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TOWARD THE NEXT GENERATION OF DAIRY POLICY

by

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Preface

Andrew Novakovic and Robert Boynton are Assistant and Associate Professors, respectively, in the Department of Agricultural Economics at Cornell University. This paper was prepared as a statement to the Joint Economic Committee of the U.S. Congress for hearings they held on the topic: "Toward the Next Generation of Farm Policy".

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Introduction

This statement focuses on a general assessment of current dairy policy and a discussion of the needs associated with the next generation of dairy policy. The statement does not focus on the specific concerns or needs of the Northeast or New York, but it does include some regional perspectives.

Dairy policy and policy making (and, to a considerable extent, agricultural policy in general) has been preoccupied with the current problem of excess supply. Although the immediate problem is serious and demands attention, the solutions that have been proposed and the focal points of the policy debates have generally not been well oriented to long-run goals. Therefore, we feel it is highly appropriate that the Joint Economic Committee and others begin formalizing some strategies for the next generation of farm policies.

Current dairy and other agricultural policies have the same fundamental design as those that were originally inspired by the Great Depression. Obviously the economic climate and economic conditions have changed dramatically since then. It may well be appropriate to carefully think through the merits of these policies and programs and to try to ascertain whether or not they can be justified given current and expected future conditions. Nevertheless, we do not attempt to deal with that issue in this paper. Rather our statements are predicated on the general assumption that, although changes in some aspects of specific policies are needed, it would not be advisable to make sweeping changes in policies or to eliminate one or more of the various dairy programs. In the following discussion we attempt to identify and comment on the major policy issues as we see them.

Policy Issues

Farm Price Supports

Current dairy price support legislation dates back to the 1949 Agricultural Act; however, the concept of using public policy instruments to raise farm prices and incomes has roots in the 1920s and 1930s. The initial aim of New Deal dairy programs was to raise farm prices and incomes to "equitable" levels as soon as possible. Whether or not a shift in emphasis has been formally codified, it is generally agreed that the justification for current federal dairy pricing policies rests primarily on the perceived need for and presumed benefits from promoting stability in prices and marketing conditions. A federal program that provides an outlet for manufactured milk products at prices and under conditions that promote orderly and stable markets may well have long-run merits for the dairy industry and the general public. For such a program to maintain long-run public benefits, it must be administered in a fashion consistent with long-run supply and demand and not be used to overtly enhance farm incomes.

This kind of program objective is feasible; however it is very difficult to achieve in the kind of highly politicized legislative environment that has existed for the last several years. Recent efforts to solve the dairy oversupply problem indicate that many people feel that the dairy price support program as it is now constructed has failed and that a new approach is needed. In our opinion, current problems were not caused by an inherent flaw in the design of the program; rather the program was misused and subjected to political maneuverings to which it should have been protected (see exhibit 1, pp.3-8). Of the many alternatives available, the current program may be the best type, given the type of long-run goals we stated earlier (see exhibits 2 and 3).

Dairy Import Quotas

Quotas are a practical necessity when a country supports domestic prices above world trade prices. As long as the U.S. keeps a price support program like the one it has, it would be well advised to keep quotas on dairy product imports. Current quota levels are probably reasonable. Bringing casein and lactose imports under quotas might be consistent with the overall U.S. dairy quota program but may be inconsistent with the principle of comparative advantage. At any rate, the impact of these and other imports on the cost of the price support program and the magnitude of excess supplies is generally over-emphasized.

Marketing Policy and Market Competition

Federal milk marketing orders, initiated in the 1930s, were originally intended to increase farm prices and to redress the oligopsonistic behavior of dairy processors. The former goal has been and should continue to be de-emphasized. The relevance of the latter goal may need to be re-examined, but we suspect that it remains a reasonable justification for marketing orders (see exhibit 4).

Although the basic legislation may not need much adjustment, the specific provisions of federal orders merit thoughtful review. For the most part this should be possible through normal administrative channels.

One issue that has received considerable public attention is the pricing of reconstituted milk. The importance of this topic is far less than the attention it has received would imply. Moreover, a position intermediate to that taken by USDA and the chief antagonists should be feasible (see exhibit 5). Nevertheless, before any changes in the pricing of reconstituted milk were made, we would endorse a more complete review of the strategy and philosophy behind federal order pricing in general. It is important to look at the big picture not just a small part of it.

