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Fostering a Dynamic Dairy Policy

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Fostering a Dynamic Dairy Policy: Part I

Designing a dairy policy that addresses perceived problems of particular industry segments at a moment in time is relatively easy. Developing policy that is in the long-run interests of the whole industry and consistently adjusts to change is much more difficult. Yet, facilitating adjustment and orderly transition to industry change over the long run is a key role played by Federal Milk Marketing Orders (FMMOs). FMMO decisions, particularly those rendered in recent years, tended to be designed to deal with perceived short-run problems/issues without consideration of their long-run consequences. Thus, the industry adjustment that would have been expected to occur in a period of rapid technological change has been forestalled. As a result, FMMO decisions have precipitated reduced producer returns, resulted in needlessly volatile prices, led to misallocated resources, by-passed opportunities for expanded consumption, and reallocated returns to the detriment of particular segments of the industry--all contrary to the goals and objectives of the enabling legislation for FFMOs.

While admittedly over simplifying, there are two main statutory dairy policy constants—the price support and the federal milk marketing order programs. For each program the Secretary of Agriculture is provided statutory guidelines that are designed to facilitative orderly adjustment to changes that are occurring within the industry and thereby fulfill the objective of these two laws.

The purpose of this article is to focus on the requirements for developing a dairy policy that constantly facilitates and adjusts to change, efficiently allocates resources, serves the dairy industry as a whole, and recognizes that securing an adequate supply of milk requires that dairy policy must operate in producers' interests. A basic premise of the article is that producers benefit from government regulation when decisions are made that foster progress in terms of adjusting to long-run changes, while considering the effects on all industry segments including producers, consumers, and handlers. This article is divided into two parts: Part I evaluates current FMMO provisions in light of AMAA goals. Part II will analyze the consequences for the dairy industry of continuing current FMMO provisions over the long run, defined as ten years into the future.[1]

Goals

The direction of policy is heavily influenced by the goals that are established. While the goals of agricultural policy often are elusive, vary by policy area, and typically are rarely discussed in the context of specific legislation, this is not the case for FMMOs. The enabling Agricultural Marketing Agreements Act of 1937, as an amendment to the Agricultural Adjustment Act of 1933, provides an unusually specific set of goals to guide FMMO decisions. Moreover, these goals have been analyzed by a number of panels of experts, mostly as advisors to the Secretary or the Congress, as guides for decisions in times of monumental industry adjustment, as currently is occurring within the dairy industry. All of these reports are amazingly consistent in their conclusions regarding policy goals. The most comprehensive and widely recognized of these was the 1962 *Report to the Secretary of Agriculture by the Federal Milk Order Study Committee* chaired by Edwin G. Nourse, hereinafter referred to as the Nourse report.

By law, FMMO decisions must be designed to fulfill the goals specified in the Agricultural Marketing Agreements Act of 1937, as amended (hereinafter referred to as the AMAA). Those goals explicitly indicated in section 602 relate to fostering orderly marketing, facilitating adjustment to change, serving the interests of consumers, being in

[1] Part II currently is being drafted.

the public interest, and avoiding unreasonable fluctuation in supplies and prices.[2] While the FMMO goal of orderly marketing, rightfully, has received substantial attention, the other goals of facilitating adjustment to change, serving the consumer interest, being in the public interest, and avoiding unreasonable fluctuation in production and consumption (and therefore prices) have received much less attention. The Nourse report and related documents shed considerable light on the meaning and appropriate interpretation of these goals:

- **Orderly marketing.** According to the Nourse report (pp. 9-10)

  If fluid milk markets are to have orderly supply there must be orderly production, and for orderly production—both efficient and remunerative—there needs to be orderly provision for the physical assembly and distribution, for dependable and equitable contract relations between handlers and producer organizations and between their organizations and individual members. There need also be orderly relationships as to prices and supplies between different markets.…Order has been conceived in the time dimensions as related to annual seasons, longer cycles, and secular (i.e., long-run) changes in productive conditions and consumptive demand. It has also been conceived geographically in terms of single market areas, regions embracing several such areas, and possibly even national areas of industry wide adjustment—including economic adjustment between the two branches of dairy farming, fluid milk and milk for manufacturing uses.…But something further has been emerging—a recognition that the outlook of the Secretary of Agriculture and his aides should not be parochial but industrywide in its scope.

