

# MARKETING AND POLICY BRIEFING PAPER



Department of Agricultural and Applied Economics, College of Agricultural and Life Sciences, University of Wisconsin-Madison  
Cooperative Extension, University of Wisconsin-Extension

Paper No. 89  
March 2005

## Dairy Policy in the Next Farm Bill: An Early Assessment

Ed Jesse<sup>1</sup>

The 2002 Farm Bill (the Farm Security and Rural Investment Act of 2002), enacted in May 2002, will expire on December 31, 2007. A replacement bill will be crafted in an environment that, while uncertain now, will certainly be different from what existed during the last farm bill debate.

The purpose of this paper is to identify likely changes within the dairy title of the new farm legislation. We begin by briefly reviewing the dairy provisions of current legislation, the Farm Security and Rural Investment Act of 2002. We then discuss the principal factors that will influence dairy provisions in the new bill. Finally, we speculate on the nature of dairy price and income support options that will likely be considered by Congress in the next dairy title.

### Dairy Provisions of the 2002 Farm Bill<sup>2</sup>

#### MILC

Passage of the 2002 Farm Bill was delayed by lengthy Senate debate over the dairy title. The debate revolved around the Northeast Interstate Dairy Compact, which expired on September 30, 2001. Vermont Senators Leahy and Jeffords were committed to including similar fluid milk over-order pricing authority in the Senate dairy title. Midwest senators were equally committed to ensuring that the Northeast Compact remained dead and buried.

<sup>1</sup> Professor and Extension Dairy Marketing Specialist, Department of Agricultural and Applied Economics, University of Wisconsin-Madison/Extension. Bob Cropp's constructive comments on an earlier draft of this paper are gratefully acknowledged.

<sup>2</sup> For more detail, see Jesse, E.V. and R.A. Cropp, "Dairy Title: Farm Security and Rural Investment Act of 2002," Marketing and Policy Briefing Paper No. 76, May 2002

Several proposals were considered in the Senate that would differentiate between the Northeast and the rest of the country, and the farm bill ultimately adopted by the Senate included two separate deficiency payment programs for dairy. One applied to the six New England states that comprised the expired Northeast Compact region plus six additional northeastern states (New York, Pennsylvania, New Jersey, Maryland, Delaware and West Virginia). The Northeast deficiency payment program was essentially the previous compact — the target price was a \$16.94 Boston Class I price and deficiency payments were equal to 45 percent of the difference between the target price and the actual Boston Class I price — except the deficiency payments were covered by the treasury instead of fluid milk processors.

The deficiency payment program that would apply to the remaining 38 states involved a quarterly target price equal to the five-year average U.S. all-milk price for the quarter. In any quarter when the all-milk price fell below the five-year average, all producers located outside the defined Northeast regions would receive 40 percent of the difference.

The House-Senate Conference Committee rejected the notion of separate deficiency payment programs. What the committee ultimately adopted for a national deficiency payment program was MILC, the Milk Income Loss Contract program. MILC was the Senate Northeast plan applied nationwide. It was authorized retroactive to December 2001 through September 2005.

MILC is a unique dairy price and income support program in several respects. It is the first application of the target price – deficiency payment concept to dairy, even though the concept has been a fixture of federal crop income support programs since the mid-1970s. It is different from the Northeast Compact in that deficiency payments are funded by the treasury, not by assessments on fluid milk handler. It limits payments to individual farmers by imposing an annual cap on production eligible for payment of 2.4 million pounds. The conventional means of limiting individual farm payments is via dollar-denominated payment limitations.

The MILC production cap has been a source of controversy. Critics claim that the cap is discriminatory, differentially benefiting smaller, inefficient dairy farmers. Worse, they say, the program was partly responsible for the long period of low milk prices extending from December 2001 until mid-2003. Smaller producers, who would normally be quicker to call it quits after several months of low prices, were induced to continue milking cows because of the large MILC payments. Hence, the argument goes, the burden of adjusting to low prices by curbing production fell disproportionately on larger farmers subject to the production cap.

