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## SWEDISH DAIRY COOPERATIVES: *They Confront Radical Switch in Government Policy*

— by V. James Rhodes —

➤ Sweden is on the verge of a dramatic restructuring of its dairy industry. A switch to the most free market dairy policy in Western Europe will lead to lower producer prices and as a result lower production. Many farmers will quit dairying but not necessarily quit farming. The decrease in cow numbers and the number of producers will be a continuation of past changes. Adjustments will be even greater for farmer owned dairy cooperatives. They face unprecedented changes in making a transition from being protected from competition to a situation where they compete openly (and possibly destroy each other) or to a situation where they cooperate with each other to reduce milk production, mitigate the speed of price declines, and preserve a cooperative system to represent farmers in dairy policy as Sweden enters the EC.

Frontier protection, price supports, restricted expansion of farms, and direct milk subsidies have characterized the Swedish dairy industry for a half century. These measures were part of a "Swedish Model" that was capitalistic, but with a heavy tilt toward a welfare state covering the entire society and financed by high taxes. The big three commodity groups (milk, grains, and pork) were heavily protected at specific price levels upheld by variable import duties and export subsidies. Prices were negotiated formally and periodically by representatives of farmers, consumers and the government. The original criteria for price-setting included food self-sufficiency, parity incomes for farmers and efficiency in production and marketing. The negotiated prices, while seemingly meager when compared to farmers' cost of production data, were sufficient in the 1980s to produce sizable surpluses of milk, grains and pork. In turn, a government sanctioned check-off (tax) on all milk sold by producers financed much of the subsidies required to export the milk surpluses—mainly in the form of butter and milk powder.

### Major Reforms

Sweden is making major changes in its farm policy. These changes appear to be part of broader based adjustments in the historic Swedish Model. Discontent with slow economic growth and high rates of taxation are commonly cited as the principal reasons. Perhaps Swedish attitudes are not immune to the swing from planned economies towards open markets that affect much of the world these days.

In early 1990 the government decided to discontinue most inter-

*V. James Rhodes is Professor, Department of Agricultural Economics, University of Missouri.*

nal regulation and agricultural support while maintaining a reduced level of border protection pending the outcome of the GATT negotiations. That broad policy is to be implemented during a transition period that ends July 1, 1996. However, it is not yet clear exactly how some measures shall be implemented. For example, the extent of frontier protection is an important policy unknown. Even so, the broad outline of a major change in the market environment for milk producers and their cooperatives is apparent.

In 1990 about 12 percent of Sweden's milk production, the portion that was surplus to domestic demands, was exported under huge subsidies financed by fees on producers. By mid 1991 large government direct subsidies per liter of milk and per dairy cow were terminated. Farm milk prices, and especially producers' incomes, are projected to fall drastically.

### Likely Effects

In response to these policy changes, many of Sweden's 25,000 milk producers will quit dairying. Many are small, for Sweden has had a long history of encouraging family farms that are quite small by U.S. standards. In 1989 only 16 percent of its milk cows were in herds of 50 or more. Sweden's average herd size of 22 head in 1989 compared to 1986 sizes of 28 head in West Germany, 55 in the Netherlands, 45 in the USA and 137 in New Zealand. However, the protected system had not frozen the structure of milk production. The number of milk producers fell from 201,000 in 1960 to 25,800 in 1989 while the number of milk cows fell from 1,215,000 to 565,000. Thus, the prospective exit of farmers from dairying in many ways will be a continuation of past changes, perhaps accelerated. Likely, the resulting concentration of production will contribute to more efficient production.

### Dairy Cooperatives

It is important to note that Swedish producers are less specialized than farm producers are in most countries. Therefore, cessation of milk production will not always equate with exit from farming. In contrast, strategic problems faced by the Swedish dairy cooperatives are different. Nearly all are totally specialized in dairy, so their dependence on the dairy industry is total. Their cooperative system is now at risk of being thrown into a bitter fight for survival. Since Swedish cooperatives operate so differently from U.S. dairy cooperatives, some description of their historic activities is essential to a clear understanding of their prospects.