  This is a powerful statement having application to current industry conditions and policies. It means that orderliness is to be viewed in the context of both the short-run and the long-run effects of FMMO provisions. It also means that decisions should consider the effects on the whole industry.

  Instead decisions have been made based on short-run expediency, such as the establishment of Class IIIA, which resulted from a lack of recognition that the M-W price did not reflect the national value of milk. This later led to the unfortunate

[2] The specific language of the AMAA relating to these goals is contained in the appendix to this paper.

decision to establish four milk classes as a part of order reform following the 1996 farm bill. Other decisions have been made that favor particular segments of the industry to the detriment of others, such as the provisions for "higher of" pricing of Class I milk. As explained subsequently, the longer such provisions remain in place, the greater the distortions created and the more difficult it is to remedy the regulatory mistakes.

- **Adjustment.** According to the Nourse report (p. 10)

  It is well to remember that the original statute from which the Federal milk orders system stems was conceived as an adjustment undertaking. It was set up as an apparatus for improving the lot of the farmer by helping in every reasonable way to bring an industry (and its subindustries) in which productivity was rising rapidly—even faster than the industrial sector of the economy—into better equilibrium over time with market demands that are relatively inelastic.…The Secretary of Agriculture under this unique institution for the rational adjustment of an agricultural subindustry—what Professor Black called "assisted laissez faire"—is the moderator of an intellectual process to promote the public interest. This calls for tailoring the master concept of individual competitive enterprise and changing conditions of large-scale operations and ever-advancing technology.

  This statement calls attention to the significance of the fact that the AMAA was an amendment to the Agricultural Adjustment Act (AAA) and that as such it should facilitate adjustment to change, if not encourage it. Most certainly, any action under FMMOs that discourages adjustment to change would be contrary to the AAA and therefore to the AMAA. A classic case in point is the effect of the installation of four milk classes and fixed make allowances that, contrary to previous order provisions, has had the effect of eliminating incentives for adjustment of production capacity in response to shifting consumer demand.

- **Serving the producer and consumer interest.** Much of the Nourse report deals with the issues of pricing to serve the interests of the producer and the consumer.

However, in contrast to orderly marketing, adjustment to change, and serving the public interest, the Nourse report does not explicitly and succinctly address the explicit meaning of serving the interests of producers and consumers. However, two of the summary objectives set forth by the Nourse report (p. 13) relate to this issue, which essentially involves balancing producer and consumer interests:

3. *To assure consumers that they will have access to adequate and dependable supplies of high quality milk from the sources best suited both technologically and economically to supply these demands;*
4. *To complement the efforts of milk producers' organizations to maintain economic order in their industry, and to bring about the co-ordination of price structures and market practices within and between market areas, between fluid and manufacturing segments of the dairy industry and between milk production and other lines of farming.*

The key role for FMMOs contained in these two objectives is that of balancing producer and consumer interests.

- **Being in the public interest.** There are two different views expressed on the meaning of the pubic interest expressed in the Nourse report. One is that the public interest establishes the "supply and demand criterion of fluid milk pricing" (p. 90) discussed subsequently with regard to section 18c. The other reflects a concept of equity in a longer-run context by stating:

Planned or rationalized competition as expounded in Part I goes far toward safeguarding the long-run prosperity of producers and handlers and would most economically meet the needs of consumers. It would not rest upon a grant of government power to any group to exploit other groups but would tend to reconcile conflicting claims.

The public interest concept of equity is also reflected in the summary statement of objectives (p. 13):

5. *To secure equitable treatment of all parties—producers, dealers, and consumers, not only within each local or regional market but throughout the system;*

This perspective is fortified by a cogent minority explanation:

In the last analysis, the interests of producer, consumer, and handler are not antithetical but in fact mutual....A prime criterion for either an individual competitive or an administered price structure is that it shall promote the most efficient allocation of all productive resources. The public interest criterion applied to the order system by the Marketing Agreements Act calls upon the Secretary of Agriculture to bring the three economic functions of the milk industry—producer, consumer, and handler—into the best commercial equilibrium attainable (i.e., dynamic stability) through optimum allocation of the nation's resources.