While plausible in theory, this argument is not strongly supported by observed structural changes in dairy farming. Between 2001 and 2004, U.S. dairy cows in herds with fewer than 200 cows fell from 48.7 to 41.6 percent of total inventory and cows in herds larger than 200 cows increased from 51.3 to 58.4 percent. The largest increase was in the

2,000+ herd size, which accounted for 11.5 percent of U.S. cows in 2001 and 18.3 percent in 2004.<sup>3</sup> Over this time, herds over 2,000 cows added more than 600,000 cows. The 2.4 million pound production cap is less than one month's milk production from these herds. Herds smaller than 200 cows lost nearly 700,000 cows. Most of these herds would be eligible for MILC payments in every month that payments were made.

While MILC payments (or lack thereof) influenced expansion and exit decisions on the margin, non-economic factors played a larger role. Many decisions to expand already large herds were made several years before implementation. Once permits and financing were obtained, there was no turning back regardless of milk prices. Similarly, decisions to exit are often based on age and health. These decisions may be temporarily delayed with improved dairy income, but they cannot be rescinded.

The MILC program was considerably more expensive than anticipated. Because of very low milk prices and a target price considerably higher than the five-year average Boston Class I price, MILC payments were received every month between the program's inception in December 2001 and August 2003. Total program payments have been just over \$2 billion. This compares to an initial Congressional Budget Office (CBO) estimate of about \$1 billion for the life of the program. There have been no payments since the 2 cents per hundredweight payout in April 2004.

The MILC program is scheduled to end on September 30, 2005. During his re-election campaign, President Bush pledged to support an extension of MILC to coincide with expiration of the 2002 Farm Bill on December 31, 2007. A pre-election attempt to attach legislation to extend MILC to a budget authorization bill failed. New legislation has been introduced, and the President's budget proposal supports extending MILC (with a 5 percent cut in payments). But any extension will likely be opposed by legislators from states with larger dairy herds.

### **Dairy Price Supports**

The predecessor of the 2002 Farm Bill, the Federal Agricultural Improvement and Reform Act of 1996, terminated the price support program effective December 31, 1999. Subsequent extensions delayed termination, and the 2002 Act reauthorized the support program at \$9.90 for milk of average (3.67 percent) butterfat through December 31, 2007.

The 2002 Farm Bill retained authorization for the Secretary of Agriculture to adjust the relative CCC purchase prices for butter and nonfat dry milk (tilt) as often as twice annually. This authorization dates to the 1990 Farm Bill. The Secretary has made one butter-powder tilt under the extended authority, in November 2002.

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<sup>3</sup> Dairy herd size distribution data are available at: <http://www.nass.usda.gov:81/ipedb/dairy.htm>

## **Other Extensions of Authority**

The Dairy Export Incentive Program (DEIP), as authorized by the Food Security Act of 1985 was extended through September 2007, as was the Dairy Indemnity Program (DIP), as authorized by the Agriculture, Rural Development, Food and Drug Administration and Related Agencies Appropriations Act of 1998.

The fluid milk (MilkPEP) promotion program, originally authorized under the Fluid Milk Promotion Act of 1990 was extended through 2007 at the 20 cents per hundredweight fluid handler assessment rate. However, the minimum exemption was increased from 500,000 pounds of fluid milk products in consumer-type packages per month to 3,000,000 pounds per month, excluding products delivered directly to the place of residence of a consumer. The 2002 Farm Bill also extended mandatory reporting of inventories of dairy products by milk processors and strengthened reporting requirements.

## **Assessments on Dairy Imports**

The current Farm Bill includes a requirement that importers of dairy products pay an assessment equivalent to the mandatory 15 cents per hundredweight that U.S. dairy farmers pay to fund the National Dairy Promotion and Research program. This provision has not yet been implemented. At issue is the WTO legality of the provision. Both USDA and the Office of the Special Trade Representative have raised questions about imposing the assessment on imports when some domestic producers (Alaska, Hawaii, and Puerto Rico) are exempt from the promotion check-off.

