

Cato Institute Policy Analysis No. 14: Dairy Price Supports: Still Milking the Public

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Executive Summary

Last December it seemed a safe enough observation that the dairy lobby was the biggest loser when the Agriculture and Food Act of 1981 was approved by two votes in the House after earlier passing the Senate by the far more comfortable margin of 65-31.[1]

It is not uncommon, however, for a legislative victory to dissolve before the victor has a chance to savor it. The Reagan administration discovered this anew in May 1982 when it admitted that despite its successful efforts in the 1981 Farm Bill to keep dairy price support levels from rising, the continuing overproduction of dairy products for 1982 was expected to cost the government a record high \$1.94 billion. Or as Agriculture Secretary John Block put it in his press conference in May, American taxpayers were being charged at the rate of \$250,000 an hour to pay for surplus dairy products which American consumers were unwilling to purchase voluntarily.[2]

As a consequence, Block asked Congress to give him the authority to reduce dairy price supports in 1982 by as much as \$1.10 per hundred pounds (cwt.) from the current level of \$13.10 per cwt., which would be frozen at that level for the rest of the year. This is far more than the Reagan administration ever asked for in the 1981 Farm Bill, let alone the compromise to which it eventually agreed.

Even so, although already a failure at reducing the cost to the government for subsidizing dairy farmers, the 1981 Farm Bill may have a long-range impact. What happened in 1981 was that for the first time since the program began in the 1940s, milk price supports were severed from any connection with "parity," which is the index for determining price supports based on the relationship of farm prices to prices of non-agricultural goods and services during the pre-World War I period of 1910 to 1914. Instead, the 1981 Farm Bill provided for a series of modest fixed price support increases during each of the next three marketing years. For the rest of the 1982 marketing year, which began in October 1981, the price remained at \$13.10 per cwt. where it essentially has been, with one exception, since October of 1980. It would have increased to \$13.25 per cwt. in October 1982; \$14.00 per cwt. in October 1983; and \$14.60 per cwt. in October 1984.[3]

This abandonment of parity is symbolically important because most people, including congressmen, do not understand the concept. It sounds so fair and equitable that setting price supports at some level less than 100 percent of parity seem to imply a sacrifice by farmers. Nothing, of course, could be further from the truth. Parity is an agricultural fable based upon a near-legendary period that no politician living today remembers. According to the accepted folk wisdom, 1910-1940 was a golden age for farmers where crops were plentiful, prices were high, and bankruptcies few. Government price supports for agricultural commodities -- dairy or otherwise -- were pegged to a percentage of what

farm products would purchase in non-farm goods at that time. In reality, parity is simply a crude political semanticism used to mask the manner in which Congress sets the level of federal welfare benefits for farmers, welfare which does not necessarily go to the smallest or poorest farmers. Of the \$2 billion paid out in price supports in 1978, USDA studies indicate that almost half of the figure went to the largest 10 percent of farms participating.[4]

Ironically, even though the 1981 Farm Bill eliminates parity for dairy farmers and sets milk price supports in stark dollar amounts, the administration had not set out with that goal in mind. What the administration had backed was the Senate version of the farm bill, passed in September 1981, which provided for milk price supports at a minimum of 70 percent of parity, adjusted on an annual basis.[5] This was a significant improvement but, more importantly, the bill also provided for no increases in price if USDA projections on net purchases of dairy products in the coming year exceeded \$750 million. Given what USDA projections were in the fall of 1981, there in fact would have been no increase in October 1982 from the current price of \$13.10 per cwt.[6]

The dairy lobby knew that 1981 would involve "give-backs"; and it tried to salvage from the 1981 Farm Bill a guaranteed minimum price support of at least 75 percent parity, which was itself a drop from the 80 percent of parity it had extracted from Congress in 1977 with the eager assistance of the Carter administration. The House Agriculture Committee naturally gave the dairy lobby what it wanted -- it always does. But the full House failed to adopt the Committee's recommendation. The dairy lobby then lowered its sights again and supported a bill, passed by the House, calling for milk price supports at 72.5 percent of parity, with annual increases thereafter as long as the government surplus dairy supplies did not exceed 3.5 billion pounds a year.[7]

