

U.S. DAIRY POLICY ISSUES
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Thank you for the invitation to address dairy policy issues. At USDA, we have a strong interest in what is happening in dairy markets and in the performance of the Federal dairy programs we operate, because milk is produced in all 50 States, and milk sales are an important source of farm revenue. Farm milk sales this year will exceed \$21 billion, over 10 percent of total farm sales of all commodities. Only sales of cattle account for a larger proportion of farm receipts and even some of those sales are cull dairy cows. So, I will start with a few comments on the dairy market situation and then address a few key policy issues that are so strongly intertwined with the dairy economy.

The Market Context for Dairy Policy Development

Many factors will determine the direction of Federal farm policy. There are big picture concerns, such as who is in political power and what are their views, the state of the Federal budget and how agriculture stacks up against all the priorities competing for funds. There are specific concerns, such as how much any new farm proposals would cost and what would be the market effects. And on and on. But, a key factor always, a factor that Congress and the Administration always want to respond to, is the state of the farm economy. And in 2000, the state of the farm economy is somewhat strained.

The dairy industry today is facing many of the same general pressures that much of farming faces. The past two years have seen an extraordinarily large drop in farm income earned from the market. This year, if direct government payments to producers are excluded, U.S. net cash farm income is expected to be the lowest since 1984. Most of the decline in net farm income during the past two years has been a result of weak major crop markets, as livestock markets started to recover in 1999 and milk prices were record high. Consider just the major program crops: wheat, rice, corn, sorghum, barley, oats, cotton and soybeans. Their net cash income, excluding government payments, during the first half of the 1990s—that is, 1990 through 1995—averaged almost \$15 billion per year. This year, their net income is expected to be only a little over \$3 billion. That is an enormous drop, and it is no wonder that farmers sought and Congress provided record-high government payments last year and again this year. And those payments, totaling \$23 billion this calendar year, have made a difference in maintaining cash flow and avoiding serious debt problems for most farmers.

But now milk has joined the low price club after the collapse of milk prices at the end of 1999. Back in 1998 bad weather in the west and south reduced milk production, the strong economy raised demand for dairy products, and declining feed prices all helped lead producers to expand U.S. milk production by 3.4 percent last year and an expected 3 percent in this year. This increase in milk production is the largest back-to-back, two-year surge in milk production on a percentage basis since 1980 and 1981, nearly 20 years ago. As a result, USDA forecasts the all-milk price to average \$12.40 per cwt. this year, down 14 percent from last year, 20 percent from 1998, and the lowest level since 1991. Looking ahead to 2001, USDA forecasts the all-milk price at \$12.70 per cwt, only slightly

better than this year. Feed prices are lower, so costs are down, but we still see a only slow recovery in net income for most dairy producers.

In addition to weak milk prices, a second major market issue is the continuing adjustment to ongoing structural changes, which could well accelerate. The most obvious change is in the size of dairy operations. The number of dairy farms has declined sharply in the last 50 years, and the rate of decline remains steady at 5-8 percent per year, as smaller farms are being replaced by larger operations. The fastest milk production increases this year are mostly coming from the western states, where the farms are largest. The average size of dairy farms now varies greatly by region. Northeast dairy farms are near the national average of 82 cows per farm, the Upper Midwest tends to be below the national average, and dairy farms in the West and Southwest tend to be above the national average. For example, less than 1 percent of farms in Wisconsin have 500 or more cows. In comparison, over 40 percent of California farms have 500 or more cows. Today, one fifth of the nation's dairy farms have 30 or fewer cows, and at foreseeable prices that size farm generates a return over variable expenses not much above the poverty level. So, there is and will continue to be enormous pressure on dairy farms to get larger.

Issues in Major Federal Dairy Programs

Federal Milk Marketing Orders. In this world of continuing price pressure and structural change, the proper role of Federal dairy programs will continue to be intensely debated. First among these is Federal milk marketing orders, voluntary programs that cover 70 percent of the milk marketed. Orders of course provide two key functions, minimum prices by use and pooling of revenues so that each producer receives an average or blend price. I want to comment on the economics of orders and a lesson we have all learned from recent history.

Upper Midwest dairy producers, and a number of economists, long argued that many of the Class I differentials interfere with market prices and encourage production in areas where, without regulation, production would be less. The argument is that some differentials are larger than needed to produce an adequate supply of milk for fluid needs. This was a big issue in the 1996 Farm Bill debate, which ended by directing USDA to reduce the number of Federal orders and authorizing USDA to make other changes in orders.