## **Required Economic Studies**

Farm Bills normally mandate USDA to conduct various economic studies. The 2002 bill required three such studies related to dairy to be completed by May 2003. USDA's Economic Research Service (ERS) combined two into a highly publicized major study released in late 2004. ERS concluded that all federal dairy programs combined had only a "modest" effect on farm milk prices, producer revenue, and consumer prices. The effect of the programs on price variability was also judged to be modest.

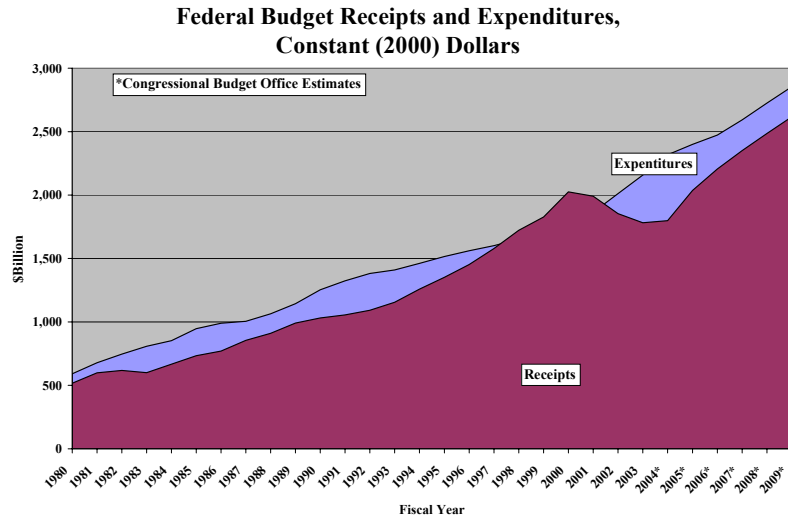
## **Dairy Policy Drivers in 2007**

The key drivers of dairy policy in the next farm bill will be the budget deficit and international trade concessions made by the United States under the Doha round of the WTO negotiations.

## Budget

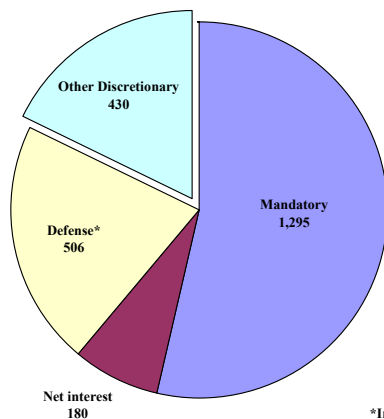
In 2001, federal tax receipts fell off sharply as federal income tax rates were cut at the same time that the U.S. economy moved into a recession. Later, federal expenditures escalated due primarily to war-related costs in Afghanistan and Iraq and funding for the Department of

Homeland Security and other activities related to the September 11, 2001, terrorist attacks. The result of smaller revenues and escalating federal expenditures was a mounting federal deficit, which was estimated to be greater than \$500 billion (2000 dollars) in FY2004. Current projections by the Congressional Budget Office (<http://www.cbo.gov>) show federal deficits continuing through 2011, even assuming strong economic growth.



Increasing federal taxes to reduce the federal deficit is not in the cards; indeed, the Bush administration favors more tax cuts. That leaves expenditure cuts as the sole means of addressing the federal deficit. This poses a major challenge, since much of the federal budget is locked up in the form of mandatory spending or untouchable spending. Note from the figure below that for FY 2005, funds remaining after accounting for mandatory program spending, interest on the national debt, and defense costs are less than the forecast fiscal year budget deficit.