Aside from the explicit recognition of handlers as an integral economic interest in orders, the most interesting term in this statement is that of *dynamic stability*. It reflects an appreciation for the basic reason for both the AAA and the AMAA—to facilitate orderly adjustment to change and to foster a dynamic industry that constantly adjusts to long-run changes in technology, supply, and demand conditions.

- **Stabilizing production and consumption.** The AMAA, section 602 is very explicit that a primary goal of marketing orders is to achieve

an orderly flow of the supply thereof to the market throughout its normal marketing season to avoid unreasonable fluctuations in supply and prices.

The key is one of defining what constitutes an *unreasonable fluctuation in prices and markets.* The answer lies in the distinction between reactions to short-run events versus the reflection of long-run force affecting supply and demand for milk. According to the Nourse report (p. 101)

(7) We believe that the Secretary must exercise care to avoid short-run partisan positions in the interests of fluid milk producers as may run counter to other dairy interests of the general economy, or the long-run interests of the fluid milk producer himself. The growing interrelationships between the market milk and manufacturing milk segments now mandated extreme care to avoid arbitrary decisions in the market milk sector which may work hardship on the

manufacturing sector. Moreover, modern marketing conditions bring handler problems more and more often to the core of orderly marketing issues

The Secretary is empowered and entrusted to develop a system of orders, integrated as to their relations with each other and to all the uses into which milk goes, not merely as to their internal housekeeping. He is cabinet minister to the nation's agriculture, with equal obligation to all farmers.

While the Nourse report was written in a different era when an issue such as the proportion of a federal order's milk supply that is to be locally produced predominated, there are at least four unambiguous truths from the objective of stabilizing production and consumption:

1. Decisions are to be made on the basis of long-run impacts on production and consumption.
2. Decisions are to consider the impacts on handlers/dealers as well as on producers and consumers.
3. Impacts of decisions on the stability of prices, production, and consumption are relevant considerations in FMMO decisions.
4. If a FMMO decision has the effect of destabilizing prices, consumption, or production, it is inconsistent with the purposes of the AAA and the AMAA as an amendment to it.

With regard to the specific issue of pricing milk, the AMAA indicates that the considerations shall include the price of feed, the available supplies of feed, other economic conditions affecting the supply and demand for milk, maintaining productive capacity to fulfill future needs, and the public interest. Once again, the Nourse report (pp. 89-90) and related documents shed considerable light on the meaning and appropriate interpretation of these goals.

Section 8(c)18 establishes the principle of economic (or supply-and-demand) justification for the specific price minimum used in the several orders. Prices are supposed to reflect actual conditions of user demand for milk in its various classes vis-à-vis cost and other supply factors. By striking a balance between consumers' ability and willingness to pay for milk and its products and the producers' ability and willingness to produce within some range of prices, this system would assure consumers of fluid milk and 'adequate' supply of milk.…The supply-and-demand criterion of fluid milk pricing is, in effect, paraphrased and amplified rather than compromised by the other phrase of Section 8(c)18 (and elsewhere in the Act) which stipulates that order prices shall reflect and promote 'the public interest.'

What do current policies mean for dynamic adjustment to changing conditions?

Once a policy is implemented, each segment of the industry adjusts economically and structurally to the policy in terms of what is produced, where, and how. In the process vested interests develop in the policy, program, and decision. Those who benefit want the policy to continue and thus become resistant to any policy change, even though it may have adverse effects on other segments of the industry. The result has been resistance to repeated attempts to modernize dairy programs. Those who resist are not just dairy farmers and their organizations. All who benefit, including the unanticipated beneficiaries such as cheese manufacturers, resist change. The consequence of this resistance is an inability on the part of the industry to adjust to change—policy gridlock leads to structural gridlock—even though there is a general admission that implemented policy and program combinations misallocate resources, slow the rate of technological advance, distort prices, reduce producer returns, and increase price volatility. The longer current policies continue, the more difficult they will be to change because the vested interests would be increasingly adversely affected by a policy change.

What does this mean for the need to adjust current FMMO provisions?

