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THE DAIRY PRODUCTION STABILIZATION ACT:
POLICY CONSIDERATIONS AND IMPLICATIONS

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THE DAIRY PRODUCTION STABILIZATION ACT: POLICY CONSIDERATIONS AND IMPLICATIONS

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The U.S. Congress recently passed what is now popularly called the Dairy Compromise Bill (officially, the Dairy Production Stabilization Act of 1983). The bill contains a rider dealing with the tobacco program that is viewed as "vital" to the South, and with elections coming up in 1984, tobacco and dairy interests prevailed in obtaining the President's signature on November 29.

This publication provides an analysis of this new dairy program, with emphasis on some of the short-term economic impacts and longer-term policy implications. Two parallel publications, FM522, The Dairy Compromise Program: Who Should Participate and FM521, The Dairy Compromise Program: Should I Participate? provide an analysis of the new program from the perspective of the individual producer and a worksheet designed to help farmers decide whether to participate in the program or not.

THE PROGRAM

The Dairy Compromise Program is essentially a 15-month paid diversion program. The bill contains the following provisions:

1. Farmers can contract to reduce their milk sales from 5% to 30% from their base. The base period is 1982 with the January-March period added in twice to give a total of 15 months - or an average of 1981 and 1982 sales with the first quarters (January-March) counted twice, whichever is higher. (Note: The Secretary of Agriculture can reduce the amount of each farmer's contract if total sign-up appears to be too large.)

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*Department Head and Professors, Department of Agricultural and Applied Economics. Ken Egertson and Hal Everett helped in estimating the likely impacts of the dairy program on livestock and grain prices. Extension dairyman Robert Appleman assisted in making estimates of the likely responses by dairy farmers.

2. Payments of $10 per cwt. of reduction from base will be made quarterly for five calendar quarters, starting January 1, 1984, and ending March 31, 1985. Precise payment plans have yet to be established.

3. The cost of the payments will be partially financed by a 50 cent fee levied against all milk sold during the 15 month period. This 50 cent fee replaces the current $1.00 assessment. But, the milk support price will be lowered by 50 cents from $13.10 to $12.60. Thus, the net price to farmers will remain about the same, except--

4. A mandatory 15 cent checkoff for promotion purposes will also be made during this 15 month period. Farmers participating in the Minnesota checkoff of 6 cents per cwt. will pay 9 cents rather than 15 cents. A referendum will be held sometime during the 15 month period to determine the future of this checkoff.

5. On April 1, 1985, if the Secretary of Agriculture projects CCC dairy removals in excess of 6 billion pounds in 1985, the support price to the producer will stay about the same - because the 50 cent fee will be dropped at that time. If the Secretary's projection indicates CCC removals of less than 6 billion pounds, the net farm price increases 50 cents. On July 1, 1985, the Secretary could decrease the price support level another 50¢, to 11.60, if CCC dairy removals are projected to be more than 5 billion pounds in the next 12 months.

OTHER ALTERNATIVES CONSIDERED

Two alternative programs were widely discussed at the time the Compromise Bill was under consideration. One alternative was to continue the present program, which went into effect on April 1, 1983. That program, which has been very unpopular with producers, currently imposes an assessment on producers of $1 per cwt. of milk produced. (Hereafter we will refer to this as the current assessment program.) Continuation of that assessment was envisaged unless projected CCC purchases fell below 7.5 billion lbs. of milk equivalent. If such a reduction were in fact obtained, the assessment was to be reduced to 50 cents per cwt.

The second alternative would have removed the existing $1 assessment, but at the same time reduced price supports by $1.50 per cwt. This alternative was not very popular with producer groups either. (Hereafter we will describe this program as a simple reduction in the price support level.)

BACKGROUND TO THE BILL

At the time the Dairy Stabilization Act of 1983 was passed by Congress the federal government was purchasing record levels of dairy products to support producer prices. Acquisitions were expected to total nearly

17 billion pounds (milk equivalent) of products for 1983, or approximately 12 percent of total U.S. milk production. Government costs of these purchases were expected to be approximately $2.7 billion with producer assessments covering about $800 million of this. The large accumulation of stocks already in government hands and continued high expenditures had become a serious political problem for the dairy sector.