As a result, USDA conducted a major review of orders and issued a final decision reducing the number of Federal orders to 11. USDA also concluded that some Class I differentials ought to be a little lower to reflect the availability of closer fluid supplies to some demand areas. USDA would have increased differentials in the Upper Midwest and generally reduced them elsewhere, except in Florida. Nationally, the average Class I differential would have been reduced from \$2.58 per cwt to \$2.29, a drop of \$0.29 per cwt. USDA also redefined the class I mover, no longer always to be the class III price, but to be the higher of the class III or class IV price. Over time this would mean a higher class I mover compared with always using the class III price. So, USDA's proposal offered a little higher class I mover to go along with a little lower average class I differential, without much change in farm income in the aggregate. In the end, however, there was enough opposition to the proposed change in class I differentials that Congress only bought half the proposal. They took the higher class I mover but

rejected the lower differentials, and implemented a regional Class I pricing structure that changed some differentials, left them unchanged in many areas, and left the average unchanged.

To put these events in historical perspective, I think it is important to understand that the trend in farm policy over the past decade has been to try to make all farm programs more economically efficient, which is generally achieved by letting markets determine what is produced and where. Economic efficiency is maximized by using capital and other resources in the commodities and regions where markets value them the highest. Making that happen does not have a lot to do with how much government spends on farm programs. It has more to do with how a program is operated, especially whether production and marketing decisions by producers are made in reaction to the market or in reaction to program incentives. A recent study by Gardner estimated that although about the same amount has been spent on farm programs in the late 1990s as in the mid 1980s, the programs of the 1980s were 5 times more economically inefficient as today's programs. The efficiency gains have mainly resulted from the elimination of government set-aside programs and reduced loan rates. USDA's proposed changes in Federal milk marketing orders were one way to improve the economic efficiency in milk production and distribution.

The lesson learned from order reform is that the efficiency gains would not have been terribly large, and society, acting through Congress, decided the efficiency improvements were not worth the geographical redistribution of dairy income that would have resulted. And because of the strenuousness of the debate, I really don't think that anyone is going to take on major order reform again in the foreseeable future. Instead, the focus will be to clean up smaller issues in orders. For example, Congress mandated that USDA review the new pricing formulas for Class III and Class IV milk, with any changes implemented by January 1 of next year. You will hear a discussion of the in a session tomorrow.

The next challenge to Federal milk marketing orders may well come in the international arena. There has been increasing interest in some regions, such as the Netherlands and in the Organization for Economic Cooperation and Development, to call orders "production and trade distorting," making them subject to discipline under the WTO. This issue may be a subject of discussion under the ongoing WTO negotiations on agriculture. USDA does not believe Federal milk orders should be classified as trade distorting and subject to discipline under the WTO.

Price Support Program for Milk. A program facing immediate and substantial action is the price support program, whose authority expires at the end of this year. USDA's pending appropriations bill for next year is expected to extend the price support program for one year and the Administration supports extending it through 2002, when authority for other farm programs expires. Many producers did not embrace the price support program through much of the 1990s because, prior to the 1996 farm bill, they paid assessments which were viewed as a price tag for the program and, the support levels were often well below market prices, so there was very little support being provided. Support has been provided the past two years as government purchases have increased, and there is both good news and bad news in that story. The good news is that farm incomes are being supported. Without the program, we estimate that milk prices would be \$0.30-0.50 per cwt lower than with the program. The bad news is that the effective level of support is not the same in all regions and whenever

prices are supported, market signals are thwarted and production decisions are being influenced. Producers cut back production less than they otherwise would.

Another problem is that last year, USDA purchased 176 million pounds of nonfat dry milk under the price support program at a cost of nearly \$200 million. This year, we think we will buy 480 million pounds of nonfat dry milk, about 40 percent of total U.S. production for the year, but no butter and only a little cheese. So our purchases are quite large and imbalanced. Government stocks of nonfat dry milk could exceed 500 million pounds at the end of this fiscal year, a level unseen in nearly 15 years. Last year, 125 million pounds of powder held in government inventory were moved out under several domestic and international programs. At that rate, it would take 4 years to move the expected government stockpile, and longer if the price support program is extended. We are now examining options for reducing the stockpile of nonfat dry milk without disrupting its commercial market.

The obvious economic prescription is to reduce the USDA purchase price of nonfat dry milk and offset that with an increase in the purchase price of butter, while continuing to support the overall price of milk at \$9.90 per cwt. That would reduce government purchases and the cost of the support program. We can legally make such a change, but the dilemma is that it would also lower milk prices to producers at a time when prices are weak. And blend prices would fall even more than in the past, because under Federal order reform, the Class I price is tied to higher of the Class III price or the Class IV price, and currently it is the price of milk used to produce butter and powder that is the base for the Class I price.

Recently, USDA reviewed purchase prices and increased the purchase price of cheese by 2.2 cents per pound and the purchase price of butter by 1.8 cents per pound in order to be consistent with the pricing formulas under Federal order reform. But we did not change the purchase price of powder because of the large purchases we are making.

