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**Options for Changing Milk
Marketing Orders**

Statement of
Brian P. Crowley, Senior Associate Director
Resources, Community, and Economic
Development Division

Before the
Senate Committee on Agriculture, Nutrition,
and Forestry
United States Senate



Crowley 135766

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our recently issued report entitled Milk Marketing Orders: Options For Change (GAO/RCED-88-9). This is one of a series of reports that we have issued on federal dairy programs in recent years in response to continuing congressional interest and a desire to solve the dairy surplus problem.

As you know, since the federal government became involved in the dairy industry over 50 years ago, a major objective of its dairy policies has been to ensure an adequate supply of milk. Two programs, milk marketing orders and price supports, which were established to carry out federal policies, have been so successful that the dairy industry has consistently produced considerably more milk and other dairy products than consumers will buy at prevailing prices.

Marketing orders regulate the marketing of milk in those areas of the country where producers have voluntarily adopted them. Orders, which are supervised by the U.S. Department of Agriculture (USDA), set forth marketing practices, terms and conditions of sale; minimum prices that must be paid by handlers; and distribution of returns among producers. Orders apply only to grade A milk, which is produced to specific sanitary standards and is eligible for fluid consumption, regardless of end use. The majority of milk produced in this country is used for manufactured dairy products, even though most milk produced is grade A.

In summary we believe that the federal milk marketing order system should be changed because its pricing provisions have contributed to excess production of milk and because it treats some producers unfavorably compared with others.

Further, the premises for milk pricing under federal orders are outdated. We no longer need to encourage and maintain a locally produced supply of milk adequate to meet all local demands at all times. Milk is produced in all regions of the country and technologies are available to transfer it, either in fluid form or in a form later to be reconstituted as fluid, should local shortages develop. Further, recent increases in dairy productivity and emerging technologies have the potential to greatly increase milk output per cow while reducing production costs. These advances will further increase dairy surpluses.

We concluded that two basic strategies for changing federal milk marketing orders could be pursued. One strategy involves establishing programs that control production, and the other involves program changes that would lessen government influence on milk prices to permit market forces to play a greater role.

Before we get into these strategies, let me discuss order pricing policies, and their effects on both national and regional production patterns, as well as their impact on government purchases.

ORDER PRICING POLICIES

First I would like to address milk marketing order pricing policies. A uniform pricing system exists under milk marketing orders, based on competitive prices paid for milk by selected manufacturing plants in Minnesota and Wisconsin. These prices are the basis for all prices paid to farmers delivering milk to plants regulated by federal orders east of the Rocky Mountains. Milk marketed west of the Rockies is influenced by prices in California, which has its own milk pricing regulations and is not covered by federal orders.

Fluid milk prices under federal orders have two components in addition to the Minnesota-Wisconsin price which applies to milk used for manufacturing. One, a grade A differential, is a \$1.04 per hundredweight (cwt) incentive to encourage farmers to upgrade their facilities to meet higher grade A sanitary standards. The other component, a distance differential, increases the guaranteed price for milk used for fluid consumption and is generally based on the distance a plant is from the Eau Claire, Wisconsin, basing point.

These pricing policies are not based on current dairy market conditions. First, the grade A differential is far higher than the added cost of producing grade A milk instead of grade B milk. The added cost may be no more than 15 cents per cwt, compared with the existing differential of \$1.04. Further, about 88 percent of all milk produced in this country is grade A, far more than is needed for fluid milk markets.

Distance differentials were set up to make it profitable to transport milk from surplus to deficit areas. Although designed to provide incentives for Upper Midwest producers to transport milk to other regions, distance differentials increased the incentive to produce milk in areas distant from the Eau Claire basing point. This led to surpluses in many regions, at the expense of producers in other regions, with the additional price incentive bearing no relationship either to the cost of production or to the cost of obtaining an alternative source of supply.

Down allocations and compensatory payments are other marketing order provisions that are designed to economically discourage the shipment of surplus milk from one market area to another, unless there is a deficit. They effectively prohibit the use of reconstituted milk, which is a more efficient means for moving milk between distant locations. These provisions foster local

production of milk by protecting local producers from the competitive advantages of reconstituted milk.

EFFECT ON PRODUCTION PATTERNS

Next, I would like to discuss the effect of milk marketing orders on national production. National milk production increased 15 percent between the 1977-79 period and the 1984-86 period. While we recognize that price supports have played a major role in increased production, we believe that the economic incentives provided by the milk marketing orders, primarily through the grade A and distance differentials, contributed to this increase in production. At any given support price, federal orders add a price differential that encourages additional milk production. However, as a result of the supply-demand adjuster provisions in the Food Security Act of 1985, any increases in production that could result in annual federal purchases of surplus production in excess of 5 billion pounds now trigger a downward support price adjustment.

This brings me to the effect of marketing orders on regional production patterns. Distance differentials provide production incentives in all regions of the country, except the Upper Midwest. These differentials were increased by the Food Security Act of 1985. The greater these differentials, the greater the production incentives and therefore the more likely that surpluses will rise high enough to cause the support price to fall. A combination of higher differentials and lower support prices can have a particularly adverse impact upon traditional milk-producing regions of the Upper Midwest, which receive little or no benefit from the differentials, but which would be hurt by declines in the support price.

Traditionally, the Upper Midwest and the Northeast have been the major milk-producing areas. Since the late 1960s, there has been a

significant trend toward increased production in all areas of the United States but predominantly in the Northwest, Southwest, and Southern Plains. Data are not available to determine whether this increased production is solely attributable to the pricing policies of milk marketing orders; however, the correlation between profitability and increases in production is relatively consistent.

