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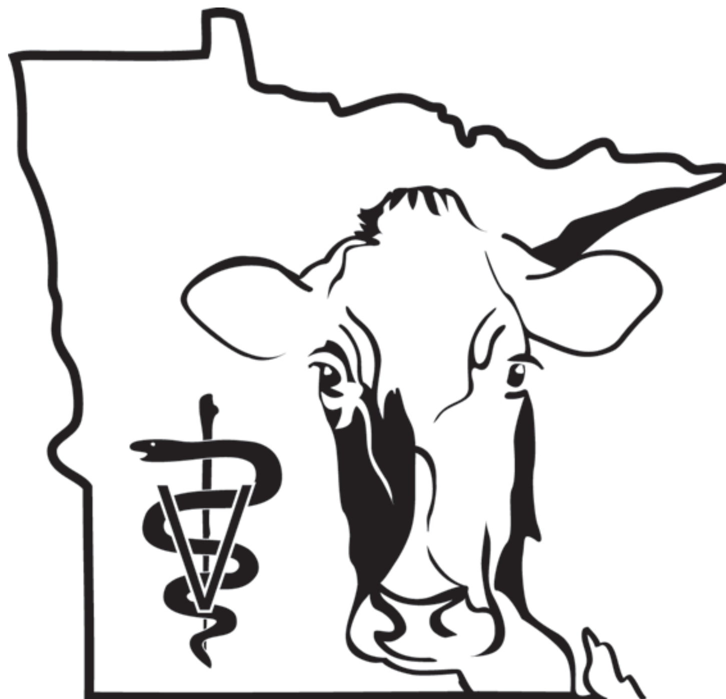

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The Future of the Dairy Industry: A Midwest Perspective

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Despite a Democratic Administration, the Republican-lead House and Senate paved the way for market reform with a "Freedom to Farm" concept that culminated into the 1996 Farm Bill. That legislation returned producer decisions to plant crops based on market conditions. For dairy it led the way for Secretary Glickman's proposals on federal order reform.

The basic concept of Freedom to Farm was entirely sound—to get government out of the way and allow farmers to make their own decisions. This concept was pushed by the Upper Midwest Dairy Coalition. The underlying principle is that government price programs may actually cause more problems than they solve. In theory a "free market approach" based on less government and greater exports would be the foundation for future prosperity.

The 1996 Farm Bill was debated within the environment of the General Agreements on Tariffs and Trade, or GATT. The U.S view was to drop domestic support and trade barriers. The common trade enemy was the European Union made up of industrialized nations in Western Europe. Their use of heavy domestic price supports and export subsidies was viewed as a source of price distortions in global markets.

There was one teeny tiny problem that was overlooked during the debate in 1996: that market prices for agricultural products could fall to market clearing levels! After all, grain and hog prices were great in 1996 and served to embolden legislators. Who would have thought that crops, hogs, beef and dairy prices would simultaneously drop below cost of production.

Farmers and legislators are now rethinking the 1996 Farm Bill. The basic concept was good; farmers must depend on strong markets. Markets are the key to economic prosperity. In hind sight, more thought should have been given to providing a better safety net.

Industry Trends

There is an undeniable trend currently going on in the dairy industry. Milk production is consolidating in a few regions of the U.S., farm numbers are rapidly declining, and the average farm size is increasing.

The modern milk sheds are in the Northeast, Upper Midwest, and West. Milk is highly concentrated in these three regions and is growing. Farmers there have a comparative advantage in milk production and have lower hauling rates and greater competition for available milk supplies.

The West continues to grow as dairy farms expand from 1000 cows to now 3000 cows and above. A new industrial age model using modern business practices is being used to make rural milk factories that are efficient. These milk factories have more focused capital, higher returns on investment, higher production per cow, and lower unit costs of production than traditional dairy farms.

Now compare that modern business model with the typical family farmer in the Upper Midwest or Northeast. Traditional dairy farmers in these two regions often don't know their cost of producing 100 pounds of milk. They don't know their feed costs per cwt of milk shipped and their milk margin. Very often they are over capitalized with equipment and have below average production per cow.

To be successful in the future (i.e. the future being today and tomorrow), traditional family farmers are going to have to learn basic business principals in order to become more competitive. Farmers need to know what they are doing in terms of income and expenses, and where they are going.