### Competition

There is no direct competition among the cooperatives for either members or markets. Swedish dairy cooperatives virtually control all milk collection, bottling and the making and selling of cheese, butter and milk powder. They have a 41 percent share of the combined butter and margarine market. In 1989 some 43 percent of Swedish milk was bottled for fluid consumption, 31 percent became cheese, 17.5 percent went into milk-powder and condensed milk, and 8.5 percent was processed for butter and other dairy products. Milk has only a 14 percent share of the total beverage market as measured in consumer expenditures.



The dairy cooperatives are linked in a federation, SMR, that allocates cheese production among the cooperatives and that buys and merchandises all the cooperative-produced cheese, butter and milk powder. SMR also administers a sizable generic dairy product promotion program, does basic and applied product research and performs other lobbying and communication functions normally associated with a trade association. Each cooperative, like a Rural Electric Cooperative in this country, has an exclusive membership territory. By "gentleman's agreement" a cooperative rarely accepts—and never recruits—members from an adjacent cooperative. Each cooperative markets its bottled milk within the market area defined by its membership. Cooperatives do not ordinarily sell bulk milk among themselves.

Each cooperative operates a pool so that a producer's payment is unrelated to whether their milk goes into a high-value milk carton, a bit lower value cheese, or low return butter or milk powder. Moreover, all the cooperatives, in conjunction with the government, have operated an equalization fund that approximates nationwide pooling. Thus, a cooperative geographically distant from the huge Stockholm market pays nearly the same price for raw-milk as a cooperative near Stockholm. And a cooperative near Stockholm puts a lower-than-average fraction of its milk in butter and milk powder. The termination of this equalization fund under the new regulations will put considerably more competitive pressure on cooperatives with poor access to fluid markets and on those highly dependent on the less profitable making of butter and milk powder. While the government will continue to provide special subsidies to the far northern areas for national security reasons, the loss of the equalization fund will adversely affect revenues of cooperatives and their members in these areas.

The most pressing problem for milk producers and their cooperatives is the large surplus of milk that can no longer be "thrown" over the border with subsidies. If the entire output is marketed domestically, farm prices are likely to fall extremely low in the short run. Such pressures could possibly goad the cooperatives into a frantic fight for markets. Market boundaries for fluid milk sales could be ignored. Absent a national quota set by SMR for cheese production, cheese output could be increased sufficiently to reduce cheese prices seriously. It is not yet known whether each cooperative will market its own cheese or whether a central marketing agency can be retained. While centralized marketing could foster more "orderly" marketing, the pressures of surplus supplies could quickly force cheese prices down.

With the help of the government in the last half of the 1980s, the cooperatives were able to cut milk production with a two-price voluntary quota system. In effect, each cooperating producer received the domestic blend price for a quota output and the realized returns from export sales for all output in excess of quota. The latter price was about one-sixth of the former price. Non-cooperating producers received a price for their total output which reflected the blend value of domestic and export sales. It was lower than the price received by cooperators. Cooperation of producers was quite high, total output fell, and average milk prices to producers rose.

The SMR leadership has been considering the feasibility of the dairy cooperatives individually operating similar two-price quota plans in the future with a system of producer contracts if the government will permit. The benefits in terms of reduced supplies and facilitating exports by cooperatives are considerable. However, the problem of coordinating numerous voluntary individual cooperative programs may be overwhelming; the whole operation may not be feasible without the control authority formerly possessed by SMR. With such a program, producers will press for larger "domestic quotas." The individual cooperatives would be tempted to grant these requests. However, the cumulative result

could easily be more milk on the domestic market than can be sold at anywhere near current price levels.

## Two Possible Scenarios

One scenario for Sweden's dairy industry is for milk output to flow undiminished into domestic markets with disastrous short term consequences for producer prices and cooperative margins. Swedish cooperatives would then engage in price wars for bottled milk and cheese markets. Eventually, many producers would be forced out of production and several, or even most, of their cooperatives would fail. As total production declined—perhaps as much as 30 percent—prices would rise to a level that would support a smaller industry. Managers of cooperatives recognize that the struggle for survival would greatly weaken the remaining cooperatives, weaken confidence of members of cooperatives and allow investor-owned dairy firms to enter the industry.