The Senate bill would probably have frozen milk price supports at the present level of \$13.10 for several years with an adjustment unlikely until October 1983. The practical effect of the House bill would have been an increase in October 1983 of more than \$1.00 per cwt. A compromise was arranged in the conference committee; the House conferees agreed to the minimum 70 percent of parity in the Senate bill, and the Senate conferees agreed to drop their provision for eliminating the annual increase if USDA projections for net dairy purchases exceed \$750 million for the coming year. The compromise would have cost approximately \$150 million more than the original Senate bill approved by the Reagan administration.[8] It was more than the administration was willing to accept. Reagan threatened a veto of the entire farm bill unless the conference committee made changes in the dairy section. The bargaining which ensued produced the modest guaranteed increases in each of the next three years in milk price supports discussed earlier but eliminated the connection between price supports and parity. As a consequence, it is quite likely that dairy price supports, which are presently effectively below 70 percent of parity, will continue to be below 70 percent given the modest, albeit guaranteed, increases scheduled for October 1982 and October 1983, increases which are now jeopardized by the latest Reagan initiative.

Will taxpayers and consumers benefit in any substantial way from Reagan's newest proposal to reduce dairy price supports? In other words, will reducing price supports actually save the government money, and will consumers pay any less for milk?

Whether the government will save any money obviously depends upon total government expenditures on price supports in 1983 and thereafter. Certainly the government will spend less with price supports at \$12.00 per cwt. than it would with \$13.10 or higher. But whether it spends more on price supports in 1983 than it does in 1982 is still an open question. Even if Congress skips the October 1982 increase of 15 cents per cwt. and grants the Secretary of Agriculture the authority to reduce price supports to \$12.00 per cwt. (or some other figure less than the current \$13.10 per cwt.), there are no assurances this will save the government any money. USDA estimates show that a \$12.00 per cwt. price support level could save the government as much as a billion dollars in fiscal '83.[9] But similar USDA estimates in February 1982 were about \$400 million too optimistic by May. Any group making a \$400 million mistake in only four months should not find a \$1 billion error beyond its capacity.

The reasons why USDA makes such mistakes in forecasting are not difficult to understand. America is blessed with enormously efficient and productive dairy farmers who respond with alacrity to the incentives offered by their government. Consider the reaction of a dairy farmer in early 1981 when asked how he would respond to a dairy price support reduction:

Oh, we would just increase our output to lower our unit cost and to keep up our money flow. Everything we buy will not go down, so we have to have more revenue if we're going to continue. Your marginal producers may get out, but your professionals, your good operators, will just increase milk output.[10]

Not only is the government going to save very little with surplus dairy purchases, even with lowered price supports, but consumers are going to pay just as much for milk at the supermarket. The reason for this is simple -- that is the way government has set things up. The explanation as to why and how things got that way is a bit more complicated.

The Origin of Price-Fixing

The giant dairy farmer cooperative, formed by huge mergers of smaller co-ops in the late 1960s and the 1970s, are organized into regional milk cartels. Aided and abetted by the USDA, they actively (and legally) fix the price of Grade A raw milk. Even if dairy price supports are reduced and dairy co-ops and their members receive less from taxpayers (an unlikely occurrence for the reasons expressed by the dairy farmer to Barron's), the co-ops still have the monopoly power to increase the price of raw milk and more than compensate for any reduction occasioned by a decrease in price supports. They have used the power in the past, particularly during the Nixon-Ford years, and they will use it again if necessary.

Raw milk historically has accounted for over 50 percent of the retail price of milk and is the single largest component of the supermarket price. There is no free-market price for the raw milk produced by members of the milk cartels. Instead, the USDA fixes a minimum price which dairies must pay to milk producers belonging to the cartels. In most of the market areas regulated by the USDA, the USDA minimum price is the key element that enables milk producer cooperatives to charge monopoly prices higher than the USDA fixed price. Understandably, dairy co-ops are keenly interested in how the USDA sets the minimum price.

