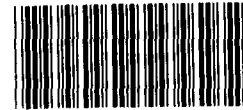


GAO

Testimony



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Federal Dairy Programs

**Insights Into Past Provide
Perspective for the Future**

Statement of
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Resources, Community, and Economic
Development Division

Before the Subcommittee on Livestock,
Dairy, and Poultry
Committee on Agriculture
House of Representatives



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Mr. Chairman:

I am pleased to be here today to discuss the implications of current dairy policy. As consideration begins on the 1990 farm bill, one needs only to reflect on changes that occurred to the dairy industry in the 1980s to understand the dynamics of that industry since the 1930s--the beginning of federal efforts to promote stable dairy markets, ensure adequate supplies, stabilize prices, and improve farmer income. The 1980s began with such excessive milk production that large government purchases of dairy products were required, costing the taxpayers about \$17.2 billion during that decade. In fact, the inventory of these products was so large that the federal government had difficulty giving them away. However, as the 1980s ended and the 1990s have begun, federal dairy surpluses of cheese and non-fat dry milk have declined to such an extent that traditional donation programs have little or no dairy products for donation. In addition, while consumer prices for retail dairy products rose an average of 2 percent annually in the mid- and late 1980s they increased by 6 percent in 1989.

As you requested, I plan to discuss (1) how the dairy industry has changed since the federal government first enacted specific dairy legislation during the 1930s, (2) the evolution of federal involvement in the dairy industry, and (3) how federal programs, according to our analyses, have affected milk supplies.

In summary, the dairy industry has changed significantly in the over 50 years of federal involvement. For example, while the numbers of cows and farms have declined substantially, milk production has increased. These production increases have contributed to changes in federal involvement in the industry. Initially, the government became involved when low milk prices appeared to threaten the adequacy of the nation's milk supply. Federal actions were therefore intended to stabilize milk prices and encourage milk production. Over time, the federal milk programs--milk marketing orders and price supports--contributed to market distortions; creating incentives for periodic surpluses by encouraging more milk to be produced than could be marketed at resulting prices. Consequently, government actions during the 1980s, including price support reductions, were directed at curbing milk production. However, those actions that paid farmers to reduce production or stop dairy farming have achieved only temporary success. Accordingly, we have continued to encourage changes that, over the long term, would provide more permanent solutions to periodic surplus problems, make dairy programs more market-oriented, and reduce the federal role in the dairy industry.

BACKGROUND

The objectives of the federal dairy policy over the years have been to support farmers' prices and incomes, expand consumption, ensure an adequate supply of good quality milk, and stabilize dairy

prices and markets. The policy is carried out principally through two programs--the milk marketing order program, created in 1937, and a price support program, created in 1949.

To meet the objectives of promoting stable markets, ensuring adequate supplies, stabilizing prices, and improving farmer income, marketing orders set forth marketing practices, terms and conditions of sale, minimum prices that must be paid by dairy plants, and the distribution of financial returns among farmers.

Under the price support program, the U.S. Department of Agriculture purchases, at designated prices, all quantities of butter, cheese, and nonfat dry milk that cannot be used commercially. The program stabilizes milk prices by, in effect, guaranteeing a minimum price for any amount of dairy product that can be produced. Federal outlays for the program are dependent upon the extent to which milk production exceeds commercial use and the support price. The more that production exceeds use, the more surplus products the government buys and the greater the cost to the government.

OUR ANALYSIS

I would now like to focus my testimony on changes that have occurred over the last 60 years in the dairy industry, federal

efforts to legislatively manage milk production, and our past analyses of how federal programs affected dairy surpluses.

Dairy Industry Has Changed

While the basic legislation has remained relatively unchanged, the efficiency of milk production has increased. Annual milk production per cow has grown from about 4,500 pounds in 1930 to about 14,200 pounds in 1988. These gains have largely been a result of advances in technology, better management, and improved breeding.

These gains in production have more than compensated for decreases in both the number of dairy cows and farms. Between 1930 and 1988, the number of cows declined from 22.2 million to 10.2 million, and the number of dairy farms decreased from about 4.5 million to about 220,000. The average herd size in that period increased from 5 to 46.

The Upper Midwest continues to be the major milk producing area, representing about 28 percent of U.S. milk production in 1988. Although its share of total milk production has not changed significantly since 1970, the shares of some other regions have. The Southwest, for example, has increased its percentage of U.S. milk production by 60 percent, to 14.9 percent of the 1988 national

milk production, while the Corn Belt's share has declined by about 20 percent.

Changes in Focus of Federal Involvement

Federal involvement in the dairy industry began in the 1930s when low milk prices were perceived to threaten the nation's milk supply. Both the marketing order and price support programs were created to stabilize prices for the farmer and help ensure an adequate supply of milk. From the 1930s through the 1970s, the two programs were changed generally to support incomes for the farmer by increasing the price support level and establishing a national pricing system.

During the late 1970s and early 1980s, farmers began to produce milk at unprecedented levels. Because the market was unable to absorb the additional production, annual purchases under the price support program dramatically increased from \$251 million in 1979 to \$2.6 billion in 1983. This led to actions in 1981 and 1983 that were intended to control the surplus, in part, through the price support program. Another action, the Milk Diversion Program, in 1984, paid farmers to reduce the amount of milk they marketed for a 15-month period. In 1985, the Congress (1) instituted a "supply/demand adjuster," which--for a limited number of years--automatically reduced price supports if surpluses were projected to exceed certain levels, and (2) authorized the Dairy

Termination Program, which paid farmers to slaughter or export their entire herds and leave dairying for 5 years. Because the 1988 drought increased feed prices, the Congress passed legislation to suspend use of the automatic supply/demand adjuster in 1989.

