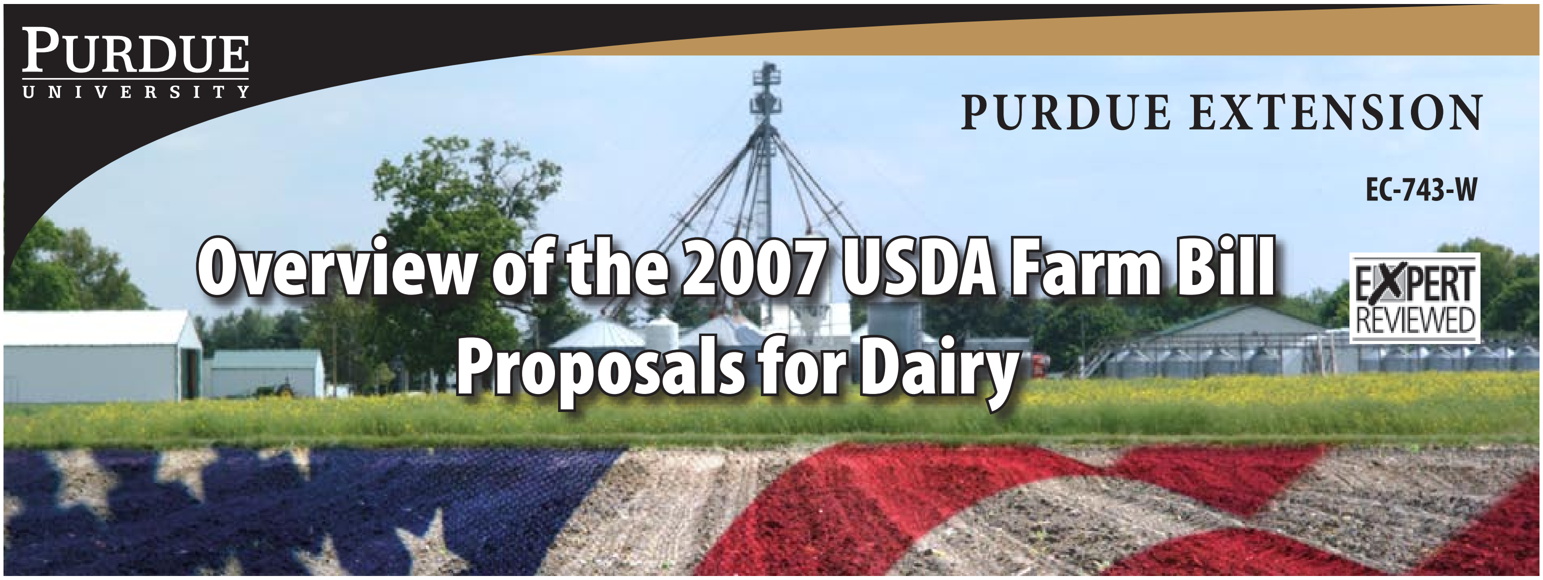

Overview of the 2007 USDA Farm Bill Proposals for Dairy

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The Commodity Title of the Administration's (USDA) Farm Bill proposal includes two specific policy recommendations for dairy. This brief outlines the key elements of the proposal and provides a brief assessment of the economic implications.

Extend the Milk Price Support Program at the Current Support Price

The Milk Price Support Program (MPSP) is currently set to expire in September 2007. The MPSP, which has its origins in the Agricultural Act of 1949, supports minimum prices for nonfat dry milk, butter, and cheese through government purchases of these products. Purchase prices for supported products are calculated so as to enable dairy processors to pay farmers a milk support price determined by Congress.

The current support price for milk is $9.90 per cwt., with purchase prices of $1.05/lb for butter, $1.13/lb for block cheddar, and $0.80/lb for nonfat dry milk (NFDM). The MPSP was scheduled to be phased out by year 2000 under the 1996 Fair Act, but it was subsequently extended and then reauthorized as part of the 2002 farm legislation.

The MPSP raises average prices for the supported dairy products and thus tends to raise farm prices for milk. There is also evidence that the MPSP reduces variability in product prices and farm prices.

Costs of the MPSP are incurred by dairy consumers, who pay higher prices for manufactured dairy products, and also taxpayers. Annual net outlays for the MPSP average $436 million from FY2000-2006 (USDA-FSA) despite relatively high market prices for supported dairy products. Under FAPRI and USDA projections, market prices for supported products would continue to remain above current purchase prices.

In addition to the direct costs incurred by consumers and taxpayers, the MPSP has important implications for trade. It raises U.S. prices of butter, NFDM, and cheese, thus reducing U.S. exports. The MPSP is also the most trade distorting of all U.S. agricultural policies, contributing $4.7 billion to the U.S. Aggregate Measure of Support. (The Aggregate Measure of Support (AMS) is used by the WTO to measure the extent of trade-distorting domestic farm policies. The U.S. is currently committed to maintain an AMS below $19.6 billion.)