The common base in the economic formula used by the USDA to fix the minimum price is the relatively free-market price of unregulated "manufacturing grade milk" (raw milk, usually Grade B, which is used in processing "hard" products such as butter, cheese, and powdered milk, as opposed to fluid raw milk, usually Grade A, which is used to process fluid milk and is regulated by the USDA). This market price, established at some 500 plants in Minnesota and Wisconsin that supply manufacturing grade milk, is known as the Minnesota-Wisconsin price series, or simply the M-W price.

Dairy price supports are a key element in the M-W price. Since the government usually absorbs surplus milk in the form of manufactured milk products like cheese, butter, and nonfat dry milk, the USDA announcement of price supports effectively sets a floor under the market price of unregulated manufacturing grade milk. Hence, the milk price support level artificially stimulates the M-W price, and thus the USDA minimum price for fluid grade raw milk.

A concept known as classified pricing, enforced by USDA, is the key to understanding the USDA milk cartels and the resulting power of dairy co-ops who participate. Classified pricing has two separate aspects: (1) the price charged by a dairy co-op to a milk processor for raw milk and (2) the amount returned by a co-op to its farmer members.

First, the co-op price to the milk processor is based on raw milk's use after processing, since the price for raw milk processed into fluid milk is higher than that for milk processed into manufactured milk products like cheese or milk powder.

Second, a co-op pays each of its farmer members the same price for raw milk, regardless of whether it ends up as fluid milk or cheese. This is typically referred to as a "blend" price and is a weighted average of the various prices received by the cooperative for its farmer members' raw milk, depending on its use.

This dichotomy in pricing of a fungible commodity like milk will not occur in a free market, except when there is a shortage of Grade A raw milk (Grade A, subject to stricter sanitary standards and hence more costly, is the only raw milk legally acceptable to be processed into fluid milk. Cheese and milk powder can come from either Grade A or Grade B raw milk). Because of its perishable nature, fluid milk cannot be stored for long periods. The demand for fluid milk is fairly constant and relatively inelastic -- a change in prices does not significantly affect demand. During a shortage, a fluid-milk processor will pay more for raw milk than he otherwise would during normal conditions because

he must supply his customers and knows he can pass on the price increase. A manufactured-milk processor, on the other hand, faces an elastic demand for his products -- changes in price will affect demand. Further, most of his products, such as cheese or powdered milk, can be made from Grade A or Grade B milk and can be safely stored for relatively long periods. During a shortage, he has no incentive to pay higher prices for Grade A raw milk because he cannot pass on the increase to the consumer and, unlike a fluid-milk processor, he can afford to wait for Grade A prices to fall because his product will not perish in the interim.

Dairy cows fail to appreciate these market nuances. They produce more milk in the spring (the "flush" season). Accordingly, raw milk ordinarily commands a higher price from fluid-milk processors in the short season than in the flush season when it tends to bring the same price from fluid-milk processors as it does from manufactured-milk processors because of the natural surplus.

Prior to the 1930s and the advent of federal milk regulation, this natural production cycle led to intense competition among dairy farmers to find a fluid-milk processor to ship to on a year-round basis because the farmers would automatically receive higher prices during the short season. The more intense the competition among dairy farmers to find a fluid market, however, the lower the short season high prices would be, and, hence, the lower the overall price for raw milk on a year-round basis.

The purpose of "classified pricing," as introduced by early dairy cooperatives, was simply to eliminate competition among dairy farmers for fluid milk outlets and to impose a year-round high price to be paid by fluid milk processors. By joining a dairy cooperative that would exclusively market milk for them, dairy farmers would no longer compete for a fluid market for their milk. Whether the cooperative sold its members' milk to a fluid-milk processing plant or to a manufactured-milk processing plant, each member would receive the same average price for his milk as any other co-op member.