The large surpluses have developed because of continued expansion of milk production without corresponding increases in commercial sales of milk products - the classic symptom of a price that is too high to clear the market. July 1983 was the 50th consecutive month that production exceeded year earlier levels. Total 1982 production was at a record 135.8 billion pounds. Total production for 1983 is projected to be 2 to 3 percent higher than 1982.

On the demand side, the trend in commercial disappearance of dairy products for the 1970's yielded an average growth rate of 1.3 percent. The increase for 1982 was 1.6 percent over 1981 levels.

Prices paid by plants to producers for 1983 will be quite similar to 1982 levels. The price support program effectively determines this price. However, the average price received by producers for 1983 will be down approximately $.50 per cwt. This will be the result of the 50 cents per cwt. assessment on producers begun in April 1983, and the increase to $1 per cwt. on October 1, 1983. In the absence of a change in the program, this higher assessment was projected to continue through 1984.

If the present program had continued, production was expected to continue to expand well into the first half of 1984. Cow numbers for the first half of 1983 were above year earlier levels. July 1 cattle numbers indicated a larger herd for next year's production, since milk cow numbers were up 1 percent from a year ago and dairy heifers, 500 pounds and over, were up 3 percent from a year earlier.

Increased culling rates could have reduced the herd, but current beef prices and the outlook for only moderately increased prices would not have provided a basis for accelerated culling rates. Production per cow, however, would likely have fallen below its annual increase which has averaged 1.9 percent since 1970 because of higher grain prices and lower milk prices. In fact, these two factors would likely have stabilized milk production in 1984 if there had been no change in the program. And, given sufficient time, this program could have brought about a reasonable supply-demand balance -- but government removal costs would have remained high for several years.

With no change in price to consumers, commercial disappearance for 1984 would have expanded about 1.3 to 1.5 percent over 1983 levels even if heavy government donations were continued. An expanding population and probable increases in incomes and employment would have provided for a small increase in total consumption.

With the program currently in place, government purchases were expected to continue near the 15 to 16 billion pound level. Producer prices were expected to decline by 50 cents per cwt. or more from 1983 levels because of the full impact of the $1.00 assessment throughout the year.

The Compromise Bill is the fourth modification of the dairy price support program since 1982. Each change was motivated by continuous expansion of CCC purchases of dairy products for price support purposes and the record levels of government costs associated with those acquisitions. The first two changes in the program merely reduced the levels of mandatory support and the rate at which support prices could be increased. The third change was the institution of the assessment program in April 1983.

EXPECTED IMPACTS OF THE PROGRAM

The new program can be expected to have an impact on CCC purchases of dairy products, on the net costs of the support program, on the price of cattle, and on the purchases of inputs such as grain, machinery, and equipment used in the dairy sector -- as well as on the incomes of dairy farmers. This section presents some estimates of these expected effects.

Estimating these impacts is complicated because it is difficult to know what participation in the program will be and how much slippage there will be. The program is new and there is no previous experience to serve as a guide. The $10 per hundredweight diversion payment appears to provide a strong incentive for producers to participate, and analysis of farm-level data suggest that participation will be attractive to many individual producers.1/ However, expectations that producers have about future program directions and their own place in the dairy industry, the ability of the USDA to effectively administer the program, and the degree of slippage will all influence both the rate of participation in the program and the actual amount by which milk marketings are reduced.

To circumvent the difficulties of making direct estimates of such rather ambiguous effects, we simply make arbitrary but feasible assumptions about what reduced levels of milk marketings and cow slaughter might be and use these to analyze possible consequences. This should provide the reader with some notion of possible program effects and a baseline against which to compare greater or lesser participation in the program.

Impacts on Production, Consumption and Product Removal

Two possible levels of reduced milk marketings for 1984 are considered: 5 percent and 10 percent. Estimates of the impact of reductions of these

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1/See The Dairy Compromise Program: Who Should Participate?, FM 522.

magnitudes on government removals and costs are presented in Table 1, together with a comparison of estimates of the same effects had the current $1 assessment program been continued or had a simple $1.50 per cwt. reduction in the level of price support been imposed.

Total milk production is estimated to be about the same with a continuation of the present assessment program or a reduction in the support level of $1.50 per cwt. (approximately 138 billion pounds of milk), although production would be somewhat less with the simple reduction in support level due to the additional 50¢ reduction in producer prices. In effect, these program alternatives would leave production very close to 1983 levels.