Comment

Government purchases through the MPSP distort dairy product markets and transfer wealth from dairy consumers and taxpayers to processors of supported products and, indirectly, to dairy farms, with the program costs exceeding benefits. The effectiveness of the MPSP as a farm policy tool has been questioned because the support is indirect, with some of the program benefits accruing to processors. Also, higher dairy product prices reduce competitiveness of the U.S. dairy sector in export markets and in the U.S. and thus may have long-term detrimental effects for the sector.

The MPSP also poses a significant obstacle to multilateral trade negotiations by preventing the United States from offering more far-reaching reductions in domestic support in WTO negotiations.

Further, the MPSP is redundant in the sense that it, along with milk marketing order regulation and the Milk Income Loss Contract, is one of several dairy policy instruments currently used to attempt to increase returns to dairy farming.

Re-Authorize and Revise the Milk Income Loss Contract

The Milk Income Loss Contract (MILC) was introduced in the 2002 Farm Bill and provides a deficiency payment to dairy farmers. Payments are triggered in months when the Class I (fluid milk) price in Boston falls below $16.94/cwt. The payment rate is currently 34% of the difference and is paid on current production up to a quantity limit of 2.4 million pounds per farm (approximately the annual output of 120 cows). The MILC program is currently scheduled to end in August 2007.

From December 2001 through December 2006, the average Class I price in Boston was $15.97/cwt, well below the target price of $16.94/cwt. Thus, MILC payments have been paid out frequently (in 39 of 61 months), with an average payment rate of $.63/cwt during that time period. More than half of the payments go to farmers in the five top dairy states (Wisconsin, New York, Pennsylvania, Minnesota, California). Because of the quantity limit, payments are a relatively important source of income for smaller farms (more than 4% of milk revenue in states such as Wisconsin and Minnesota) and less important for larger farms (approximately 1% of milk revenue in California).

The USDA proposal would make two additional changes to the current MILC program. First, it would tie payments to historical production in an effort to make the program more WTO friendly. Specifically, payments would be made on 85% of the annual average production during 2004-2006, and the current cap of 2.4 million pounds would still apply. Also, the payment rate would be reduced gradually to 20% of the difference between $16.94 and the Boston Class I price. Second, in addition to the quantity-based payment cap, MILC payments would count towards a $110,000 cap on counter-cyclical payments, and eligibility would be restricted to farmers with adjusted gross income less than $200,000.

By tying the payments to historic, not current, production, the proposal would reduce the incentive to increase production in response to the payments. Also, making payments based on 85% of historic production will tend to lower payments to smaller farms (those for whom the 2.4 million lb cap is not binding) and thus reduce the cost of the MILC program. The reduced payments rates over time will also reduce the cost of the MILC program.

Comment

The MILC program, like other deficiency payments, perpetuates the problem of low market prices in that the supply response to program payments induces lower market prices, which in turn increases payment rates. Reducing payment rates and tying the payments to historical production moderates, but does not eliminate, this cycle.

The MILC program may make many larger farms worse off despite the payment, because supply response from the payment tends to lower the market price. Thus, the MILC program has had important distributional effects across U.S. dairy farms. Basing payments on historical production could reduce this negative effect on larger farms.

The proposal to base MILC payments on historical production faces some practical difficulties. Similar payments for program crops are tied to farmland. However, there is no obvious productive asset to which MILC payments can be based. Will rights to the proposed MILC payments be given to the farm entity? Will those rights be transferable? Will new dairy farms, with no production base, be eligible for payments?

The new eligibility requirement based on adjusted gross income would tend to reduce government costs of the program. If the income restriction is binding for more farms than the current quantity limit, then it may exacerbate the distributional effects of the policy. The proposed eligibility requirement based on adjusted gross income also raises some practical questions. How will the adjusted gross income restriction be implemented? How many dairy farms affected? What are the characteristics of these farms?

It is not clear that deficiency or counter-cyclical payments based on historical production can withstand challenge in the WTO—see cases against U.S. policies for corn and soybeans.

Like the counter-cyclical payments for program crops, the MILC program may not be particularly effective in providing a safety net for net revenue on dairy farms. For example, suppose bad weather or disease problems resulted in low milk production per cow and low net farm revenue. All else equal, reduced milk production would tend to raise milk prices and therefore reduce the likelihood of a MILC payment. The USDA proposal addresses this problem for program crops by proposing a revenue counter-cyclical payment. No such program is proposed for dairy.

Final Comment

The Farm Bill Proposal offered by the Administration in February 2007 includes two proposals for U.S. dairy. The first is to extend the Milk Price Support Program (MPSP) unaltered from its current form. The second is to extend the Milk Income Loss Contract (MILC) with modifications that could reduce the cost (and effectiveness) of the program, and also make the program more amenable to multilateral trade.

The MPSP and the MILC program each may be viewed as income support for dairy farms. Milk marketing orders achieve a similar result. Issues not addressed by the proposal include how these policies interact and whether all three of these policies are justified. Can income support for dairy farms, or for a subgroup of dairy farms, be achieved with a better, more transparent policy?

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