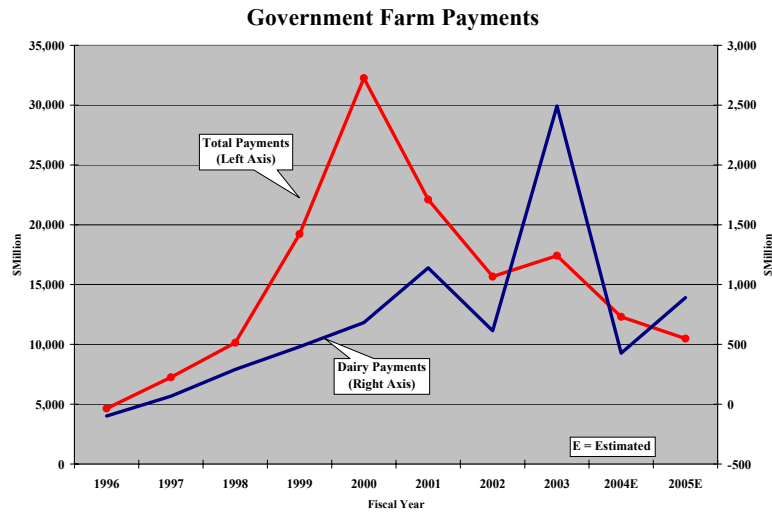
**Composition of Federal Budget Expenditures, FY2005  
(Billion Dollars)**



\*Includes Homeland Security.  
Source: Congressional Budget Office

Among farm program outlays, dairy program expenditures represent a relatively small share. But dairy program costs have been trending upward while total farm program costs have been going down. And recent MILC payments have made dairy program costs more visible.

Efforts to control federal spending will strongly influence the debate on new dairy legislation. Inter-commodity battles will occur over what is a “fair share” of what will undoubtedly be a smaller pie. Unconstrained funding commitments (like MILC) will probably not be acceptable.



## Trade

Negotiations related to agricultural trade under the Doha round of WTO have been proceeding in fits and starts for several years. The latest step forward was publication of the *Framework for Establishing Modalities in Agriculture* in early August 2004. This document lays out the basic elements by which export subsidies will be reduced, market access increased, and domestic agricultural support programs made less trade-distorting. Subsequent negotiations will focus on the specifics within these elements.

Especially pertinent to dairy are domestic support programs. Agreements made under the current WTO agreement (Uruguay Round) limited “amber box” programs — farm price and income support programs deemed to be trade distorting. These include price support programs even though no treasury payments are actually made — the WTO position is that price support programs represent a transfer from consumers to producers whether or not the support prices are binding. The U.S. must adhere to a declining Aggregate Measure of Support (AMS), calculated as the total of amber box program benefits. The current maximum AMS permitted the U.S. is \$19.1 billion. In 2001, the last year in which reporting was made, the U.S. reported an AMS of \$14.4 billion, \$4.7 billion under the cap.

The dairy price support program contributes about \$4.5 billion to the annual U.S. Aggregate Measure of Support. This represents 25 percent of the AMS cap and 75 percent of that portion of the AMS associated with price support programs. The dairy price support program benefits are calculated by multiplying total U.S. milk production by the difference between the farm milk price support level of \$9.90 per hundredweight and a base period world market reference price for milk used for manufacturing. The

reference price is \$7.25 per hundredweight, resulting in a \$2.65 per hundredweight program “cost.”

Doha round WTO negotiations may or may not be completed by the time the new farm bill is debated in earnest. But it is clear that any new agreement will further ratchet down permitted amber box farm programs and further limit exemptions. Consequently, the dairy price support program, at least as currently structured, would appear to be in trouble. However, the U.S. may — and should — negotiate a change in the manner in which price supports contribute to aggregate measures of support. It is unreasonable to compare a low domestic safety net price with a fixed world market price that was negatively affected by large export subsidies. And with market prices well above support, it is unreasonable to argue that the dairy price support program transfers income from consumers to producers.