The dairy industry is at a crossroad in terms of the need to evaluate both the objectives of its policies and their effects. Current dairy programs are not achieving their statutory goals either individually or in the aggregate. The following list provides specific illustrations without attempting to prescribe solutions:

- Four milk classes discourage shifts in milk utilization to the highest valued use and to changes in consumer demand. As a result, producer returns are not maximized; cheese producers benefit at the expense of butterfat users; and disincentives exist to develop, manufacture, and utilize US producers' milk components in alternative product uses.
- Fixed make allowances discourage adjustment to changing demand conditions by providing constant margins and, therefore, reducing the incentives for change.
- Depooling provisions create disorderly market conditions--a malady orders were designed to remedy--while discriminating against producers who do not depool.
- "Higher of" pricing provisions benefit producers in high utilization markets at the expense of those in low utilization markets—the same disorderly market effect as interstate compacts.
- Resistance to USDA tilt actions under the price support program (that reflect changes in supply-demand conditions) discourages adjustment of production and consumption as indicated by the market and provides disincentives to develop innovative dairy ingredients and establish new markets for products that are not supported by the price support program. This has placed the U.S. dairy industry at a competitive disadvantage in global production and marketing of dairy products and ingredients.

- Limitations on payments to larger producers under the new direct payment program discriminate against the most efficient industry segments and thereby discourage adjustment to change.

Implications

Because of this resistance to change, it is very important that policy makers answer the following questions as a part of the decision process:

- What are the goals that the policy/program changes are designed to serve? How are the various policy/program goals affected by the change? How does the achievement of a goal in one sector affect another?
- Are the policy options being considered designed to serve the vested interests of a static industry? Will they facilitate adjustment and foster a dynamically competitive dairy sector? It is important to note that while technological change traditionally has played a very important role in the dairy industry, it rarely appears on any list of policy goals. While advisory reports to the Secretary, such as the Nourse report or the more recent University Study Committee on Order Reform, clearly indicated the importance of technological change as an influencing factor on policy, program changes are seldom made to facilitate dynamic changes within the dairy industry—largely because of the resistance posed by vested interests who oppose change. The role of AAA and AMAA, and therefore, the responsibility of the Secretary is to rise above these vested interests. Programs that might posit efficiency as their primary goal are often criticized for ignoring other social objectives, such as preserving family farms or preventing environmental degradation. The issue of efficiency versus other social goals is at

the heart of many policy/program conflicts. It is riddled with value judgments and requires careful attention by policy decision makers.

- Will the policy options being considered benefit the entire whole industry or only one segment to the detriment of another? Increasingly, policy options and program proposals are pitting farmers against farmers. Historically, farmers were pitted against processors—even particular processor segments. Either instance needs to be carefully scrutinized in the FMMO decision process.

How are these questions to be answered in a political/adversarial environment where, in the case of FMMOs, decisions must be made on the basis of a hearing record? The following remedies need to be carefully discussed and considered:

- In preparation for the 2002 farm bill, Chairman Combest instituted a policy of requiring that all witnesses address certain questions as a condition for testifying. A similar procedure should be developed and installed for proposals for hearings and required of witnesses in FMMO hearings. Specific questions to be addressed for each individual proposal and in the aggregate include:

  1. How does the proposal foster orderly marketing?
  2. How does the proposal facilitate adjustment to changes occurring within the industry?
  3. How does the proposal serve the interests of both producers and consumers?
  4. How is the proposal in the public interest?
  5. How will the proposal affect and avoid unreasonable fluctuation in production, consumption, and prices?

- USDA should install a public analyst/witness in hearings to assure that all of the above questions are addressed in an objective manner as part of the hearing record. This witness should appear early in the hearing process, perhaps as the first witness.
- USDA should, in its decision, address each of the above questions.
- Land grant universities should be encouraged by USDA and the industry to provide training on the role of dairy institutions, the economics of dairy markets, and the role of dairy regulations. USDA should require that directors of FMMO qualified cooperatives receive such training.

In closing, the author is well aware that the USDA is not always the final judge of what FMMO provisions are best for the dairy industry. Congress has had a propensity to substitute its judgment for that of the Secretary. While it may be considered presumptuous to suggest that the Congress apply the procedures proposed by Congressman Combest to its decisions, restraint in preempting reasoned decisions by the Secretary is certainly in order.

