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FEDERAL DAIRY PROGRAMS

Dairy Inventory Management Alternatives

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

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our views on alternatives studied by USDA to address the dairy inventory management problems. As you are aware, in 1990 the farm price of milk dropped significantly, resulting in adverse financial impacts on farmers. This drop in farm milk prices is partly attributed to a surplus in dairy production and inventories. The Food, Agriculture, Conservation and Trade Act of 1990 required USDA to study dairy inventory management alternatives as a solution to surplus production and lower producer income. Our testimony today is based on a limited review of USDA's study and the work we have done over the years evaluating dairy programs.

In summary, any evaluation of changes in the U.S. dairy program should be viewed in light of the long-term objectives for this program. Over the years, our work has suggested the need to make the dairy industry more market-oriented. Making dairy production more responsive to market forces could provide a more permanent solution to the periodic dairy surpluses as well as reduce the federal role in this industry. We do not believe, however, that any one of the alternative programs as described in the USDA's study would completely achieve this market-oriented goal for a variety of reasons. For example, some of these programs would increase export subsidies and others would require the use of production or marketing quotas.

Before providing our specific comments on the dairy alternatives studied by USDA, let me briefly provide a historical perspective of the U.S. dairy program.

HISTORICAL PERSPECTIVE

The relatively high federal price support levels during the late 1970s and early 1980s contributed to unprecedented milk production. Under the price support program, USDA purchases, at designated prices, all quantities of butter, cheese, and nonfat dry milk that are not purchased commercially. Because the commercial market did not absorb the surplus production, annual federal purchases under the price support program dramatically increased from $251 million in 1979 to $2.6 billion in 1983. Consequently, the Congress took a series of actions during the 1980s to reduce production and thus reduce government purchases of surplus dairy products. In 1983, the government reduced the amount it would pay for surplus dairy products. In 1984 the government established the Milk Diversion Program which paid farmers to reduce the amount of milk they sold over a 15-month period. In 1985 the Congress (1) instituted a "supply/demand adjuster," which would--until 1991--automatically reduce the price support level if surplus purchases were projected to exceed a certain level in any one year, and (2) authorized the Dairy Termination Program, which paid farmers to slaughter or export their entire herds and leave dairying for 5 years. While the 1990 farm bill reauthorized the supply/demand adjuster, unlike the 1985 version, it restricted the level to which the support price could fall, thus limiting its value in controlling surpluses. We issued reports on the Milk Diversion Program and the Dairy Termination Program and concluded that as designed and implemented, they were successful over the short-term but were not permanent solutions to the dairy surplus problem.

Because the Dairy Termination and Dairy Diversion Programs were not permanent solutions, the surplus problem persisted until 1989, when the extended consequences of the 1988 drought resulted in a temporary production short fall. By 1990, however, production had returned to predrought levels and large surpluses again began to appear.

Government purchases and stocks of dairy products have also been increasing. As of March 1, 1991, government stocks of dairy products stood at 9.9 billion pounds of milk equivalent, a high level compared to levels during the late 1980s, and up about 80 percent from 1990. This stock level represents about 75 percent of the level in 1983, when it reached a record high. Therefore, even though the milk diversion program and the dairy termination program helped to reduce the dairy surplus problem for the short term, today we are still faced with overproduction and excess capacity.

GAO'S COMMENTS ON DAIRY INVENTORY MANAGEMENT ALTERNATIVES

The Act required USDA to study two dairy inventory management programs--target price/deficiency payments and milk reclassification. The act also required USDA to solicit proposals from the dairy industry and the public, and based on that input, USDA included two additional programs in its study--two tier pricing and milk diversion. The act prohibited USDA from evaluating the effect of a reduction in the government support price or another Dairy Termination Program. We did not make a detailed evaluation of the USDA study and its methodology.

Target Price-Deficiency Payment Program

A target price-deficiency payment program can be used to raise farmer incomes while allowing farm prices to be competitive in the market place. Each year the government would establish a target price but if market prices fall below the target price, the producer would receive a deficiency payment from the government. Producers are generally eligible to receive deficiency payments if they agree to limit their production to a level determined by the government. The government would manage the level of dairy production by determining the amount each program participant could produce.

USDA studied four target price/deficiency payment program scenarios. In one scenario there were no production limitations on producers and the study showed that average government costs were more than six times higher ($3.2 billion per year) than expected under a continuation of current programs. In the other three scenarios, production limitations were used to contain government cost at about the same level as expected under current programs. Government purchases of surplus dairy products are lower under all alternatives analyzed.

The level of government expenditures required for deficiency payments would depend on the established target price, market demand for dairy products, and the level of producer participation in the program. If the target price was set substantially above the expected market price, deficiency payments would be large. Further, inadequate production limitations could also make total deficiency payments large.

Reclassification Program

A reclassification program, would create a new use category, Class IV, for milk that is in excess of the needs of the domestic commercial market. Under one USDA alternative, the reclassification program was designed to export surplus milk products by setting guaranteed prices for milk used in surplus products equal to the world price. In other alternatives, the government would purchase the surplus dairy products. The objective of a reclassification program is to establish an outlet for excess milk production.