In contrast, if the diversion program should reduce marketings by 5 percent, production would decline to approximately 132 billion pounds. If it should reduce marketings by 10 percent, production is estimated to be about 125 billion pounds.

An important difference among the programs is the expected impact on domestic consumption of dairy products. Commercial disappearance for 1984 is estimated to be 124 billion pounds if the current assessment program were to continue. Disappearance would rise to 125 billion pounds under the diversion program, since price to the consumer would be 50 cents per cwt. lower, but would increase to almost 127 billion pounds with the simple $1.50 per cwt. reduction in support level. An obvious advantage of the latter program over the longer term is that it would give a greater stimulus to consumption as well as reduce production, thereby helping to bring about a market equilibrium by inducing changes on both the demand and supply side of the market.

If milk marketings were to decline by 10 percent under the diversion program, total disappearance would be about in balance with total supply with minimal government removals (0.5 billion pounds). Hence, current large government stocks would not be expected to decline under this scenario, but additions to stocks would be minimal. If milk marketings were to decline by only 5 percent, the government would still be expected to acquire 7.2 billion pounds of product, and government-held stocks would continue to grow. We think that the economic incentives for participation are strong enough to attract the maximum participation that will be allowed by the government. Although this level is likely to be about 10% (the maximum acceptable has not been announced), unanticipated increases by nonparticipants and other slippage factors could result in a net decrease of less than 10%.

If the current assessment program were to continue through 1984, it is estimated that net government removals from the market would be 15.4 billion pounds. On the other hand, if a simple reduction of $1.50 per cwt. in the support level were to be implemented, government removals would decline to 11.6 billion pounds, largely a consequence of the stimulus to consumption because of the lower price.

Table 1.
Projected Impacts on Supply, Utilization and Government Costs of Selected Price Support Alternatives for the U.S. Dairy Industry, 1984.

	Continuation of 1983 program of $1.00 Assessment for Producers	A $1.50 Reduction in Support Price, No Assessment	Dairy Diversion with: 5% reduced marketings	Dairy Diversion with: 10% reduced marketings
	----------	Billion Pounds	----------	
Supply				
Production	138.8	138.1	131.9	125.2
Less Farm Use	2.3	2.3	2.3	2.3
Marketings	136.5	135.8	129.6	122.9
Beg. Comm. Stocks	4.6	4.6	4.6	4.6
Imports	2.5	2.5	2.5	2.5
Total Supply	143.6	142.9	136.7	130.0
Utilization				
Commercial disappearance	124.0	126.7	124.9	124.9
Ending comm. stocks	4.6	4.6	4.6	4.6
Net gov't. removals	15.4	11.6	7.2	.5
Total Disappearance	143.6	143.0	136.7	130.0
Government Costs	----------	Millions of Dollars	----------	
CCC purchases	2,391	1,645	1,148	80
Diversion payments	0	0	690*	1,360*
Total gov't. costs	2,391	1,645	1,838	1,440
Less Assessments	1,194	0	648	615
Net gov't. costs	1,197	1,645	1,190	825

*Assumes a 1.0% paid diversion for each 1.0% reduction in marketings from 1983 levels. This ratio would be less than 1.0 if one assumes that most participants will need to cut back production by more than they get paid for because of increases since their base period. But, we assume that increases in production by non-participants and other slippage factors will offset this factor.

Impacts on Government Costs

An important aspect of the program is that net government costs for the three programs are not greatly different unless milk marketings should be reduced by 10 percent. However, the kinds of program costs and cost recovery are different for each program.

Total government outlays are estimated to be the greatest with a continuation of the current assessment program, at $2.391 billion. Half of these costs would be recovered from assessments on producers, with the result that net government costs are estimated to be $1.194 billion.

Under the paid diversion program, government outlays for product removals are reduced substantially for both the 5 and 10 percent reductions in marketings. However, government costs of diversion payments would replace much of the product removal costs. The 50 cent per cwt. assessment on milk marketed would recover part of these costs. Net government costs are estimated to be lowest if marketings should be reduced by 10 percent. They would be between .8 and $1 billion depending upon the ratio between the reduction paid for and that actually obtained. (See footnote to table.)