However, classified pricing had enforcement problems. Fluid-milk processors attempted to subvert the system by finding cheese plants that would purchase raw milk from co-ops at a lower price ostensibly for their own use and then resell it to the processor for fluid use at a price less than the co-op was charging. Likewise, any independent farmer who dealt directly with a fluid-milk processor in a classified-pricing market could usually receive more for his milk than the blend or average price paid by co-ops to their farmer-members. This would be the case because a co-op often found itself with a large surplus, because of overproduction, which it disposed of at the manufacturing rate to cheese plants, thus lowering the average price paid to its members. In this way, the processor often could pay an independent farmer more than the co-op's blend price for his raw milk and still pay less for its raw milk than a competitor buying from the co-op.

Milk processors could find such independent farmers who were willing to sell their milk at manufactured-milk prices, thus undercutting the co-op's higher price, despite the willingness of milk-producer co-op's to use milk strikes and violence to enforce their higher price. Accordingly, throughout the 1920s and the early years of the Depression, the two-price system was unstable. Cooperatives that supplied milk to large urban markets regarded the frequent breakdowns in the two-price system as socially undesirable and chaotic. Their disingenuous argument was that violent milk strikes (resulting from the efforts of cooperatives and their members to enforce the discriminatory two-price system) were an undesirable consequence of competition. Their solution -- a not atypical reaction of businessmen confronted with competition and a genuine free market -- was to have the federal government suppress the competition. And that is precisely what happened. Government-sponsored cartels were created via federal "milk marketing orders," and competition was declared illegal wherever the cartels were in power. Today, almost 50 years later, that system is still in place, covering approximately 80 percent of all fluid grade milk produced in the country.[11]

More important for consumers, that system has been systematically abused by dairy cooperatives who charge monopoly "premiums" above the prices established by the federal milk marketing orders. During the 1970s, U.S. Department of Justice economists estimated that these monopoly premiums cost consumers from \$210 to \$260 million a year more than was justified by market conditions.[12]

And it is the USDA's milk marketing orders, most economists agree, which have furnished the institutional framework

to make these monopoly premiums possible.

Milk Prices in the Reagan Era

Hence, what will happen to milk prices, even in a Reagan era of reduced price supports, is that they will continue to go up, in excess of the general inflation rate, just as they have in the past. Consumers who do not like, or cannot afford, the higher milk prices that will be charged in the wake of any Reagan price support victory will have to pay them or do without. Even if these higher prices result in a continuing decline in the per capita consumption of whole milk (it dropped from 38 gallons per year in 1964 to 24 gallons in 1978),^[13] the dairy co-ops do not care. The government will still buy the surplus. Even with the lower Reagan price supports, if the surplus is large enough, the cash flow will remain the same.

The symptoms of the dairy industry sickness were correctly identified in a recent paper from the Dairy Department of the American Farm Bureau Federation presented in January 1982 at the Farm Bureau's annual meeting:

The current dairy plant is over-expanded by about 725,000 cows....To get "our house" in order, the buildup in cow numbers must cease; the downward trend in cow numbers must be resumed; and the present herd must be reduced by about 1.2 million cows by 1985 to achieve a reasonable balance between the market for milk and the milk supply.^[14]

The plain truth is, however, that no "reform" of present government policies will solve the problem. Milk production increased by 4 billion pounds in 1981. Per-cow production is rapidly approaching 1,000 pounds per month.^[15] And the problem is not going to get better. Today's dairy cows produce 2 1/2 times as much milk as did cows 30 years ago, largely due to artificial insemination. But even more productive dairy cows -- "supercows" -- are on the way through the new technology of embryo transfer, already a \$25-million-a-year business. Embryo transfer involves using hormones to stimulate purebred dairy cows to produce as many as 30 eggs with each ovulation. The eggs are then artificially inseminated, and the embryos are transplanted into recipient cows. The supercow then goes back to work producing more eggs and embryos. Some produce as many as 50 calves a year. Equally important, the best supercows can produce over 40,000 pounds of milk a year compared with a national average just under 12,000 pounds.