Another scenario is that the cooperatives, by working together, could cut back milk production with little immediate reduction of milk prices. The cooperatives could retain the joint marketing of cheese, butter and milk powder. With this scenario there would no longer be a national quota for cheese. Cooperatives would continue to respect individual territories for members and the marketing of fluid milk. The amount of subsidized exports would decline rapidly. This decline would come about because producers would be unwilling to produce milk at the meager marginal returns available in the export market through a two-price system of contracts. Were frontier protections removed, some domestic cheese prices could be reduced somewhat to discourage the growth of imports. The cooperative system would have to reduce handling and processing capacity because of the reduced national output. Ending the cross-subsidization long prevalent in the equalization scheme would reduce prices more in cooperatives and in areas at a competitive disadvantage.

In effect this second scenario assumes that Swedish dairy cooperatives would continue to cooperate closely. The SMR-led system may be able, like a U.S. marketing order, to maintain orderly marketing and price differentials between fluid and manufactured products. However, the system's market power is restricted by possible dairy product imports, margarine supplies, and substitute drinks. The system's market power would also be limited by the two-price contracts which would likely achieve only modest success in limiting total production. This is particularly important since large cuts in total output are necessary if prices are to be maintained. A further weakness is the difficulty of coordinating among the members. Coordination is likely to be even more difficult because the government is no longer supportive of cooperatives' restricting supplies but is passive or even hostile.

A chief strategy of SMR is to encourage the rapid merger of its member cooperatives. SMR made amazing progress in 1990, bringing the number of dairy cooperatives down from 17 to 10. The government's policy is generally to permit mergers where the resulting entity has less than a 25 percent market share. Arla, the largest cooperative, already has a 60 percent share. However, it may be permitted a few more mergers with small cooperatives where geography makes such mergers most reasonable.

In this new environment Arla will be a powerful force. It is a well-managed firm with a record of many successful product innovations. It provides bottled milk to several large markets, including Stockholm. It will have a natural leadership role and could exert market discipline on the other cooperatives. But, cooperative coordination is not likely until mergers reduce the non-Arla group down to 2 or 3 surviving cooperatives. SMR is now encouraging such an amalgamation. Whether they can be



accomplished within two or three years depends upon the leadership of key members and managers.

Many assume efficiency is served best when competition reigns supreme. They would not be sympathetic to SMR's attempt to develop an oligopoly and maintain coordination among the cooperatives. On the contrary, the Swedish dairy cooperative system is a model of efficiency. Plants are generally well located, well equipped and well managed. There is virtually no duplication of facilities and, of course, you won't find two to four competing milk trucks running down the same farm roads as happens in many parts of the United States. As milk production is squeezed down in response to this shift in Swedish agricultural policy, some facilities will have excess capacity. If the cooperative system breaks up, these unneeded facilities will likely remain in operation and put pressure on processing margins.

At least three forces led to high efficiency of the dairy cooperatives:

- Potential competition—investor dairy firms have been free to enter the industry in competition with the cooperatives;
- The equalization fund was allocated in ways that encouraged improved efficiency;
- Cooperative members and board members recognize

that plant costs directly affect their milk checks and have therefore pressured the managers to achieve high plant efficiencies.

## A Preference

Of the two scenarios sketched earlier, is one better than the other to achieve? Your answer depends on your perspective. Under both scenarios, producer output in the year 2000 would be lower than in 1990 and probably not drastically different. With the first scenario, in the short run producer and consumer prices would be lower than with the second scenario. But by the year 2000 the prices for the two scenarios would be nearly the same. With the second scenario, the cooperative system would survive and its leadership would be in place. That leadership may be vital for negotiating further adjustments in agricultural policies that will occur if Sweden is admitted to the European Community in the 1990s. Saving this cooperative system may contribute to Sweden's ability to meet competition from imports and, indeed, to export some specialty items to the rest of Europe. Moreover a viable cooperative system will likely provide more efficient marketing of milk and milk products than a less cooperative system. Thus, this observer has a preference for the second scenario.