Net government costs for a simple reduction in support level - had that program been voted in - would have been about $1.645 billion for 1984. This is the highest of the alternatives considered, in part because it included no provision for partial cost recovery from producers.

Impacts on Producer Incomes

Producer incomes in the short run of 1984 would be quite different under each price support program that was considered. The earnings of participating dairy farmers will be sharply higher -- by perhaps $7,000 to $10,000 per farm -- than they would have been on the alternative programs considered. Participation will not be financially attractive for all dairy farmers -- especially those who have significantly increased cow numbers since 1982. And, those producers who will have difficulty growing back to their desired herd size after the 15 month paid diversion program ends could lose up to a third of their earlier gains in 1985 and '86. Nonparticipating dairy farmers will have slightly lower earnings in 1984 because of the mandatory 15¢ checkoff for promotion but would, of course, share in any future milk price increase that may result if the program is successful.

Impact on Cattle Prices

An expected consequence of the paid diversion program is that increased culling of herds will lead to increased cow slaughter and a subsequent decline in cattle and hog prices, thereby spreading adjustment costs of the program to other sectors of agriculture. There is considerable

uncertainty as to what this increased cow slaughter will be, with estimates of various observers ranging from 300,000 to 1,000,000 head. For purposes of our analysis we use an estimate of 500,000. Proportional departures from that base assumption would lead to proportional differences in the expected impact on cattle prices.

If one assumes an average cow weight of 1,100 lbs., a cow slaughter of 500,000 head would increase cow beef production by 550 million pounds. This would be equivalent to 275 million pounds of cow beef on a product weight basis. Available estimates of impact coefficients for this increased slaughter suggest that each 100 million pound increase in cow beef supply on a meat product basis would cause prices for fed cattle to decline by $0.28 per cwt., and prices for cows to decline by $0.47 per cwt., other things remaining equal.

The ultimate impact of the increase in cow slaughter would depend on how it is distributed throughout the period of the program. If one assumes the slaughter is distributed equally throughout the projected 15-month period of the program, the price of fed cattle is estimated to be $0.60 lower than it otherwise would have been, and cow prices to be $1.03 per cwt. lower than they otherwise would have been.

Alternatively, if one assumes an unequal distribution of the slaughter, with 75 percent of the increase occurring in the first six months and the remaining 25 percent in the following six months, the impact on cattle prices would be rather different. Under this assumption, price of fed cattle is estimated to decline by $1.15 per cwt. in the first six months and cow prices to decline by $1.93 per cwt., compared to what they otherwise might have been. In the second six months, on the other hand, price of fed cattle would be $0.38 per cwt. less than it otherwise would have been, and cow prices $0.64 per cwt. lower.

Obviously, the paid diversion program will have a significant impact on incomes of cattle producers in 1984. It will also lower the expected income of many dairy producers, since they will receive a lower price for their slaughter animals. However, some of these losses would be recovered in 1985 as dairy cow slaughter drops <u>below</u> normal due to (1) a lower culling rate and (2) a smaller base herd from which to cull.

A simple reduction in the price support level could also be expected to have an impact on cattle prices. However, the distribution of the impact might reasonably be expected to be spread out over a longer period of time, with less of an impact in 1984 but with a continuing downward impact over several years until a milk supply/demand balance was achieved.

Impact on Hog Prices

Hog prices could also be expected to decline as a result of the increase in cow beef supply. If one assumes the slaughter is distributed equally through the projected 15-month period of the program, the price of hogs is estimated to be $0.40 per cwt. lower than it otherwise would have been.

Alternatively, if one assumes an unequal distribution of the slaughter, with 75 percent of the increase occurring in the first six months and 25 percent in the following six months, the impact on hog prices would be as much as $0.75 per cwt. in the first six months and a decline of $0.25 per cwt. in the second six months compared to what it would have been with the increase in cow slaughter. Again, some of these losses would be recovered in 1985 because of the reduction of beef sales expected as some dairymen rebuild herds.

Impact on Grain Prices

Grain and soybean prices will also be affected as participating dairy farmers make adjustments in rations and cow numbers. In the past feeding year USDA estimates show that dairy cows comprised 14.8 percent of total U.S. grain-consuming animal units and 10.6 percentof high protein-consuming animal units.