### **Options for 2008**

It is very early to speculate on farm policy that is three years away from the making. Nonetheless, some things seem reasonably clear:

#### **MILC in its present form is not a viable long-term option**

MILC was a compromise dairy program that ended up costing more than expected because of lower than expected milk prices. It also limited payments in an unusual manner that large dairy farmers found egregious.

The program in some form will very likely be extended to expire concurrent with other provisions of the 2002 farm bill. The President apparently intends to make good on his campaign promise. An extension makes sense from the standpoint of consistency — it is not clear why the program was authorized for an abbreviated time period except, perhaps, to demonstrate cost containment. And given longer-term milk price projections, program costs during an extension will not approach the costs incurred during the first two years of MILC.

But MILC will probably not be part of the new farm bill for the two basic reasons noted above: program costs and production caps. The MILC target price is too high relative to average milk prices over the past several years, making the program a price enhancement rather than a safety net tool. The \$16.94 Boston Class I price target translates to a \$13.69 Class I mover. Since adoption of the current mover concept in January 2000 through December 2004, the Class I mover averaged \$12.64, \$1.30 less than the target. The 10-year, 1995-2004 Class III price, which parallels the Class I mover, averaged 12.40, \$1.54 less than the target. Setting a target price well above the expected average price level not only makes the program income-enhancing, it guarantees, on average, large per hundredweight payments and related large program costs. Moreover, setting a constant

price target fails to recognize seasonality in milk prices — average seasonal highs are more than \$1.00 per hundredweight higher than seasonal lows.

MILC's payment eligibility based on annual milk production is a remnant of earlier one-time market loss payments made to dairy farmers. Applied to one-time payments, the production cap was essentially equivalent to the more conventional lump sum payment limitations applicable to most farm programs — dairies subject to the production cap received the maximum allowable payment. But the production cap proved problematic for a continuous direct payment program like MILC because it resulted in large dairies receiving smaller payments than smaller dairies. That's because the monthly payment rate could be less on milk marketed before the cap was reached. While dairies subject to the cap could pick the month they wanted to begin receiving payments, few were fortunate or foresighted enough to select a starting month that maximized payments.

**A MILC-like counter-cyclical payment program for dairy is a viable option that will receive considerable attention.**

MILC's deficiencies can be addressed and its counter-cyclical payment feature makes it an attractive policy option. Moreover, it avoids some of the market distortions inherent in the Dairy Price Support Program.

MILC is a target price-deficiency payment program identical in concept to federal income support programs used for many farm commodities since the 1970s. Deficiency payment programs replaced non-recourse loans when it became clear that relying on loans to support grain prices was impeding exports. The loan rates were often above world market prices, inducing farmers to release their grain to the CCC and pocket the loan proceeds rather than sell to foreign buyers. Letting prices fall to levels necessary to clear markets and making up the difference between the market-clearing price and an announced target price removed the CCC as an intermediary in grain markets.

Dairy continues to use a price support program that has the same effect on markets as the non-recourse loan program. With non-recourse farmer loans, the CCC retains the grain pledged as collateral when market prices fall below the loan rate. Under the dairy price support program, the CCC purchases dairy products directly from manufacturers at specified prices (loan rates) designed to maintain a minimum milk price. In both cases, the support price (loan rate) floors the market price.

Like the non-recourse loan program, the dairy price support program distorts market prices and interferes with exports. The prime example is nonfat dry milk. Until recently (when world markets for milk proteins tightened considerably), the CCC purchase price for nonfat dry milk was well above world market prices. In fact, competitors for nonfat dry milk exports used the CCC price as an upper bound reference price. The CCC purchased vast quantities of nonfat dry milk, even during times when the farm price was



well above the support price. High CCC purchase prices for nonfat dry milk also impeded the development of domestic production capability for milk protein concentrate and other forms of milk proteins.