Appendix
Title 7, Chapter 26 – Agricultural Adjustment
Subchapter I – Declaration of Conditions and Policy
Section 602
It is declared to be to be the policy of Congress –

(1) Through the exercise of the powers conferred upon the Secretary of Agriculture under this Chapter, to establish and maintain such orderly marketing conditions for agricultural commodities as will establish and maintain such orderly marketing conditions for agricultural commodities in interstate commerce as will establish, as the prices to farmers, parity prices as defined by section 1301 (a) (1) of this title

(2) To protect the interest of the consumer by (a) Approaching the level of prices which is declared to be the policy of the Congress to establish in subsection (1) of this section by gradual correction of the current level at as rapid a rate as the Secretary of Agriculture deems to be in the public interest and feasible in view of the current consumptive demand in domestic and foreign markets, and (b) authorizing no action under this chapter which for the maintenance of prices to farmers above the level which it is declared to be the policy of Congress to establish in subsection (1) of this section.

(3) Through the exercise of the powers conferred upon the Secretary of Agriculture under this chapter, to establish and maintain such production research, marketing research, and development projects provided in section 608c(6) (I) of this title, such container and pack requirements provided in section 608c(6) (H) of this title such minimum standards of quality and maturity and such grading and inspection requirements for agricultural commodities enumerated in section 608c (2) of this title, other than milk and its products, in interstate commerce as will effectuate such orderly marketing of such agricultural commodities as will be in the public interest.

(4) Through the exercise of the powers conferred upon the Secretary of Agriculture under this chapter, to continue for the remainder of any marketing season or marketing year, such regulation pursuant to any order as will tend to avoid a disruption of the orderly marketing of any commodity and be in the public interest, if the regulation of such commodity under such order has been initiated during such marketing season or marketing year on the basis of its need to effectuate the policy of this chapter.

Title 7—Agriculture
Chapter 26—Agricultural Adjustment
Subchapter III—Commodity Benefits
Sec. 608c. Orders regulating handling of commodity
(1) Issuance by Secretary

The Secretary of Agriculture shall, subject to the provisions of this section, issue, and from time to time amend, orders applicable to processors, associations of producers, and others engaged in the handling of any agricultural commodity or product thereof specified in subsection (2) of this section. Such persons are referred to in this chapter as "handlers." Such orders shall regulate, in the manner hereinafter in this section provided, only such handling of such agricultural commodity, or product thereof, as is in the current of interstate or foreign commerce, or which directly burdens, obstructs, or affects, interstate or foreign commerce in such commodity or product thereof. . . .

(3) Notice and hearing

Whenever the Secretary of Agriculture has reason to believe that the issuance of an order will tend to effectuate the declared policy of this chapter with respect to any commodity or product thereof specified in subsection (2) of this section, he shall give due notice of and an opportunity for a hearing upon a proposed order.

(4) Finding and issuance of order

After such notice and opportunity for hearing, the Secretary of Agriculture shall issue an order if he finds, and sets forth in such order, upon the evidence introduced at such hearing (in addition to such other findings as may be specifically required by this section) that the issuance of such order and all of the terms and conditions thereof will tend to effectuate the declared policy of this chapter with respect to such commodity.

(5) Milk and its products; terms and conditions of orders

In the case of milk and its products, orders issued pursuant to this section shall contain one or more of the following terms and conditions, and (except as provided in subsection (7) of this section) no others:. . . .

(18) Milk prices

The Secretary of Agriculture, prior to prescribing any term in any marketing agreement or order, or amendment thereto, relating to milk or its products, if such term is to fix minimum prices to be paid to producers or associations of producers, or prior to modifying the price fixed in any such term, shall ascertain the parity prices of such commodities. The prices which it is declared to be the policy of Congress to establish in section 602 of this title shall, for the purposes of such agreement, order, or amendment, be adjusted to reflect the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk or its products in the marketing area to which the contemplated marketing agreement, order, or amendment relates. Whenever the Secretary finds, upon the basis of the evidence adduced at the hearing required by section 608b of this title or this section, as the case may be, that the parity prices of such commodities are not reasonable in view of the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk and its products in the marketing area to which the contemplated agreement, order, or amendment relates, he shall fix such prices as he finds will reflect such factors, insure a sufficient quantity of pure and wholesome milk to meet current needs and further to assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest.