow is too low for California and Washington and probably too high for Idaho. Consequently, the net return per herd estimate does not reflect well the range in herd sizes and other characteristics across states in the Pacific region. California net returns per herd would likely be much larger on average, at least using the USDA data. Net returns in Washington and Idaho would likely be lower.

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 applies no matter what region of the country the farm happens to be in. It must also be recognized that such fundamental differences cannot be mitigated by changes in a broad-based, national price policy.

If federal policy moves in any of these directions, the traditional milk producing areas in the Northeast and Upper Midwest will be in an increasingly challenging situation. It is overly simple to point to just one factor, but the biggest factor that will determine the future of the dairy industry in these areas will probably be the total income opportunities for farmers there compared to the parts of the country that have been expanding more rapidly.

Indeed, it is crucial to emphasize that this situation is not, per se, a regional one. Each region has its share of farm families who are doing quite well and those who are not doing well at all. What data exist on individual farms suggests that the differences between the haves and the have-nots is growing. Dairy policy has tried to steer a middle of the road course. This has always been hard to do. It will get harder and harder to do.

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

| Region | <u>Net Cash Returns, 1987</u> | | <u>Net Cash Returns, with \$1 Cut</u> |
|-----------------|-------------------------------|---------|---------------------------------------|
| | \$/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 |

Feed Grain Programs

Farmers are well aware that their largest single input cost is feed, whether it is primarily purchased or produced at home. Federal programs for feed grains obviously have effects on feed costs for dairy farmers. Indications are that feed grain programs will not be significantly changed and this will keep feed grain prices where they are or slightly lower. Analyses of

where milk price supports should be pegged or of the implications for production of a particular support price must factor in relatively inexpensive feed costs.

Conservation, Rural Development, and Globalization

Rural development provides an example of why dairy, and agriculture in general, needs to get involved in some larger dialogues. Obviously farmers (and many processors) are interested in rural development because they and their families live in rural communities. Rural development specialists are well aware of this; however, specialists in rural development issues and farmers have different points of view on the role of agriculture in rural economies. To be sure, there are parts of the country where the rural economy wouldn't exist without agriculture; however it is also true that rural economies rely less and less on agriculture. Agriculturalists frequently argue that the way to revitalize rural areas is to revitalize agriculture. Rural development specialists are typically skeptical of that approach. They contend that rural economies need to look outside of agriculture for growth and that, even if it becomes more prosperous, agriculture has a limited impact on rural economies. This is important for agriculture to understand because rural development policy will be influenced more by rural development specialists than by agricultural specialists. If agriculture, or dairy in particular, wants to have a voice in rural development policy, it is up to them to initiate a dialogue with the rural development community.

A very similar stories could be told with respect to environmental or conservation policy. Environmental issues involve two approaches or issues. First, how can we get people to stop doing bad things to the environment (compliance); second, how can we get people to do good things for the environment (recoupling). Environmentalists typically stress the imposition of penalties on those responsible for pollution or other undesirable practices. Farmers typically have asked for programs to help defray the costs of equipment and practices that need to be adopted for conservation purposes.

The globalization of food markets presents direct challenges to dairy food markets, with implications for farm markets. The earlier discussion pointed to the interest that exists in liberalizing trade, and even making changes in domestic policies to encourage free trade. Free trade advocates speak of free trade; the dairy industry tends to speak of fair trade. Free trade advocates speak of changing domestic policies to enable farmers in different countries to compete with each other on the basis of underlying economic strengths. Dairy farmers tend to speak of letting each country chart its own domestic course and leaving dairy trade at a minimum.

If the dairy industry doesn't get involved in these broader policy discussions, they shouldn't be surprised if changes are made that they don't like. Some policies may inevitably be changed in ways that force adjustments on the dairy industry, but better policies will surely be chosen if dairy and the rest of agriculture work with others to design them.

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