Using counter-cyclical direct payments prevents this kind of market distortion, providing producer income support only when it is needed. Moreover, counter-cyclical payments can provide an absolute price floor to producers, which is not possible using price supports that rely on purchases of manufactured dairy products (see below).

To meet likely budgetary constraints, any counter-cyclical dairy payment program that might be considered must use a target price that will not result in consistent payments or stimulate surplus milk production. That means something close to the current support price rather than the \$13.69 per hundredweight that triggers payments under MILC. Using a target price of \$10.50 per hundredweight and paying 100 percent of the deficiency relative to the Class III price on all milk would have yielded a total program cost of about \$1.4 billion since MILC began in December 2001 through February 2005. In other words, an unconstrained counter-cyclical payment program with a target milk price \$0.60 higher than the current support price would have cost 70 percent of the \$2.0 billion cost of MILC.<sup>4</sup> Of course, per hundredweight payments would have been correspondingly smaller, at least for herds not subject to the production cap.

Payment limitations are a controversial fixture of most farm price and income support programs, and would undoubtedly apply to any dairy deficiency payment program. However, applying dollar-denominated rather than production-denominated payment limits would avoid some of the objections to MILC. It seems reasonable to use the same per-farm payment limits applicable to other payment programs.

A “pure” dairy counter-cyclical payment program — tying payments to current production — would be an “amber box” program under current WTO rules, and more binding restrictions are expected in the next agreement. To accommodate U.S. trade liberalization commitments, counter-cyclical payments might have to be decoupled from current production and linked to a recent base period. However, the contribution of a budget-feasible counter-cyclical dairy program to the U.S. Aggregate Measure of Support would most likely be less than the current price support program.

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<sup>4</sup> CCC net purchases of dairy products (mostly nonfat dry milk) over this same period were approximately \$1.3 billion. Total dairy expenditures of \$3.3 billion for both MILC and price support purchases would have funded a (no payment limitation) dairy deficiency payment program with a target price of nearly \$11.50 per hundredweight.

**If the Dairy Price Support Program is retained, it will be modified to minimize market distortions and provide a more solid safety net**

If a multilateral trade pact is approved prior to the 2008 farm bill debate, the dairy price support program may not be an option. In any agreement, the U.S. will surely be obligated to systematically reduce domestic support to its farmers over time. Unless the procedure used to calculate the “cost” of price support programs is altered, then dairy price supports could prove to be too large a contributor to the permitted level of support, if not immediately, then down the road.

Even if dairy price supports are possible under a new WTO agreement, it is unlikely the program would be continued in its current form. Besides the market distortions noted above, the dairy price support program is becoming ineffective in maintaining the mandated price floor for milk used for manufacturing. Since the January 2000 federal order “reforms” were implemented, the announced Class III price was less than \$9.80 per hundredweight (the \$9.90 support price adjusted to 3.5 percent butterfat) in 16 months. Between July 2002 and June 2003, the Class III price was below support in 9 of 12 months. In November 2000, the Class III price was \$8.57.

The problem is primarily with cheese, which frequently trades on the Chicago Mercantile Exchange (CME) at less than the CCC purchase price. CME block cheddar cheese has traded as low as 1.0075 since 2000, more than 12 cents per pound under the \$1.1314 offered by the CCC. This discrepancy results in part from CCC standards different from trade standards — it costs more to sell to the CCC than to commercial buyers. But there is also a question of whether, given contractual sales commitments, cheese sellers have the flexibility of selling cheese to the CCC even if the CCC price is higher.

If the dairy price support program is reauthorized in the 2008 Farm Bill, it will likely be modified to better ensure that the intended floor under manufacturing milk prices is maintained. There are three ways to accomplish this: (1) Floor (snub) the Class III and Class IV federal order prices at \$9.80;<sup>5</sup> (2) Increase the make allowances used to derive CCC purchase prices in order to account for any higher costs of selling to the CCC; and (3) Require the CCC to alter product specifications and payment terms to conform to those used on the CME and to place standing bids on the CME block and barrel cheese markets at the CCC purchase prices. All of these options involve implementation problems and would not guarantee the \$9.90 support price floor to producers.<sup>6</sup>

To reduce market distortions, any reauthorized dairy price support program would also likely include a more systematic procedure for adjusting CCC purchase prices. While authorized since 1990, butter-powder price tilts have become rare events. Changes in

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<sup>5</sup> California adopted this method in its state milk pricing system in April 2003.