What will be the fate of the price support program? The program is designed as a safety net to support income in the off year when milk prices are excessively low. However, farm policy has generally moved away from programs with rigid floors. Grains, oilseeds and cotton now have marketing assistance loans, which let prices fall below loan rates. The peanut loan rate has been reduced. And even the sugar loan rate is under attack as sugar loan collateral is now being forfeited. Given the concern over the effects of higher loan rates on competitiveness and production incentives, I think there is not much prospect that the support price for milk will be raised appreciably to provide greater income support.

Up to this point, Congress has been pretty clear that it won't raise support prices to support dairy incomes. They extended the support price at the \$9.90 level for one year, but they provided additional dairy income support all as direct payments—\$200 million in 1998 and \$125 million in 1999. The Senate-passed agriculture appropriations bill contains provisions that would provide about \$440 million in direct payments to dairy producers.

These actions by Congress suggest that income support for dairy farmers is not likely to disappear, as envisioned by the 1996 Farm Bill. But I don't think income support is likely to take the form of high price supports or costly direct payment programs either. I believe there will be continuing debate about having a price support program set near current levels, or replacing it with a modest direct

payment program. And with regard to direct payments, there would be focus on targeting the benefits. We have clearly observed that as farms concentrate, or industrialize as some would say, there is less public interest in spending taxpayer dollars to support large operations. The hog industry is an example. The emergency spending bills by Congress are notable for their lack of support for hogs, despite a 50-year low in hog prices in late 1998.

Export Assistance. USDA also supports the price of milk by subsidizing dairy exports. Tariff-rate quotas also limit U.S. imports of many dairy products. In 1999/00, about 250 million pounds of dairy products, mainly nonfat dry milk, received export subsidies under the Dairy Export Incentive Program (DEIP). This year, DEIP exports could drop to half of that level, due to our WTO Uruguay Round commitments.

The WTO negotiations on agriculture are proceeding in Geneva. Countries must table their proposals by the end of this year. The U.S. proposal was tabled in mid summer, and it calls for greater import access, the end of export subsidies and further limits on trade distorting domestic support. All of these proposals, if adopted, would have serious implications for the U.S. dairy industry and dairy policy. They would mean more imports, the end of DEIP, and tighter limits on income support programs. The market-oriented proposals in the WTO cannot be ignored when designing domestic dairy programs. They are a signal that domestic programs must be increasingly market oriented and sensitive to global competition. This could well make us pay more attention to non-distorting programs such as conservation, risk management, research and market promotion.

Northeast Interstate Dairy Compact. Another policy issue that must be resolved is the Northeast Interstate Dairy Compact, which evolved from concerns over loss of dairy farms in the New England. The Compact establishes a minimum price for milk in fluid use that sometimes exceeds the Federal order minimum price in the six New England States. Dairy farmers in many other areas of the country support compacts as a way to raise prices, and more than twenty States outside of New England have passed legislation to join the Northeast or a Southeast compact.

The economics of a compact generally are not the same as a price support program. Under a price support program, all farmers face a higher blend price when the support program is operating. And, the government is supporting the market price for everyone by removing surplus product from the market. Neither of those conditions may hold for a compact. Under a compact, the higher fluid prices do increase blend prices in the region, consequently they can increase that region's milk production and reduce fluid milk consumption. Unless the compact removes surplus from the market through its own supply control, the increased milk supplies go to manufacturing and lower prices for manufactured dairy products. If there is no supply control and you are in an region outside the compact area, your blend price will fall. For these reasons and because of the effect of compacts on lower income households and food assistance programs, I think Congress will have much difficulty in extending or expanding the current compact, although I am mindful they have done it in the past..

I want to conclude by emphasizing that with all of the dynamic change going on in the farm economy and in dairy, it would be a mistake to put all of our policy attention on marketing orders and the farm income safety net. The Federal government must continue to negotiate more open markets

globally and work to reduce trade distorting foreign subsidies. The government must ensure domestic markets are competitive and that farmers have negotiating power in imperfect markets. The government should ensure new market institutions, such as e-markets and contracting, are fair, competitive and not discriminatory. The government must help deal with the environmental impacts of farm production. The government should help ensure adequate risk management tools are available. The government must conduct basic research that teaches us more about the quality and health effects of milk and dairy products, the science of dairy cows and milk production, the economics of milk production and marketing and what is needed to develop new dairy products. So is there anything left for the industry to do? As great as our challenge is, yours is greater. All you must do is forever strive to produce high-quality, safe dairy products that consumers want, at the lowest possible cost and in an environmentally friendly way. You have been meeting that challenge for a long time. We hope USDA can help you and we wish you the best in continuing to meet that challenge in the future.