No combination of dairy farmer self-restraint and government subsidy is going to stop these trends. The only answer is to allow the free play of market forces -- to abolish dairy price supports and milk marketing orders.

If the National Milk Producers Federation has its way, however, the trend will continue. The dairy lobby's prime goal is to make consumers pay top dollar for milk, but it also wants to alleviate the scandal of the dairy price support program. Consequently, NMPF proposed in February a scheme called the "Dairy Stabilization -- World Price Program." The details of the program are unimportant; essentially it involves U.S. taxpayers and consumers continuing to subsidize U.S. dairy farmers at levels well over twice the world price. The resulting huge surplus -- there is always a huge surplus -- will be administered by a National Dairy Board, which will dump it on the world market, depressing prices there by 3-4 percent.^[16] Recent refinements in the plan include a base or quota system to encourage farmers to cut back production -- and not incidentally to discourage the entry of new dairy farmers.

The idea is hardly original. It was first conceived in the 1920s when the Moline Plow Company of Moline, Illinois, was thrown into bankruptcy. Moline's managers, George N. Peek and Hugh S. Johnson, correctly calculated that the farm machinery business was not going to prosper unless agriculture prospered. Both Peek and Johnson had served on Woodrow Wilson's War Industry Board and preferred the safety of government subsidy to the rigors of competition. Accordingly, in late 1921 Peek and Johnson presented a plan to the American Farm Bureau Federation to create prosperity on the farm through government action (at the expense of the rest of the economy). The Federation persuaded Congressmen McNary and Haugen to introduce a bill calling for a government framework for selling farm products for domestic consumption at a "fair exchange value" guaranteed by government and based on the ratio between industry and agriculture in the golden period between 1910 and 1914. It also called for selling the surplus on the world market for whatever it would bring.

Despite its dubious heritage, Agriculture Secretary John Block's initial reaction to the NMPF's recent reincarnation of the McNary-Haugen bill was that it was "a step in the right direction." Presumably, Block was referring to the elements of the program designed to reduce the cost of the price support program. Already, USDA economists have criticized

the base/quota aspect of the plan as tending to freeze the size of farms, thereby preventing development of more efficient methods of production.

Unfortunately, no one in Washington today is looking out for the consumer on a systematic basis. It is not only the price supports that cost taxpayers money, but also milk marketing orders and the monopoly power of the huge cooperatives.

The dairy lobby, led by the NMPF, wants to save the price support program, marketing orders, and monopoly power and export the surplus. The only changes in the current system it is willing to consider are those that take more money from the pockets of consumers and taxpayers and put it in the pockets of dairy farmers with as little fuss as possible.

The principal organized opposition to the dairy lobby comes from the newly formed National Independent Dairy Foods Association (NIDA). NIDA is composed of independent proprietary dairies who must, in many cases, both purchase raw milk from cooperatives and compete with them in the sale of wholesale dairy products. Needless to say, the deck is stacked in favor of the cooperatives who benefit from federal tax laws, milk marketing orders, and antitrust immunity. NIDA's chief aim is to either eliminate altogether the over-order premiums charged by dairy cooperatives or, at a minimum, eliminate the co-ops' antitrust immunity which allows them to amass the monopoly power to charge such excessive prices. Significantly, NIDA does not oppose the system of federal milk marketing orders itself even though (1) it produces raw milk prices higher than a free market and (2) it is the base from which the huge co-ops have amassed their monopoly power. This is because NIDA's members, largely independent dairies, prefer a system in which their major costs -- procurement of raw milk -- are identical to their competitors. Federal milk marketing orders provide this; it does not matter to them that raw milk costs are higher overall than they would be in a free market. As long as everyone pays the same, nobody gains a competitive edge, the higher costs are passed on, and only consumers are the losers.

