

Production costs

(Continued from Page D18) measuring them. Such things as expectations for the future, the pride of ownership, and the desire to farm are some possible examples.

Social justification

The principal social justification for the dairy price support program is to assure an adequate supply of milk for domestic consumers. Of course, to effect such an assurance, it is necessary that dairymen receive a price that at least equals the sum of costs relevant in their decision-making process. They need not receive a price that assures some minimum level of profits or return, only one that will maintain the desired flow of milk to market. Establishing a minimum price above that level will result in the production of milk surpluses. The point emerging

here is that dairy farmers have produced an adequate supply of milk at prices that are below the costs which include a charge for land at the opportunity rate of return on that land. Thus, to assure an adequate supply of milk, it is not necessary to assure a rate of return to land where value is based on current market values.

When the purchase of any capital asset is contemplated, the decision is made on the basis of whether an additional return will be generated that is at least equivalent to the additional costs of owning the asset. In the special case of land, which does not depreciate in value in the usual sense of the word, there has been unusual appreciation in values due to increased demand for the fixed supply that exists. These increases in values really should be counted

on the returns side of the ledger as offsets to the costs of land if the opportunity cost concept of land valuation is employed. Otherwise, an upward ratchet effect is set in motion that assures higher and higher costs and so requires higher and higher prices to cover those costs. For example, if the value of land goes up \$10,000 during a year, there is an increase in costs of \$1,000 if the appropriate opportunity rate of return is 10 percent. Since costs went up to \$1,000, then price must go up enough to cover the additional cost. In part, at least, because the price of milk went up, then the value of land also goes up next year. Then cost of production again increases, the price of milk must again be raised to cover the increased cost, the value of land again rises, and so on. What is forgotten, ignored, or simply omitted in the cost analysis is the \$10,000 in appreciation in the value

of land. This is a return to the owners of the land that is as real as the foregone opportunity costs of the land that is usually considered a cost.

Replacement reserves in lieu of depreciation

Replacement reserves in lieu of depreciation for depreciable capital assets have been incorporated in the USDA-COP estimates since their inception in 1974. Through 1978 they were referred to as depreciation instead of by their current nomenclature, but the basis for their calculation has been the same throughout the entire USDA-COP series. Replacement costs for any given year are current list prices for the item of interest divided by years of expected life. Using this approach, instead of the conventional depreciation approach, generally overstates the costs of depreciable capital assets in two respects. One is that "list" prices are in fact usually ceiling prices — seldom do dairymen pay full list. The second upward effect on cost estimates is the fact that most dairymen have been in business for some time and they have a collection of depreciable capital assets of varying ages and values, bought at average prices lower than current prices.

The USDA-COP studies assume that each dairyman is starting all over each year with a complete set of new machinery, equipment, and buildings. This is somewhat akin to valuing land at its current rather than its acquisition value. It does not seem likely that a dairy farmer, when contemplating the purchase of a tractor, really considers what it will cost to replace the tractor say 10 or 15 years down the road. What is of

importance now is whether enough revenue will be generated to cover the present purchase price over the time the tractor is used. What a farmer paid for a depreciable capital asset is what is cost him or her — not what he or she would have to pay for that asset if he or she were to buy it now. Suppose, unlikely though it seems, that prices of depreciable capital assets generally decline over time rather than continue to increase as has been the case for many years. Is it as likely that anyone would then still argue that replacement costs should be used in lieu of depreciation?

Management

Management charges are now computed at seven percent of the total costs associated with the dairy enterprise in the USDA-COP series. Earlier, they were computed at seven percent of dairy enterprise product sales. The 1973 Agricultural and Consumer Protection Act, the basic legislation governing the USDA costs studies, specifies that a "return for management comparable to the normal management fees charged by other comparable industries" can be included in costs (1, page 1). The problem associated with determining the appropriate level of such fees or charges is recognized and remarked upon in the USDA reports. The notion that management is a risk factor hoping for a return on owner-operator dairy farms, rather than a cost factor demanding to be paid was developed in an earlier section of this report. Feed is the most important cost item on dairy farms, and feed prices are probably the most variable of all

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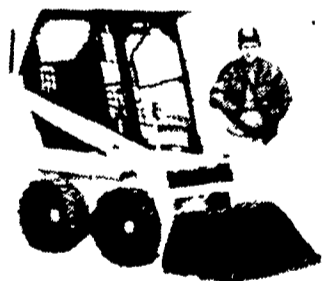
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