If we assume a 500,000 cut in dairy cow numbers and a 10 percent cut in the concentrate rations for the remaining herd (due to reduced concentrate feeding by participating farmers) corn feeding would decline by about 125 million bushels and soybean use by about 25 million bushels. Although these are not large amounts in light of total grain supplies, in a relatively tight supply year like the current one corn prices are likely to be a few cents lower and soybean prices a dime or so lower because of this reduction in feed useage.

Impact on Other Input Supply Industries

Finally, if the diversion program is successful in reducing milk marketings it will result in reduced demand for other feeds and inputs used in the production of milk, and in a reduced demand for marketing services. We will not attempt to make a quantitative assessment of these impacts.

Summary

In summary, the earnings of participating dairy farmers will be enhanced in 1984 while almost all other farmers and farm related businesses will suffer some income losses. In an important dairy state like Minnesota

the net effect will likely be some increase in net income to the agricultural sector if there is more than a 5% cut in Minnesota milk production. A 10% cut from the 1982 base would bring in about 100 million dollars in dairy diversion payments. However, reduced milk sales and lower prices to beef, hog and grain producers would likely reduce the impact upon the net earnings to Minnesota farmers to less than $50 million. States with proportionately higher grain and meat animal sales - like Iowa or Illinois - may well have lower net earnings in 1984 because of the dairy program.

OTHER ASPECTS OF THE PROGRAM AND MORE GENERAL POLICY IMPLICATIONS

There are a number of other aspects of the diversion program that need to be considered, in addition to the assessment of the direct impacts outlined above. This section is devoted to these other dimensions of the program and its alternatives.

Administering the Program

The paid diversion program created by the Dairy Production Stabilization Act of 1983 is the first time under the price support program that an attempt has been made at production control programs for the U.S. dairy industry. Such programs have been in place in Canada for some time, however.

A number of aspects of administering the program are important. First, it will undoubtedly result in an enlarged bureaucracy to manage the program. This will add to taxpayers' costs, although these costs are not included in the estimates of government costs presented above. This increase in costs could be significant, however, because the dairy industry is widespread throughout the nation and the program will require close monitoring.

Second, it will take some time to learn how to manage the program since we have not had anything like it in the past. If additional staff are needed to manage the program this would further complicate this problem, since they will have to learn the ways of government in addition to learning the new program. For these reasons one should expect some difficulties in administration of the program in the beginning months.

Third, administration of the program will involve a great deal more intervention in the activities of dairy producers than past programs. In fact, the lack of production control programs in past policies have enabled dairy producers to remain remarkably free of direct government involvement in their production activities, despite the high degree of government intervention in the sector to support producer prices. This will now change, and dairy producers will need to learn to work more closely with government people. This is a new dimension to the program.

Fourth, participation in the program will incur costs in terms of the time of the producer. They will need to learn the regulations, fill out forms, and work with government agents. These may not be insignificant costs to the individual producer. However, aggregated over the industry, such costs will be significant to society as a whole, and subtract from more productive activities.

Participation in the Program

Our analysis presented elsewhere 1/ suggests that, based only on short-run, within-year considerations, participation in the program will be attractive to many producers. Whether producers decide to participate, however, depends on a number of other factors. One of these is the expectations that producers have about future programs. Those who expect relatively high support levels when this 15-month program ends, may well continue to produce, leaving the desired production adjustments to others. In contrast, if producers expect prices to be lower after the program, and are considering exit from the sector in any case, the program may provide the incentive to implement that decision.

Cash flow problems are also a consideration. Producers most likely to benefit in this sense are likely to be those with low production per cow and therefore high production costs per hundredweight. This suggests that marginal producers with cash-flow problems may participate in the program at a relatively high rate. For those producers the program may offer an opportunity to improve their short term cash flow positions, upgrade the quality of their herd, and become more efficient producers when the program ends.

The behavior of cattle prices will also be a factor influencing participation. If cattle prices remain near December lows during the January sign-up period, it will appear less attractive to reduce the herd, especially if this is expected to be a short-term phenomenon. If cattle prices should rise during the next month, participation in the program will appear more attractive.