Critics of federal orders and other dairy programs have often assumed that the alternative to these regulations and policies is an unfettered, competitive market. Unregulated dairy markets would not conform to perfectly competitive standards. As often applied in policy analysis, the perfectly competitive market is not an appropriate norm. It is an unrealistically rigorous standard. However, we believe that regulations can be used to make an inherently noncompetitive market perform more like a competitive market. Regulations of this type deserve public support.

Cooperatives

Dairy farmer cooperative are an important and growing force in the U.S. dairy industry. In 1981 about 84 percent of all dairy farmers shipping milk under federal milk marketing orders were members of one of the 269 dairy cooperatives operating under federal orders nationwide. These associations ranged in size from very large organizations covering several states and many federal order markets to small, local cooperatives associated with a single processing plant. Dairy cooperatives are involved in a variety of activities including finding outlets for member milk, providing farmers assistance with production problems, coordinating hauling arrangements, providing market information, and with increasing frequency, owning and operating manufacturing and processing facilities for milk and dairy products. Many cooperatives are also involved in activities that affect non-members and private milk dealers, such as manufacturing milk not needed for fluid purposes (thereby balancing the market), negotiating milk prices in excess of federally-mandated minimum prices, and providing private milk processors with a milk supply to fit their production schedule. With few exceptions, dairy farmers rate cooperatives favorably relative to private milk buyers (see exhibit 6).

Dairy cooperatives and the federal milk marketing order system enjoy a symbiotic relationship. The order system relies on cooperative stewardship to keep order provisions up-to-date and workable. Cooperatives recommend order amendments and offer farmers information on the order system. Bloc voting by cooperatives on behalf of their full membership makes maintenance of the order system easier. Cooperatives derive benefits from the order program through order enforcement of classified pricing and fair rules of exchange between farmers and milk buyers. Neither federal orders nor cooperatives would be as strong without the existence of the other institution.

In the past 10 years or so, dairy cooperatives have been charged by some with the accumulation and abuse of political and market power. In the main, these charges are unfounded. Through their heavily endowed Political Action Committees, dairy cooperatives exercise considerable political power. This power is wielded under the rules applying to any and all groups attempting to influence Congressional and Executive decision. Dairy cooperatives appear to be operating legally and rationally, the transgressions of a very few in the late 1960s aside. One might question their aims, strategies, or successes, but they are operating within the prescribed system.

Market power by dairy cooperatives is a reality today just as it was throughout the 1970s. This market power, however, is tenuous in almost all cases and with few exceptions, its abuse is ephemeral. This is true for three primary reasons. The first reason is cooperatives' inability to control the total supply offered for sale. Without supply control, classic monopoly or oligopoly gains cannot be captured by sellers. Second, dairy cooperatives face tough competition from independent milk supplies and each other. In almost every market, sufficient uncommitted milk supplies exist to help discipline cooperatives' price demands. Moreover, the dairy cooperative community does not behave as a unified group of dairy farmer associations working for the good of their collective membership, despite some rhetoric to the contrary. Inter-cooperative competition can be intense and helps to prevent the abuse of market power theoretically possessed by a cooperative. Four-firm concentration ratios for dairy cooperatives are above 0.50 in most U.S. markets but these ratios are not barometers of market power or its abuse. The final reason that apparent market power is seldom manifested is that large private bulk milk buyers, most notably integrated chain stores, can and do exert a major influence over cooperative pricing decisions. These big private accounts often name the tune to which milk suppliers will dance.

Cooperative-negotiated prices in excess of federal marketing order minimums are perhaps the most frequently cited symptom of the abuse of market power. The research evidence suggests that there have been short periods of time in a limited number of markets when premium prices likely reflected undue price enhancement. For the reasons previously enumerated, however, these gains were short-lived. In the research literature price premiums have been linked most strongly with the costs of providing services to milk buyers and with the extra money needed to induce milk to move from surplus to deficit fluid markets.