The Industry's Future

The Reagan administration takes a similar approach to consumer welfare. Its major concern is the high cost to the government of dairy price supports. This is not an unpraise-worthy attitude, but ignores the major transfer effects on consumers of the milk marketing orders and the monopoly power of the cooperative these orders foster. Alden Manchester, a senior economist in USDA's Economic Research Service, has recently written on the status of marketing cooperatives under antitrust law, but he never once mentions marketing orders, let alone the undeniable economic fact that they are the source of the monopoly positions held by such Fortune 500 giants as Sunkist, American Milk Producers, Inc. (AMPI), and Dairymen's, Inc.[17]

Such myopia is hardly an accident. Alden Manchester is typical of the bureaucratic mindset at USDA. Despite his knowledge of agricultural economics, his analysis is rooted in the policies of the past, and he fails to even consider free-market alternatives. This year USDA will be engaged in both an overall study of dairy programs as required by the 1981 Farm Bill and a specific study of milk marketing orders requested by Vice President Bush's task force on government regulation. One of the alternatives under consideration in these two USDA studies is a free market with no dairy price supports or milk marketing orders. But with career bureaucrats like Manchester around to furnish, in his words, "the intellectual base for thinking about and discussing cooperative antitrust law,"[18] cooperatives could not be better served if Manchester were on their payroll. And consumers had better resign themselves to paying more since Manchester considers them to be "in the aggregate, affluent" and hence fair game for USDA to use marketing orders to continue to forcibly transfer welfare benefits from them to farmer-members of cooperatives who, presumably, are not considered by Manchester to be as well off.[19]

The plain truth is that the giant dairy cooperatives in this country do not need the cartel-like protection of federal milk marketing orders to survive. But as long as that protection is offered by the government, they will accept it. Their monopoly positions depend on it. The only way for Reagan's cuts in dairy price supports to have a permanent effect is to eliminate the federal orders and return dairy farming to a free market. It is the only solution which both maximizes consumer welfare and eliminates the present burden on taxpayers.

FOOTNOTES

- [1] Seth S. King, "Everyone Throws Dirt on the New Farm Bill," New York Times, December 19, 1981; "Edging Toward A Free Market In Farming," Nation's Business, February 1982; Dairy Industry Newsletter, December 11,
- [2] Jeffrey H. Birnbaum, "Cut in Support of Dairy Prices Asked by Reagan," Wall Street Journal, May 6, 1982; Seth S. King, "Block Seeks Cuts in Dairy Supports," New York Times, May 6, 1982.
- [3] Dairy Industry Newsletter, December 11, 1981.
- [4] Policy Report, January 1982, p. 5.
- [5] Leonard M. Apar, "Senate Endorses Cutting Support for Price of Milk," Wall Street Journal, September 16, 1981, p. 2; Dairy Industry Newsletter, September 25, 1981.
- [6] Dairy Industry Newsletter, September 25, 1981.
- [7] Dairy Industry Newsletter, October 9, 1981.
- [8] Dairy Industry Newsletter, November 13, 1981.
- [9] Birnbaum.
- [10] Roscoe C. Born, "Udder Nonsense: Milk-Price Subsidies are a Costly Farce," Barron's, September 14, 1981, p. 20.
- [11] Alden C. Manchester, Pricing Milk and Dairy Products: Principles, Practices and Problems (Washington, D.C.: U.S. Government Printing Office, 1971), p. 2.
- [12] Roger W. Fones, Janet C. Hall, and Robert T. Masson. U.S. Department of Justice Study of Milk Marketing (Washington, D.C.: U.S. Department of Justice, 1976), pp. 398-399.
- [13] Michael McMenamin and Walter McNamara, Milking the Public (Chicago: Nelson-Hall, 1980), p. 43.
- [14] Dairy Industry Newsletter, January 22, 1982.
- [15] Ibid.
- [16] Dairy Industry Newsletter, February 26, 1982.
- [17] Alden C. Manchester, The Status of Marketing Cooperatives Under Antitrust Law (Washington, D.C.: U.S. Government Printing Office, 1982).
- [18] Ibid.
- [19] Ibid.