Slippage

An important problem with this program is that there may be considerable slippage. First, monitoring the program will be relatively difficult. Keeping track of rather mobile cows and production will be a great deal more difficult than with the more familiar production control programs associated with crops where the idling of land is the means of production control. Produced milk can rather easily show up on a neighbor's production account, causing total production to decline less than expected even though participation rates in the program may be rather high. To minimize this problem it will be necessary to require that producers dispose of their cows by slaughter. With some exceptions, selling, leasing or transfering cows

1/The Dairy Compromise Program: Should I Participate?, FM 521.

to another dairyman is prohibited. This will be another intrusion of government agents in the day-to-day activities of producers. But, this regulation, plus the threat of loss of diversion payments in case of failure to comply with regulations should help limit slippage. Also, the fact that most dairymen will have to cut back from current production levels before they even return to their 1982 base production could result in total milk sales reduction during 1984 being about equal to the amount the government actually pays for.

Longer Term Adjustments

Perhaps the most serious deficiency of the program is its expected failure to induce longer-term adjustments in the sector. The dairy industry is obviously out of adjustment, with supply outpacing demand at prevailing prices by a significant margin year after year. It is this imbalance between supply and demand that causes government acquisitions to be high and that cause government costs to burgeon out of control. A simple reduction in price supports would reestablish balance by means of a decline in price, thereby increasing the quantity demanded and lowering the profitability of dairying so as to induce the needed outflow of resources from the sector.

The diversion program has deficiencies on both the demand and supply side of the market. It offers some improvement over the current program in that it provides a modest reduction in prices to consumers, thereby providing a modest stimulus to consumption. At the same time, to the extent that it increases expectations for higher prices after 15 months, it may make staying in dairying a relatively attractive economic activity to some who might better shift out. Hence, the program may well serve as an impediment to the longer-term adjustment that the sector needs so badly.

This problem is exacerbated by the short-term nature of the program. By careful planning of culling, breeding of replacements, early drying off of milking cows, and feeding, producers may be able to make substantial reductions in milk production during the 15-month period and then reestablish 1983 levels of milk production very quickly. Moreover, many producers may use the cash flow provided by the program and the extra time they will have in 1984 to upgrade their management skills as well as the genetic composition or quality of their herds. Hence, even if the program succeeds in reducing 1984-85 milk production, there is little if any assurance that the excess resources devoted to dairying will be reduced. In fact, there is a good chance that the production capacity of the sector will be even greater at the end of the program.

The dairy industry faces a serious adjustment problem, since supply has been exceeding demand by approximately 10 percent in recent years. The adjustment problem is complicated by two factors. First, many resources in the sector are relatively fixed in the sense that they have no alternative uses. Milking stalls and equipment, for example, have little value outside

of dairy. Highly specialized dairy cows also have much lower value as slaughter animals than in the production of milk. Unfortunately, the relative profitability of dairy as a production activity in recent years -- because of unrealistically high government support prices -- has increased the investment in such inputs, making the adjustment problem even more serious.

Equally as important, alternative production activities for many dairy farmers (such as in the Northeast and the cut-over area of Wisconsin and of Minnesota) would require a major restructuring of agriculture and the exit from farming of many people. For example, the next best alternative for many such producers would likely be some form of hog production, beef production or possibly small grain production. In other cases the land may simply go out of production. Beef or small grain production would require a reorganization of the farms into significantly larger and more extensively operated farms and/or into part-time farming operations.

There are programs and policies that can be used to facilitate such adjustments, however. These include retraining programs for alternative employment, support for transition to alternative employment, assistance in reorganizing into larger units, and rural development to provide alternative employment close at hand. Government expenditures to bring about such adjustments would help to reestablish the longer-term health of the industry. Such expenditures would undoubtedly have a higher payoff both to the producers involved and to society at large than to pay large numbers of farmers for not producing -- especially if the provision in the new law for reducing prices if production rebounds in 1985 are not taken seriously enough to result in any longer-term adjustment in milk production.