The regions with the greatest rate of increase in milk production between the 1977-79 period and the 1984-86 period were the Northwest, with a 38-percent increase, the Southwest, with a 35-percent increase, and the Southern Plains, with a 25-percent increase. These regions also experienced the highest average profit between 1977 and 1986 and also have higher differentials because of their distance from the Upper Midwest. The Corn Belt and the Southeast had only minor increases in production. However, the Southeast, with the highest differentials, has increased production even though it has a relatively high cost of production.

GOVERNMENT PURCHASES OF SURPLUS MILK

While government purchases of surplus production under the price support program have also been occurring in all regions of the United States, the rate of increase in some regions has been greater than in others. The Northwest, the Southern Plains, and the Western Plains had the greatest rate of change. The correlation pattern between profitability, influenced by the higher distance differentials, and rate of change in milk production also carries over to the rate of change in government purchases. For example, the Northwest, the Southern Plains and the Southwest, with an average profit from 1977 to 1986 of \$2.96, \$2.59 And \$2.96 per cwt, respectively, show increases in sales to the government of 695 percent, 4,227 percent and 262 percent, respectively.

Normally, increases in government purchases would be expected to occur in regions with high production and low fluid use patterns, such as the Upper Midwest. However, because guaranteed prices under milk marketing orders provide increased incentives to produce milk as the distance increases from the Upper Midwest, all areas have increased production, so that the government has purchased surplus manufactured dairy products from all regions. This relationship is especially evident from the increase in the rate of change in the purchases in those regions having high milk prices relative to the cost of production, such as the Northwest, the Southwest and the Southern Plains.

Recent technological advances in dairy production threaten to further aggravate the milk surplus situation. According to a 1986 office of technology assessment report, milk production per cow could double by the year 2000. Further adoption of technology such as artificial insemination, embryo transfer, and bovine growth hormone promises increased herd productivity.

OPTIONS FOR CHANGE

Because of our findings, we analyzed various options for changing federal milk marketing orders. These options were suggested by various industry representatives or were discussed in literature we reviewed for our study. The specific options we analyzed were to

- eliminate the grade A differential;
- eliminate distance differentials;
- establish more basing points;
- eliminate down allocations and compensatory payments;
- establish transportation pools;

- establish a standby pool;
- establish marketwide service payments;
- establish regional orders;
- establish a national order;
- establish marketing quotas;
- eliminate order pricing provisions, but retain order supervision; and
- eliminate orders entirely.

We then evaluated how the adoption of each of these options would affect various federal dairy program goals. These goals relate to producer receipts, the orderliness of milk marketing, the level of national milk production, the local supply of milk, and consumer prices.

Our analysis showed, for example, that eliminating distance differentials would most likely reduce national production in the short run. Because this change would almost certainly lower the price that producers receive, producers could be expected to reduce production. This option would also reduce the incentive to rely on local supply. The greatest reduction of milk production would occur in markets that are distant from Eau Claire.

After our analysis we concluded that two basic strategies are available for changing the federal milk marketing order system--adopting production controls or lessening government influence on milk prices.

If production controls were chosen, some industry sources have suggested the option of a marketing quota system. Such a system would limit the quantity of milk that could be marketed at a given price by each producer as well as in total. Quotas could reduce national production, but have numerous drawbacks. Accordingly, we do not prefer a production control strategy.

We prefer the second strategy of lessening government influence on milk prices so that market forces can play a greater role. Overall, with about 88 percent of milk production classified as grade A, improved transportation, and new technology on the horizon, extensive government regulation of fluid milk markets is needed less than in the past. A number of possible options for decreasing government influence are available. These options include establishing more basing points and eliminating the grade A differential, distance differentials, and down allocations and compensatory payments. Other options include eliminating order pricing provisions while retaining order supervision, and eliminating orders themselves.

All of these options would reduce the influence of marketing orders on regional production patterns and would have varying effects on consumer prices and market orderliness. National production would also fall, but such decline may be offset if the supply-demand adjuster causes the support price to rise. Although any or all of these options could be adopted, the steps should be made incrementally to allow time for the dairy industry to adjust and for the government to monitor such adjustments to ensure that unanticipated adverse effects do not occur.

The sequence of steps to change the system might be

- first establish new basing points in various regions of the United States to minimize the influence on regional production patterns;

- then assess the impact of that change;
- next, remove down allocation and compensatory payment provisions to make reconstituted milk competitive;
- again assess the impact; and finally
- eliminate the grade A and distance differentials in federal orders.

With these changes, the price support level, as set by the adjuster provision in the Food Security Act of 1985 and competitive market forces, would play a larger role in setting prices paid to producers. Elimination of the pricing provisions would also lessen the likelihood that the support price supply-demand adjuster would trigger price reductions in the future. The above steps would eliminate the pricing aspects of orders, but supervision would still exist. If appropriate, the next step could be to eliminate orders completely.

We believe that the best way to accomplish changes in the milk marketing order program is through the Congress. Therefore, we suggest that the Congress consider establishing the goal of decreasing the federal role in milk pricing, and working with USDA to develop and adopt legislation necessary to accomplish that goal. If this is done, the Congress also should direct the Secretary of Agriculture to (1) monitor the conditions in the industry that result from changes to pricing policies and (2) act, if necessary, to help the industry adjust.

Mr. Chairman, that concludes my statement. We will be glad to answer your questions.