Farmers aren't the only ones facing consolidation in the dairy industry. Cooperatives and processors are rapidly facing consolidation. Dairy Farmers of America now commands 25 percent of the nations milk supply. In addition, two publically traded dairy companies: Deans Foods and Suiza, are buying up bottling plants in many parts of the U.S.

Clearly the trends are evident: more competition and greater consolidation. There are costs that can be wrung out of the system via consolidation. We are fast approaching the point, however, where future consolidations could result in anti-competitive markets. Thus there will be a limit to how much of the milk supply cooperatives can dominate, or how much of the fluid milk business that proprietary dairy companies can own.

Dairy Policy: All Wrapped Up, or Just Getting Started?

The 1996 Farm Bill put off any serious decisions regarding dairy policy. Congress gave Secretary Glickman the task of reforming federal milk marketing orders. That has not been an easy process. Yet Secretary Glickman developed a bold initiative to "modernize" federal orders through a well-studied reform process. A final rule was released March 31 of this year.

Glickman's final rule was controversial, to say the least. It lowered Class I differentials in most areas of the country, except the Upper Midwest and Florida. Class I differentials are important since they determine the price of fluid milk and farm gate milk prices. The final rule also lowered the definition of other class prices. This author estimated that adoption of Glickman's final rule would lower farm milk income by $0.46 per cwt, or $583 million in 2000.

Secretary Glickmans proposal will not likely represent the finishing touches on dairy policy. The recent $6 drop in the Basic Formula Price (BFP) will focus renewed attention on the vulnerability of current farm policy. Price stability and income

protection are two basic issues that have yet to be clarified. Thus in many ways, we are back to the drawing board regarding future directions in dairy policy. These policies range from a free market approach to supply control.

It is very likely that Congress will intervene. Congressman Roy Blunt (R-MO) has introduced legislation to adopt a higher Class I pricing plan (called 1A). Other legislation has been introduced to extend the dairy price support program beyond 2000. Congress has allowed themselves a review period between now and October for USDA's final rule. They will likely make a political decision on what Class I differentials will be much like what they did back in 1985. And Congress will have other issues to deal with as well. In fact, dairy policy may not be as "wrapped up" as some think it is.

Let's review the many options being discussed.

Dairy Compacts

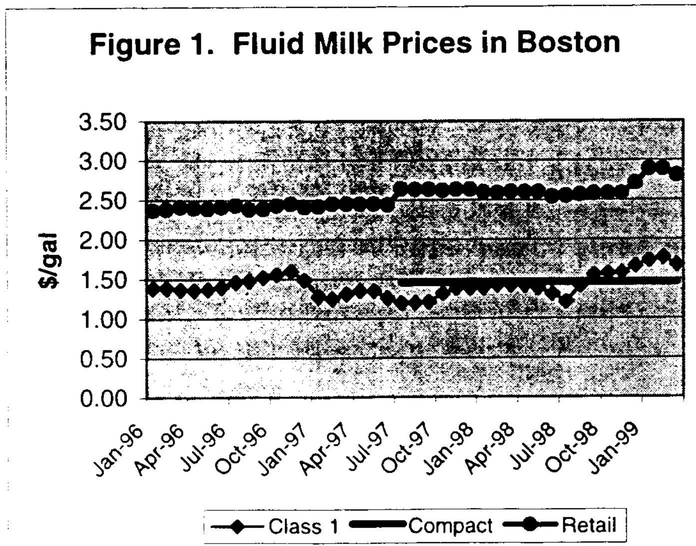
Individual states are passing compact legislation with the hopes that Congress will maintain and expand the Northeast Interstate Dairy Compact and create new regional dairy compacts such as the Southern Dairy Compact. States must first approve legislation, then Congress must give their consent.

But are compacts good public policy? How do they work? Compacts only affect the regulation of fluid milk. They express the right of a group of states to regulate their own fluid milk industry. Compacts work by forming a Commission, promulgating a set of regulations, and amending those regulations.

A Compact Commission would set a compact price, a floor on the price of Class I milk in the compact region. If the minimum federal order price is below the compact price, the difference is collected by the Commission from fluid milk handlers. The proceeds are then paid back to all dairy farmers in the compact region by some economic formula.

Our economic study (Bailey and Gamboa) shows that compacts are effective in raising the price of milk to compact farmers. However, they also raise the price of milk to consumers who in turn cut back on milk consumption. For example, Figure 1 shows that fluid milk prices in Boston rose after compacts became effective in July 1997. The compact was ineffective September 1998-March 1999 due to high U.S. milk prices.

Farmers are likely to respond to higher compact prices by expanding. Current milk production levels are evidence that farmers do respond to price signals. The result? More milk is manufactured into butter, nonfat dry milk and cheese. That in turn lowers



commodity prices and hence milk prices for non-compact dairy farmers in places like California and Wisconsin. They bear part of the brunt of dairy compacts.

There are two fundamental problems with dairy compacts. First, they bring direct economic harm to non-compact farmers. Second, they reduce fluid milk consumption.

It would be hard to argue that compacts are neutral to farmers outside of compact states, particularly when the potential size of a Southern Compact appears to be growing (i.e. Missouri, Oklahoma, Kansas, Texas now want to join). If a Southern Dairy Compact is formed and if the compact price raises farm prices, then excess milk will be produced.

One should also ask whether raising prices to consumers is a good idea. In today's marketplace, it is risky to require consumers to pay more and get nothing in return. Consumers expect the opposite: getting more and paying less. The real problem in the dairy industry is that consumers have been buying less milk each year (see Figure 2). By my estimates, if fluid milk sales nationwide were to increase say 5 percent, farm prices would rise 47 cents per cwt!

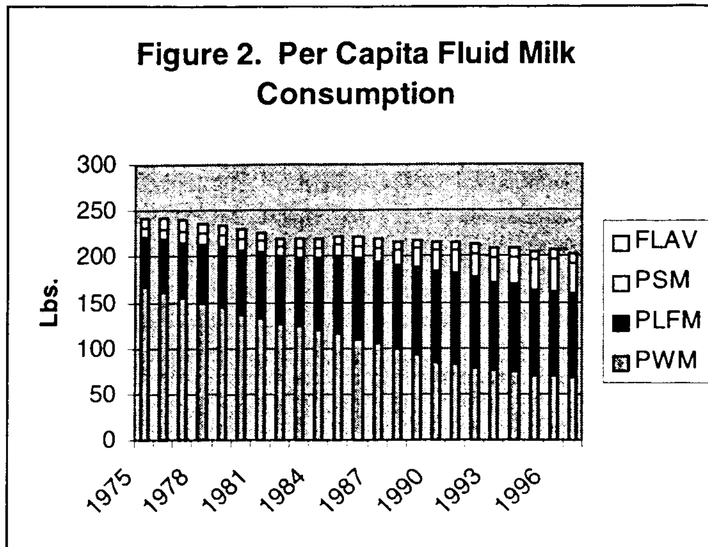
Revised Price Support Program

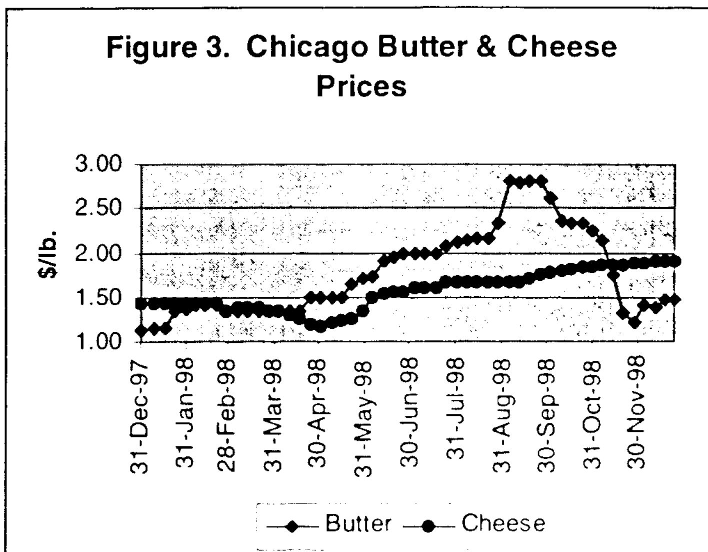
The dairy price support program is scheduled to end this year. Why? Because it was deemed too expensive for taxpayers. Policymakers wanted the market to bear the cost of maintaining inventories of dairy commodities. But is this good public policy? Is it really cheaper for taxpayers and consumers to allow the market to "do it's thing?"

The reality is the marketplace has been unwilling to shoulder the expense of maintaining an adequate reserve of dairy commodities. The result has been unprecedented wholesale

butter and cheese prices in 1998 (see Figure 3). What was the social cost of having an ineffective price support program in 1998?

One option would be to have Congress revisit some kind of a revised price support program. This program would not be used to enhance wholesale commodity prices! Instead it would be used to stabilize such prices. A non-recourse loan could be developed





thereby processors could take out a loan for say cheese in the spring and then either repay the loan for forfeit the cheese to the Commodity Credit Corporation later in the fall. A cap could be placed on the amount of cheese put under loan.

The problem with this program is that it will cost money, but it will prevent the high price runs experienced in 1998.

Farm Margin Guarantees
One policy option gaining momentum is a new program that would guarantee dairy farmers a minimum price margin. The margin is the difference between the farm price and the cost of feed. Such a program would focus on protecting a dairy farmer's gross income. One could either develop an insurance program, whereby farmers could share in the cost of maintaining such protection. Or, the program could be offered as a government program much like the old target price protection program for crop farmers.

The advantages of such a program is that it would afford income protection to farmers and would not interfere with the market place. The problem, however, is that such a program would represent a significant cost to taxpayers.

Income Shifting Programs

Representatives Kenny Hulshof (R-MO) and Karen Thurman (D-FL) have a unique idea for helping our nation's farmers. The program is called Farm and Ranch Risk Management (FARRM) Legislation. This program would allow farmers to set aside up to 20 percent of their annual sales into a tax-deferred interest bearing trust fund. Farmers would then have up to 5 years to withdraw the funds at which time they would pay taxes. The advantages of such a program are that it would provide better cash flow between years, it could reduce taxes over time, and would provide farmers an incentive to save for bad years. Again, this program would help farmers but would not interfere with the market place. It is an excellent idea. The only problem—would farmers use the program?

Supply Management
During debate on the 1990 Farm Bill many dairy farmers and their cooperatives were studying the efficacy of supply management. One program proposal would use a two tiered pricing system. Farmers would receive one set of prices on milk produced within the first tier. This price would be much higher than current prices. Then, farmers would receive a much lower price (i.e. $8-$9 per cwt) on any production beyond the first tier. Farmers would have an incentive to produce within an individually assigned quota.

The advantage of such a program is that prices could be raised without resulting in a mountain of excess milk production. In addition, it would safeguard today's dairy farmers and provide an adequate supply of quality milk. The problem, however, is that such a program would severely limit the ability of new startup operations. There would be a high cost associated with buying quota. Consumers would be required to pay more for milk and dairy products. And there is the question of whether such a program is GATT legal, particularly if tier II milk is exported at world prices.

Free Market Approach
Another option is to get rid of the price support program and federal and state order programs and go "free market." This is what occurred in New Zealand when the country ended many of its social programs.

The problem with this approach is that it may result in economic casualties. Many of these casualties may be small family farmers. The political consequences of such a program could be dramatic. Thus far, society has shown interest in providing some kind of economic safety net for small family farmers (i.e. federal dairy programs, cooperatives, small farm loans, interest buy downs, etc.).

Lessons Learned
So what have we learned? First, there is growing interest in providing some degree of income protection to dairy farmers. Dairy farming is a risky business and requires a lot of capital. Such a program would directly benefit consumers by providing an adequate supply of quality milk. We now know what could happen if our nation's milk supply is just a little short (i.e. 1998).

Second, no matter what policy is chosen, it should be consumer friendly. Sometimes we forget that our economic system doesn't work unless we sell things. In the case of dairy, economic prosperity can only be reached if we sell more and more dairy products.

To sum up, dairy farmers in the Upper Midwest will be better served if Glickman's federal order reform program is adopted. There are a number of benefits. The exact option for class I differentials (option 1A or 1B) is a matter of opinion. Option 1A has broad political support. Option 1B is more popular in the Upper Midwest. Clearly a new formula for Class III and a dairy price support program is in order.

In addition, in order to have a bright future, dairy producers in the Upper Midwest must learn to increase production per cow to a competitive level, and learn to keep monthly cost of production records. Farmers should also learn to use budgets to guide their daily decision making towards a solid financial plan.

References for Further Reading:

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