Vested Interests in Program Continuation

Another unfortunate aspect of the program is that it establishes a precedent for production quotas in the sector, something dairy producers have avoided with past programs. The problem with quotas is that they tend to become institutionalized. The value of whatever effect the program has in raising farm incomes becomes capitalized into the quotas, and they therefore become a barrier to future changes in the program. They also make it more difficult for young farmers to get started -- an often expressed concern of rural people. If a quota program should exist for some years, ownership of the quota may pass to a different person than received the original capital gain, and future elimination of the program would impose a capital loss on that owner unless the government should buy him or her out. Over the longer term, then, the Dairy Production Stabilization Act may well make it increasingly difficult to bring about changes in the program.

Other Longer-Term Considerations

An important limitation of the program, as noted above, is the danger that it will have only a temporary impact on milk supplies. If producers are to make the longer-term adjustments that are needed to restore balance in the sector and reduce government expenditures, they need to have some degree of certainty as to what future prices and programs will be. A 15-month program that is the result of a bruising political fight does little to cure the basic problem unless it can be followed up with strict adherence to that part of the law that provides for reducing price supports further if government purchases move up over 5 billion lbs. after July 1, 1985.

It would have been better from the longer term standpoint to have specified in the law that prices would remain at current levels until supply/demand conditions move them up of themselves. The expectation of continued low prices over at least 2 or 3 years would have resulted in a much larger permanent adjustment according to what we know about the response of milk supplies to changes in price. Existing statistical evidence suggests that in a period of one year that response is quite low, with a 10 percent change in price inducing only a .4 of a percent adjustment in supply. A somewhat larger response occurs in the second year, but the largest response doesn't occur until the third year, and there is still some response in the fourth year. After sufficient time has passed, however, the accumulated response is relatively large, .6 percent. That means that a 10 percent reduction in price, if it were maintained for four years, would bring about a 6 percent reduction in production, other things being equal. On a 139 billion pound base, that would amount to a reduction of 8.34 billion pounds in production.

Similar considerations apply on the demand side. The response to a decline in price at the supermarket is fairly modest in the short term. However, if a decline in price persists for a longer period of time, the response will be greater.

The key to restoring balance to the dairy sector is to encourage increased consumption at the same time that production is being reduced. A serious weakness of the assessment program that started last April is that it attempted to restore balance by working only on the supply side of the market. Prices to consumers remained unaltered.

If prices were to be lowered to both producers and consumers, backed by a strong commitment by policy makers that they would not be changed until balance was stored in the market, the required reduction in price might be much smaller than many people expect. Analyses in the Department of Agricultural and Applied Economics suggest that a long-term price in the range of $10.50 to $11.00 per cwt. would reestablish balance between demand and supply.

The new compromise program is superior to the current program in that it contains two of the criteria needed for a successful dairy program - both lower consumer and producer prices. Our concern is, will the expected temporary drop in supplies give too many producers false hopes as to future milk prices.

Another factor that producers need to keep in mind is the emergence of substitute products when prices are held at artificially high prices for any period of time. Dairy producers have already witnessed the erosion of their longer-term markets by the emergence of oleomargarine. Artificial cheeses are now appearing on the scene. Continued maintenance of artificially high prices only encourages the search for such artificial substitutes and provides protection to the new industries that bring them into production.

Finally, those producers committed to dairy production as a longer-term vocation should be concerned by the added entrants to the industry that higher prices bring. Once additional resources are induced into the sector, it is very difficult to move them out. The alternatives are either prolonged periods of lower prices, or government interventions in dairy activities that will be increasingly prominent in the day-to-day activities of individual producers.

Concluding Comments

The Dairy Production Stabilization Act provides a means of reducing and possibly eliminating the addition to government stocks of dairy programs during the next 15 months. Participating dairy farmers will enjoy higher incomes during this period while most other farmers and dairy related industries will have lower incomes. The program does not, however, significantly lower government expenditures. Direct government costs of the dairy program itself may be moderately reduced over the next two years, but it is very likely that costs to administer the program will increase. The program also will introduce a great deal more government intervention into the day-to-day activities of producers.

The disappointing feature of the program is that it is expected to induce very little longer-term adjustment in the sector. In fact, the chances are quite good that the production capacity of the sector will be larger at the end of the program than at the beginning. If this should occur, the eventual day of reckoning has only been put off and perhaps made more difficult.

The need is for programs that will help individual producers adjust to new economic activities, some of which will be outside of agriculture, and to facilitate the reorganization of the resources that remain in agriculture. So far, policy makers have given little attention to programs of this kind.