It is our belief that dairy farmer cooperatives are an important component of the marketing system. They provide a viable alternative to the private milk buyer but appropriately, natural market pressures continue to exist for an independent, unaffiliated milk supply. Large processors and other cooperatives limit cooperatives' exercise of market power. Cooperatives bring some order and cohesiveness to the marketplace and establish a place for the willing dairy farmer in the market beyond the farm gate. Make no mistake! These organizations are not possessed of any special virtue whereby objectionable behavior is automatically spurned. Rather, the marketplace and the very nature of such voluntary organizations tend to yield such a result. It is clear to us, however, that it is unwise to rely solely on these "invisible" disciplinary forces. The authority of the Secretary of Agriculture under Section 2 of the Capper-Volstead Act to prohibit undue price enhancement should be wielded as a deterrent to cooperative excesses. Moreover, the laws and regulations administered by the Justice Department and the Federal Trade Commission should continue to be applied to cooperatives as appropriate. In this latter regard, however, it would seem reasonable to coordinate their activities and jurisdictions with that of USDA to ensure clear, consistent, and appropriate treatment of cooperatives.

Product Identity Standards

Product identity standards generally serve to assure consumers that certain products, especially those whose composition (identity) is difficult for consumers to ascertain, meet some minimum standards. Recently, proposals have been made to change the national standards of identity for fluid milk products, in particular to increase the standards for their nonfat solids content. There is nothing wrong with current standards in terms of food safety or quality. Proponents of higher nonfat solids standards for beverage milk believe that it will result in greater sales of milk (or at least nonfat solids), which would help alleviate the current surplus problem. That higher solids standards would indeed result in more total milk sales is questionable. The implications of these proposals need far more careful study. We suspect that such proposals are not in the longer run interest of milk producers or the general public. Further discussion of this issue is provided in exhibit 7.

Generic Promotion

A considerable amount of research on New York State generic milk promotion programs has been done at Cornell (see exhibit 8). In general, the conclusions have been that generic promotion can result in greater sales than would otherwise occur and that dairy farmers receive a favorable return on these investments. Recently proposals have been made that could result in mandatory, 2-year nationwide assessments on farmers for the purpose of generic milk product promotion (contrasted to present state or regional programs on which farmers have voted their approval). Cornell researchers have attempted to estimate the impact of the latest such proposal (see exhibit 9). They concluded that an effective promotion campaign of the magnitude implied by the proposal might increase dairy sales from four to six billion pounds (approximately 3 to 5% of 1982-83 U.S. marketings). Perhaps these estimates should be viewed as optimistic; nevertheless the research indicates that such a program may well be worth considering. Given government involvement in generic promotion programs that consists of no more than providing 1) an opportunity for farmers to decide whether or not to collectively tax themselves for this purpose and 2) an administrative framework in which to operate, we can see little reason to oppose such programs.

New York and the Northeast

Although the dairy industry is by no means a homogeneous entity across the U.S., the problems and concerns in New York and the Northeast are remarkably similar to those expressed by dairy industry leaders elsewhere. Despite differences in average farm size, production per cow, costs of production, and Class I utilization among major milk-producing regions, their degree of reliance upon federal dairy programs is remarkably similar. While regional solutions to the current over-supply problem have been touted, we do not feel they would be economically or politically sound.

Despite claims to the contrary, New York and the Northeast have been contributing to the milk surplus problem. During 1981 and 1982, production increases here generally lagged behind those in other major milk-producing regions. Since late 1982, however, the rate of increase in the Northeast, and especially New York and Pennsylvania, has been well above the national average. While it's true that sales to the Commodity Credit Corporation (CCC) from New York and Northeast manufacturers are significantly less than sales from the upper Midwest or California (New York sells about 8% of its production to the CCC, which is about the state's share of total U.S. production), the Northeast receives direct and crucial benefits from this federal market-clearing program. This region can take some pride in the fact that most of its manufactured dairy products find commercial outlets, but wholesale prices in those national product markets are directly supported by the government's purchase program. The market prices that Northeast dairy products receive are supported by CCC purchases from California and the upper Midwest. Moreover, through the linkage between the support program and the federal milk marketing order program, farm level milk prices (in fluid and manufacturing uses) in New York and the Northeast are bolstered by the national level of price support. If the support price is lowered $1.00 per hundredweight, the Northeast farmer's blend milk price will fall by approximately the same amount. Clearly then, the dairy industry in the Northeast and New York is dependent on the price support program to undergird farm and wholesale prices.