In the USDA analysis, the effect of a Class IV program on government outlays depends primarily on the level of prices and selling opportunities for surplus products. Two alternatives in USDA's analysis showed average government costs to be lower than expected if current programs are continued. However, another alternative included in the analysis that assumed a price support level of $13.10 ($3.00 higher than the current level), showed government costs more than doubled from levels anticipated under present programs.

Although one of the reclassification alternatives studied by USDA showed that it could lead to significantly lower government costs, subsidies inherent in this program would appear to conflict with the position the U.S. has taken in international trade negotiations that commodity subsidies should be reduced.

Two Tier Pricing Programs

Two-tier pricing involves establishing a national marketing quota for the amount of milk each producer could market at a price established by the government. Producers receive one price for milk marketed within their quota and a lower price is received for milk marketed in excess of their quota. The reduced price is used as a tool to discourage excess production. The marketing quota could be set based on a producer's historic production level.

USDA, in its study, made several assumptions and analyzed several alternatives for implementing a two-tier pricing program. The results of its analysis showed that average annual government costs for fiscal years 1992 to 1997 would range from $362 million to $499 million--somewhat less than the $522 million level expected under the continuation of current programs.

In our past reports on dairy programs, we generally have expressed concerns about marketing quotas. Quotas are not very responsive to market forces because they do no provide an incentive to reduce overall production costs. While there are always some incentives for farmers to reduce costs as a means of increasing profit, quotas tend to limit the amount of product that can be profitably marketed and therefore place constraints on farmers' abil'ity to expand output and reduce costs per unit of output.

Also, because quotas have to be acquired and can increase in value, they tend to create barriers to entry for future dairy farmers or those wishing to move where milk can be produced more efficiently.

While we have not discussed the international trade issue in our past reports on dairy matters, we agree with USDA's observation that, when milk production quotas are established on the basis of expected domestic commercial use only, and not on export opportunities, two-tier pricing is one of the least export-oriented of any of the proposals USDA studied. Import protection would be needed to prevent the domestic price from being undercut by imports. With milk prices no more competitive than under the current programs, and supply availabilities limited, two-tier pricing would limit the ability of the U.S. dairy industry to take greater advantage of current or future dairy export opportunities.

Milk Diversion Program

A milk diversion program provides payments to dairy producers in return for voluntary reduction in production. A production level is established for each program participant. The cost of the diversion program is funded by assessments, which can be levied either against all producers or only on participating producers. The cost to the government can be at least partially controlled through the assessment process. The higher the assessment, the more of the cost is borne by consumers and producers, and the less the cost to the government and the taxpayer.

USDA, in its study, estimated the government's cost could range from $472 to $500 million depending on the amount of production to be reduced, support prices, and other factors.

The Dairy Production and Stabilization Act of 1983 (Public Law 98-180, Nov. 29, 1983) established a milk diversion program for a 15 month period ending March 31, 1985. Our analyses of that program indicated it was effective--in the short term--in reducing surplus production and USDA purchase and storage costs. However, once the program ended, milk production increased. We believe that the relatively short term effects of the 1984-1985 program may have been due to the rather short statutory life of the program and that the program didn't require a reduction in production capacity.

TRANSITIONAL PROGRAM MAY BE NEEDED

We have suggested market-oriented solutions to address dairy management issues. While we continue to support the use of a supply-demand adjuster like the one adopted in the 1985 farm bill, a transitional program may be needed to facilitate the adjustment process to a more market-oriented industry.

Although it was not included as a part of USDA's study, such a support price adjuster would make milk prices more responsive to market forces, thus more closely balancing production and utilization. However, past price support decreases have been insufficient to preclude large surpluses because prices have not been allowed to fall to a sufficiently low enough level to discourage over production. Consequently, government purchases of surplus dairy products have been increasing. Further, the price floor in the 1990 farm bill restricts the ability of the support price to fall when necessary to reduce incentives for producing milk.

In our past reports, we have pointed out that substantial industry instability and adverse financial impact on some dairy farmers and dairy plants may result from a move to a more market-oriented program. To help the adjustment process, a transitional program designed to reduce dairy production capacity may be needed. All the programs studied have drawbacks in terms of the way they could affect the market. However, of the programs studied, a temporary milk diversion program with some modifications regarding program design, timing of implementation and duration, in our opinion, seems to offer the most potential as a transitional program to help the industry adjust.

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

RELATED GAO PRODUCTS

International Trade: Export Enhancement Program's Recent Changes and Future Role (GAO/NSIAD-90-204, June 14, 1990)

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

International Trade: Activity Under the Export Enhancement Program (GAO/NSIAD-90-59FS)

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).

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).

International Trade: Implementation of the Agricultural Export Enhancement Program (GAO/NSIAD-87-74BR, Mar. 17, 1987)

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).

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

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