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Designing Marketing Orders for the Future

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Few people understand marketing orders, and a lot of people distrust them. Those who claim to understand them argue that they are useful in promoting "orderly marketing," reducing "market failure," and assuring adequate supplies of a commodity of value to consumers. Those who distrust marketing orders believe them to be devices to promote the economic well-being of favored producers at the expense of consumers. Both points of view contain elements of truth.

In considering the future of marketing orders, it is first important to define the goals we hope to achieve. We need a "vision," to use the currently fashionable term. The implicit vision in Dr. Shaffer's paper is matching supply and demand through advance contracting at prices that cover the cost of production for the largest producers. It is a producer-oriented vision.

I prefer a consumer- or public interest-oriented vision because the end users of the commodity in question will ultimately pay the bill for any institution designed to improve market performance. What, then, are the attributes that consumers are likely to value? Here is my list:

1. *Low Cost.* Consumers want value. They are entitled to the lowest set of production, distribution and marketing costs that are compatible with an adequate supply. Programs that favor high cost production areas over low cost production areas, or programs that enhance producer prices across the board, probably do not meet consumer expectations.
2. *Adequate Supply.* Consumers do not like shortages. We saw ample evidence of that in the early 1970s during price controls. Most households have established, relatively stable patterns of consumption and resent their disruption by shortages or high prices. In economic terms, there will always be an adequate supply, for price will ration whatever is available. However, consumers have a perception of a "fair" price and expect an abundance at that price.
3. *Price Stability.* Consumer households need to plan, just as commodity producers need to plan. Reliable expectations about price facilitate good planning and benefit both ends of the market. Price stability goes hand in hand with adequate supplies.
4. *Meaningful Product Differentiation.* Any raw agricultural commodity exhibits a significant degree of variation. Even milk can be different in composition and quality from load to load. Also, a given commodity can be presented to consumers in a variety of forms, from fresh to preserved to embodiment in processed food. Many quality variations are meaningful to consumers. So are the different forms in which the commodity is purchased. The values consumers place on these differences are also different. We serve the consumer interest by discerning the difference in size, qualities and forms of presentation that are important to consumers, and then insuring that the market responds to them. People want a range of choice and are willing to pay extra to express their choice.

There may be other criteria of value to consumers, but I have offered enough to make the point that the consuming public has an important stake in the performance of any marketing institution that we create, including marketing orders.

Next, I will respond specifically to some of the points made by Dr. Shaffer. He recites good economic theology in stating that "Resources should not be used to produce something which isn't worth what

it costs to produce it; and, conversely, resources should be used to produce something which is worth more than it costs to produce it." Unfortunately, we are not smart enough to draw the line and produce exactly the amount for which a remunerative price can be had. That leaves us with two choices. One is supply management, which implies under-production, but which also insures a satisfactory producer price. The second is over-production, which implies low cost and adequate supplies for consumers, but which could result in an unsatisfactory producer price.

I prefer the second. It comes closer to satisfying the public interest or consumer conditions I specified above. However, I do not favor producer prices at levels where producers would not choose to produce. Therefore, we need some form of price discrimination to generate adequate producer revenue to bring forth plentitude, without greatly exploiting differences in elasticity of demand. Marketing orders are ideal tools for bringing about this kind of limited price enhancement. The target level of production should be such that the primary market is satisfied at "normal" prices even in the lowest production year or seasonal period. The remaining production is the "reserve" which probably "...isn't worth what it costs to produce it..." For a producer to come out whole, the *average* returns from the primary and secondary markets must be worth as much as it costs to produce all of the product for both markets.

I disagree with Dr. Shaffer that accounting costs of production, including competitive returns, is the appropriate standard for setting producer prices. Most of us realize that agricultural production is not an isolated activity. In some cases, it is the least-cost method for engaging in real estate speculation or tax avoidance. In other cases, it is a hobby. There are numerous examples of thriving agricultural production in the face of dismal economic returns. Most part-time farms are like that.

The test for adequate prices should be whether or not they bring forth an adequate supply. If an adequate supply is available for the primary market and the reserve, then the price is not too low. However, if the forthcoming supply is not adequate, then additional devices need to be adopted to increase producer prices.

How can one tell if producer prices are too high? If the available supply exceeds reserve requirements, then a lower price would adequately reimburse farmers for their resources and would go further toward satisfying the public interest criteria mentioned above. The above comments apply reasonably well to both fruit and vegetable and milk marketing orders.

Dr. Novakovic did an excellent job of reviewing the history, philosophy and operations of federal milk marketing orders. I have nothing new or better to contribute to the discussion. However, I would like to add the public interest twist to the current issues enumerated by Dr. Novakovic.

Low Cost

Do Federal milk marketing orders foster efficiency in production, distribution and marketing? This was at the core of the debate about Class I differentials in 1990. The question of whether a new mechanism for setting Class I differentials could result in less total cost with no loss of supply assurance was never answered. The Midwest coalition argued that a system of transportation credits that would pay transportation costs only when and if milk was transported was less costly than the distance-related Class I differentials now in place. USDA evaded the question of efficiency and system costs by reinforcing the local, rather than systemwide, supply and demand standard.