GAO Analyses Support Less Federal Involvement in Dairy Programs

Over the last 10 years, we have reported (see attached list of related products) that the milk marketing order and price support programs have contributed to periodic surpluses by creating incentives to produce more milk than can be marketed. We found that the guaranteed purchase of all production and the consistent increases in price supports during the 1970s--from \$9.00 per hundredweight of milk in 1977 to \$13.10 per hundredweight of milk in 1980--created incentives for farmers to continue to increase milk production despite accumulating dairy surpluses.

The pricing policies established by milk marketing orders were intended to encourage and maintain a locally produced supply of milk. These policies can no longer be justified for this reason; grade A milk is now produced in all regions of the country and technologies are available to transfer it between regions as needed. As such, milk marketing orders provide incentives, in addition to those provided by the price support program, to produce milk.

Milk marketing orders created incentives for excessive production because the fluid milk prices under certain orders were artificially high. Under marketing orders, the grade A differential is higher than the added cost of producing grade A milk (only grade A can be used for fluid consumption) instead of grade B milk (used only for manufacturing dairy products). About 88 percent of all milk produced in this country is grade A, far more than is needed for fluid milk markets.

Other marketing order provisions (called down allocations and compensatory payments) are designed to economically discourage the shipment of reconstituted milk, which is a more efficient means for moving milk between distant locations.

In addition, marketing order distance differentials that were originally intended to make it profitable to transport milk into deficit areas have, in fact, created regional inequities. Distance differentials provide production incentives in all regions of the country, except the Upper Midwest. The greater these differentials, the greater the production incentives. These incentives have been partly responsible for the increase in milk production in some regions of the county.

Further, as production increases nationally, the more likely it is that surpluses will rise high enough to cause the support price to fall, if the supply/demand adjuster is retained. A

combination of higher differentials and lower support prices can have a particularly adverse impact upon the traditional milk-producing region of the Upper Midwest, which receives little or no benefit from the differentials but which would be hurt by declines in the support price.

Efforts to reduce milk surpluses, under the milk diversion and dairy termination programs, have achieved only temporary success. For example, we estimated that the milk diversion program reduced production by about 4 billion pounds in 1984 and could have saved up to \$664 million. We also estimated that from 1986 through 1990, the dairy termination program would reduce milk production by 39.4 billion pounds and save the government about \$2.4 billion. While these figures may sound impressive, the estimates of annual milk reductions attributable to the dairy termination program declined each year after 1987, indicating the program would have no lasting effect on milk production. However, unlike the temporary impact of these programs, price-support reductions have a permanent impact.

CONCLUSIONS

While short-term solutions have addressed the periodic surpluses, we believe that a long-term, permanent solution is needed. We have recommended to the Congress that it adopt changes in dairy programs that would make them more market-oriented,

reducing the federal role in the dairy industry.¹ Accordingly, in regard to the price support program, we recommended that the Congress continue to use a supply/demand adjuster, tied to a relatively low level of expected surpluses, to set price support levels. In regard to milk marketing orders, we recommended that the Congress gradually decrease the federal role in milk pricing through a series of steps that better reflect regional cost-of-production differences, allow freer movement of milk between regions, and eliminate features of milk pricing that distort regional production patterns.

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This concludes my formal testimony. I would be happy to answer your questions.

¹Federal Dairy Programs: Insights Into Their Past Provide Perspectives on Their Future (GAO/RCED-90-88, Feb 28, 1990).

RELATED GAO PRODUCTS

Federal Dairy Programs: Insights Into Their Past Provide Perspectives on Their Future (GAO/RCED-90-88, Feb. 28, 1990).

Dairy Imports: Issues Related to Chocolate Products (GAO/RCED-89-159BR, July 18, 1989).

Milk Pricing: New Method for Setting Farm Milk Prices Needs to Be Developed (GAO/RCED-90-8, Nov. 3, 1989).

Dairy Termination Program: An Estimate of Its Impact and Cost-Effectiveness (GAO/RCED-89-96, July 6, 1989).

California Dairy: Production, Sales, and Product Disposition (GAO/RCED-88-180FS, June 15, 1988).

Dairy Termination Program: A Perspective on Its Participants and Milk Production (GAO/RCED-88-157, May 31, 1988).

Milk Marketing Orders: Options for Change (GAO/RCED-88-9, Mar. 21, 1988).

Farm Programs: An Overview of Price and Income Support and Storage Programs (GAO/RCED-88-84BR, Feb. 29, 1988).

Federally Owned Dairy Products: Inventories and Distributions, Fiscal Years 1982-88 (GAO/RCED-88-108FS, Feb. 23, 1988).

Surplus Commodities: Temporary Emergency Food Assistance Program's Operations and Continuance (GAO/RCED-88-11, Oct. 19, 1987).

Food Inventories: Inventory Management of Federally Owned and Donated Surplus Foods (GAO/RCED-86-11, Dec. 5, 1985).

Overview of the Dairy Surplus Issue--Policy Options for Congressional Consideration (GAO/RCED-85-132, Sept. 18, 1985).

Effects and Administration of the 1984 Milk Diversion Program (GAO/RCED-85-126, July 29, 1985).

Government-Owned Surplus Dairy Products Held in Inventory (GAO/RCED-85-43, Jan. 7, 1985).

Improved Administration of Special Surplus Dairy Product Distribution Program Needed (GAO/RCED-84-58, Mar. 14, 1984).

Savings Are Possible Through Better Management of Government-Owned Dairy Products (GAO/CED-82-79, May 18, 1982).

Alternatives to Reduce Dairy Surpluses (CED-80-88, July 21, 1980).