<sup>6</sup> For a comprehensive discussion of issues related to the ability of the dairy price support program to maintain an effective price floor, see Jesse, E.V., *Flooring the Support Price for Milk*, Marketing and Policy Briefing Paper No. 81, March 2003.

federal order pricing mean that reducing the nonfat dry milk purchase price reduces Class I prices when the Class IV skim milk price is the Class I price mover. Consequently, Agriculture Secretaries have come under strong political pressure not to adjust relative butter and nonfat dry milk prices.<sup>7</sup>

The President's FY 2006 budget proposal would, "Requir(e) the dairy price support program to minimize expenditures," which probably would include tilting relative prices for butter and nonfat dry milk. The *Budget of the United States Government: Program Assessment Rating Tool Fiscal Year 2006*<sup>8</sup> is more specific:

"The FSRI (Farm Security and Rural Investment Act of 2002) permits the Secretary of Agriculture to change the butter and nonfat dry milk (NDM) purchases price biannually to reduce Commodity Credit Corporation (CCC) expenses or attain other objectives the Secretary deems appropriate. CCC purchase prices for butter and NDM are out of alignment with each other and their respective market prices. Misalignment is causing unnecessary expenditures, product accumulation well above use, and significant market distortions.

Two purchase price adjustments have been made to bring NDM and butter prices into better alignment with market prices for the two commodities. Additional adjustments may be warranted when milk prices decline and *an automated system of purchase price adjustments needs to be developed.*" (p. 152, emphasis added)

The report does not identify how adjustments would be automated. Presumably, tilts would be triggered in relation to relative CCC purchases of butter and nonfat dry milk.

**There will be concerted efforts to reauthorize and broaden the Northeast Compact concept, but they will be unsuccessful.**

This concept is embodied in the "Reynolds Bill," introduced in the House by Rep. Thomas Reynolds (R-NY) and 24 cosponsors in the last session of Congress. The Reynolds Bill extended the Northeast Compact method of committee-based over-order pricing to 3 of 5 designated regions of the U.S., including the Upper Midwest, and permitted participation by the other 2 regions upon petition. Regional committees consisting of 3 representatives from each participating state would set Class I price floors. When federal order prices fell below the floors, fluid milk processors would pay the difference into a National Dairy Trust Fund. The fund that would be used to pay all

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<sup>7</sup> See Jesse, E.V. and R.A. Cropp, "The Butter-Powder Tilt," Marketing and Policy Briefing Paper No. 72, June 2001.

<sup>8</sup> <http://www.gpoaccess.gov/usbudget/fy06/part.html>

producers in the region in accordance with the regional percentage Class I utilization with a utilization floor of 45 percent. The government would add money to the fund to ensure payments at the 45 percent rate in markets with less than 45 percent Class I utilization.

The Reynolds bill accomplishes the same thing as MILC (deficiency payments at 45 percent of the difference between a target price and a related market price) but with a complex bureaucracy and a host of rules and regulations pertaining to participation eligibility, cross-regional milk sales, offsetting costs of federal feeding programs, and supply management. Since the regional committees would operate independently, there would be no assurance that Class I price targets and producer payments would be coordinated. It would further exacerbate the problem of declining fluid milk consumption and the related impact on prices for milk used for cheese, which is the expanding use for milk. For all intents and purposes, it would make the dairy industry largely a regulated public utility.