Adequate Supply

Federal orders have fully succeeded in assuring an adequate supply of Grade A milk for fluid use. Blend prices are high enough to attract about 2.5 times as much Grade A milk as is needed to satisfy fluid needs. This relative abundance varies a great deal from market to market, but it is hard to argue that the system is short of milk. The problem seems to be how to facilitate efficient allocation of milk to markets within the system.

It is understandable that producers in markets with virtually all the producer milk in the pool being used in Class I products would want to keep it that way. By exhibiting periodic local shortages and high transaction costs in securing supplemental supplies, they buttress the argument for high Class I differentials and the high blend prices that result.

A lot of federal milk order rules inhibit the movement of milk between markets and, therefore, impede an efficient systemwide allocation of milk to markets. These include uniform shipping requirements for near-in and far-out milk, pro-rata allocation of other-order milk and inadequate compensation for transportation costs actually incurred.

I believe that assurance of supply on a local market basis could be improved by writing rules under which all markets feed on an abundant systemwide supply of milk.

Price Stability

Federal milk orders contribute in a small way to price stability. They do nothing to moderate the price volatility inherent in the manufacturing milk market. This volatility is transferred to all Class prices through the M-W price. Federal orders do stabilize the relationships among Class prices, however. Without regulation, it is likely that differentials paid for Class I milk would vary greatly throughout the year. Fixed Class I differentials avoid that source of price volatility.

Maybe more could be done to achieve improved price stability in fluid milk markets. Little attention has been given to the issue in recent years. Maybe intertemporal pooling would be a useful device.

Product differentiation

Federal milk orders do differentiate between fluid products of different butterfat contents. Consumers find differences in butterfat content to be meaningful as evidenced by the growth in sales of lowfat and skim milk at the expense of fluid whole milk. The use of butterfat differentials in milk orders transmits difference in consumer values back through the production and processing system.

Very little of the debate about federal milk orders is centered on consumer issues. Most arguments are about producer and processor price equity. The argument about Class I differentials was more about how the revenue benefits of the milk order system should be distributed than about the level and type of incentives needed to service the needs and expectations of the consuming public. Farmers in every region need as much or more benefit from federal milk orders as is currently available, or so it would seem from listening to the arguments. The advocates of conflicting points of view could find no common ground for reducing or reallocating benefits. Therefore, USDA chose to maintain the *status quo.*

Price equity issues between milk processors, especially milk manufacturers, have heated up in recent years. Three such issues now on the table include the replacement for the M-W price, Class III-A pricing, and the make allowance provisions of the Food, Agriculture, Conservation and Trade Act of 1990. There are several underlying forces driving these arguments. First, the market for individual manufactured dairy products is essentially national in scope. Products move from areas

of relative abundance such as the Upper Midwest, California and Washington, to areas of relative shortage such as the Northeast and Southeast. Product price differentials representing transportation costs do exist, but these differentials do not justify much geographic difference in the price of milk going into these products.

Second, shifts in consumer demand have called for more cheese production and less butter and nonfat dry milk production. As a result, the rewards for making cheese have been more favorable for 20 years than the rewards for making butter and nonfat dry milk. Some argue that regulatory devices, such as Class III-A pricing, should be adopted to neutralize this market-driven difference in rewards. Others argue that the changing market for manufactured dairy products should encourage a shift in resources toward the higher reward products.

Third, the intensity of competition for milk for manufacturing varies greatly across the country. Competition is most fierce in the Upper Midwest where milk production is declining and a significant amount of idle manufacturing capacity represents an unfilled demand for milk. As a result, effective pay prices in the region exceed the blend price by $.90 to $1.00.

Competition is probably least intense in California and Texas-New Mexico, where it is difficult to create enough milk manufacturing capacity to keep up with the growing milk supply.

Given these three forces, what is the proper level and relationship of regulated manufacturing milk prices? There is no good answer. High regulated manufacturing milk prices serve the interest of Upper Midwest processors because they would force competitors in other regions to pay as much as they do. However, high regulated manufacturing milk prices would deter the development of new capacity in regions where it is needed.

Low regulated manufacturing milk prices would benefit manufacturers in regions where the level of competition was low because manufacturers would improve both profitability and their ability to capture markets from high competition areas.

Low regulated manufacturing milk prices would not affect the cost of milk in high competition areas because actual pay prices would be driven by the competitive environment, not by the regulatory environment.

The disputes about the replacement for the M-W price and about "make allowances" in California are really arguments about the appropriate level of regulated manufacturing milk prices.

The dispute about Class III-A pricing is about protecting (or not protecting) investments that serve a dying market for nonfat dry milk. The regulatory question is whether market driven adjustments should be deterred or allowed to proceed at their normal, but somewhat destructive, pace.

I have nothing to add to Dr. Novakovic's discussion of Class II prices, order mergers and component pricing. I see these as fine tuning of orders to make them more effective and efficient.

In summary, I offer the following points:

(1) Marketing orders of all sorts must first and foremost serve the public interest. Otherwise, how can we legitimize the price discrimination and producer price enhancement that go with them?

(2) Abundant supplies, with some price enhancement, are better than restricted supplies with a lot of price enhancement.

(3) Federal milk orders have a long way to go to achieve the standard of efficiency that the public has a right to expect.

(4) We need a new and better philosophy of regulation of manufacturing milk prices before we can resolve the competing claims of participants in the manufacturing milk sector.