There are some very economically-sound reasons why New York and other Northeastern states produce a significant share of the nation's milk. These include low costs of milk production, abundant land and water resources, a good transportation system, a restricted set of agricultural alternatives to milk production, and proximity to huge retail markets. The inevitable reduction in milk prices which began last April with the collection of the first 50-cent assessment, will do nothing to change the Northeast's comparative advantage in milk production. Analyses performed at Cornell University indicate that times will be hard for Northeast dairy farmers (see exhibits 10 and 11), but they will be hard for milk producers nationwide. In fact, producers in the South and the West, where costs of production--especially feed--are high relative to the Northeast may be squeezed first and hardest. In our judgment, New York and the Northeast will emerge from the impending nationwide adjustment as they went in, major milk-producing areas. The transition will not be easy. The absence of good alternative agricultural enterprises in many parts of the Northeast suggests that many dairy farmers in this region will find it less difficult to survive than to develop alternative uses of their resources. Unfortunately, there is no way out of our serious over-capacity problem except through reductions in cow numbers and dairy farmers. In the long run, our milk supply will be produced by fewer cows on fewer but bigger farms and will be processed in fewer but larger plants. This is true in the Northeast and nationwide.

There is one factor exacerbating New York dairy farmers' hard financial times which producers in many other parts of the country do not face. This is the generally more fragmented and less financially-sound set of dairy farmer cooperatives in New York relative to most other parts of the country. This has resulted in relatively greater marketing inefficiencies and higher marketing costs in this area. Dairy farmer members pick up the tab for such inefficiencies. Leaving such an association, however, is also costly for farmers because of the equity capital they have contributed over the years. These problems must be dealt with by the respective organizations, individually and collectively. There is really nothing more that government can or should do to assist these organizations. It is, however, important to appreciate these problems and recognize that they work to frustrate the ability of New York's cooperative milk marketing system to make adjustments.

Exhibit 1

Novakovic, Andrew. The Dairy Industry and Dairy Policy in 1982. Department of Agricultural Economics, A.E. Ext. 82-4, Cornell University, February 1982.

Exhibit 2

Novakovic, Andrew. An Overview of Dairy Policy Options. Department of Agricultural Economics, Staff Paper 82-3, Cornell University, March 1982.

Exhibit 3

Novakovic, Andrew. Reflections on Criteria and Strategies for Choosing Among Dairy Price Support Proposals. Department of Agricultural Economics, Staff Paper 83-6, Cornell University, March 1983.

Exhibit 4

Boynton, Robert D. and Andrew Novakovic. "The Role of Milk Marketing Orders." Prepared as a Resource Paper for 'Farm and Food System in Transition,' Extension Education Project, Michigan State University.

Exhibit 5

Novakovic, Andrew. A Further Analysis of the Comparative Cost of Reconstituting Beverage Milk Products. Department of Agricultural Economics, A.E. Res. 82-32, Cornell University, October 1982.

Exhibit 6

Boynton, Robert D. and Emerson Babb. Grade A Dairy Farmers' Perceptions of Milk Buyer Performance: The Findings of a National Survey. Department of Agricultural Economics, Station Bulletin No. 367, Purdue University, March 1982.

Exhibit 7

Boynton, Robert D. The Solids Standards Issue. Department of Agricultural Economics, Staff Paper 83-5, Cornell University, April 1983.

Exhibit 8

Kinnucan, Henry W. Dairy Promotion Research at Cornell: What Have We Learned? Department of Agricultural Economics, Staff Paper 81-18, Cornell University, September 1980.

Exhibit 9

Kinnucan, Henry W. and Olan D. Forker. "Will a National Dairy Promotion Program Reduce Dairy Surpluses?" Dairy Marketing Notes, Vol. 2, Summer 1983. Department of Agricultural Economics, Cornell University, Ithaca, N.Y.

Exhibit 10

Boynton, Robert D. and Robert A. Milligan. The Cash Flow Impact of the New Milk Price Assessments on Selected Groups of New York Dairy Farms. Department of Agricultural Economics, A.E. Ext. 83-2 (Revised April), Cornell University, January 1983.

Exhibit 11

Hallberg, M. C. and R. L. Christensen (eds.). Implications of Reduced Milk Prices on the Northeast Dairy Industry. Department of Agricultural Economics and Rural Sociology, A.E. & R.S. No. 167, The Pennsylvania State University, April 1983.