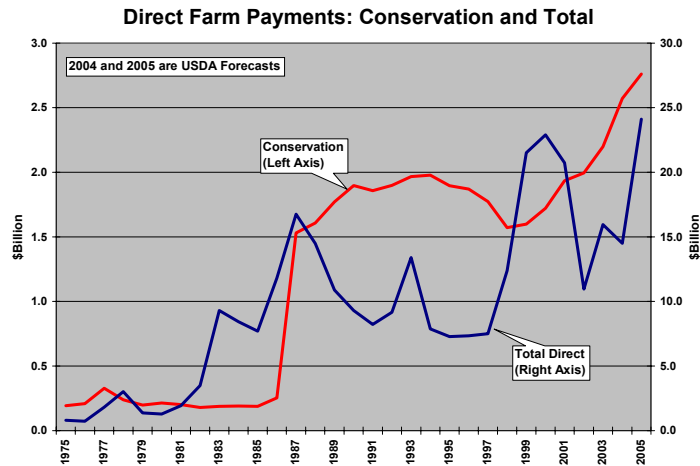
The Reynolds Bill or a similar national compact approach will have supporters in the next farm bill debate or, perhaps, even earlier. Northeastern legislators, in particular, seem intent on restoring compacts. And there is a certain political appeal in compacts because of their low treasury costs. Compacts are often touted as a way of, “getting income out of the marketplace, not the taxpayer.” This is a disingenuous claim because getting income from fluid milk consumers by artificially raising fluid milk prices is a very regressive tax.

On the other hand, enthusiasm for elevating dairy producer income by raising fluid milk prices seems to be dwindling. There is mounting evidence that fluid milk consumption is becoming more sensitive to price, especially as an increasing share of consumption is in single-serve packages competing head-on with soft drinks and juices at convenience stores and in vending machines. In addition, soy-based “milk” drinks have become a more important substitute for milk. A more elastic demand means that higher fluid prices result in smaller revenue benefits. Higher prices may also be impeding the development of new fluid milk products.

There is also growing recognition that artificially enhanced fluid milk prices have a negative effect on markets for manufactured products. Without a compensating reduction in milk production, falling fluid milk sales increases the supply of milk used for manufacturing and decreases the prices of manufactured dairy products. This is an especially important problem in cheese. The demand for cheese is becoming more inelastic as an increasing proportion of total cheese is used as a food ingredient or in away-from-home food outlets where there is limited ability to substitute. Consequently, the negative effect on cheese prices of an expanded supply of cheese milk caused by reduced fluid milk sales is becoming more pronounced.

**There will be attention to and perhaps some steps towards converting farm income support to “Green Payments.”**

U.S. farm programs have become “greener” over time in the sense that direct payments to farmers for conservation practices comprise a larger share of total direct payments. Creation of the Conservation Reserve Program (CRP) in 1987 substantially increased conservation payments. Conservation payments tailed off in the late 90s as some CRP land came out of the program. But new conservation programs in the 1996 and 2002 farm bills have added \$1 billion to conservation payments since 1998. When the Environmental Quality Incentives Program (EQIP) reaches full funding in 2007, another \$1 billion will be added to the conservation spending total.



Increasing concerns about possible environmental degradation from agricultural practices, including dairying, will likely stimulate further debate in the 2008 bill about how to encourage environmentally sound practices. With a tight budget, spending money to improve the environment leaves less for supporting farm income. So Congress can be expected to look at ways of simultaneously accomplishing both objectives. This could mean imposing cross compliance requirements if a counter-cyclical direct payment program replaces the dairy price support program. Or dairy payments could be partially targeted to covering the cost of complying with environmental regulations.

Shifting farm payments from supporting income to supporting conservation and environmental protection will also accommodate expected WTO restrictions on farm income supports linked to current production. The European Union has adopted that strategy in its 2003 Common Agricultural Policy (CAP) reforms. Single farm payments will be phased in that are decoupled from current production. In order to receive single farm payments, farmers will be required to comply with specified environmental, food safety and animal welfare requirements.