

A Static Policy for a Dynamic Industry: The California Young Act of 1935

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Abstract

An economic history of the development of California dairy policies from 1935 to 1965 is used to support the hypothesis that the incompatibility of discrete policy changes for a dynamic industry generates deadweight losses. Combining quantitative industry data with legal and personal narratives provides evidence in support of the hypothesis.

Introduction

California is the number one milk producing state with 17 percent of total U. S. production. Unlike other states, California operates outside of the Federal Milk Marketing Orders; however, California has its own policies regulating milk marketing in the state. The two systems are similar in that both pool producer revenues. Where the federal system pays all producers the same blend price, California pays producers different blend prices depending on the amount of quota a producer owns. The quota does not limit production or direct marketing; the quota is simply a tool for distributing revenues. Sumner and Wolf (1996) show that the blend price under the quota policy encourages less output as compared to the blend price under a federal-style policy.

This paper presents an economic history of the creation of the California dairy quota program. The history begins with the Agricultural Adjustment Act of 1933. Through injunctions, in at least three examples in California, federal court judges deemed the provisions of the Agricultural Adjustment Act of 1933 in violation with the Commerce Clause of the U. S. Constitution¹.

By these cases (and cases for other commodities and in other states), dairy producers in California could see the Agricultural Adjustment Act crumbling. So, in June 1934, the California Farm Bureau Federation, milk producer associations, and others pushed for state legislation. On June 1, 1935, Governor Frank Merriam signed into immediate effect the Young Act, named for State Senator Sanborn Young of Los Gatos. (Kuhrt, 1965)

The Young Act of 1935 codified the dairy title from the Agricultural Adjustment Act for California. By placing the power to regulate market milk in the hands of the California Director of Agriculture, the Young Act did not violate the U. S. Constitution.

The Young Act of 1935

The Young Act granted eligible producer groups the opportunity to develop marketing plans that set minimum prices in each marketing area. The act stipulated that producer groups write stabilization and marketing plans; however, before implementation, the plans had to be approved by the California Director of Agriculture and the local control board. (*California Agricultural Code*)

A marketing plan defined a marketing area, minimum prices, and fair trade practice requirements. Any distributor receiving more than a 100 gallons of fluid milk from a producer (or association of producers) was required to have a contract to specify 1) an amount of milk to be purchased; 2) prices and quantities of Class 1 and 2 milk; 3) date and method of payment; and 4) transportation charges. The writers of the contract filed a copy of the signed contract with the Director of Agriculture. (Tinley)

The Young Act also required the California Director of Agriculture to establish or provide a method for determining minimum prices. The minimum prices were to maintain an "economic relationship" between the fluid and manufacturing milk prices. The minimum price was to reflect the additional costs of producing and marketing fluid milk relative to manufacturing milk. (*California Agricultural Code*)

Economists at the University of California did most of the work creating the minimum price formulae. The basis of the pricing formulae was the differential between fluid and manufacturing milk prices during 1925 to 1929. The differential also reflected the higher cost of transportation, the maintenance of a uniform supply of milk year round, the cream price in the adjacent marketing area, feed and labor costs, and any additional items discussed in the hearing

to set the minimum price. (Tinley) Although there was a formula and a hearing process to set the minimum price, the Director did have limited power to adjust the price.

Milk Markets Evolve

Like federal attempts to “stabilize” agricultural markets, the Young Act was an emergency response to the marketing conditions of the 1930s. Of course, the markets for market and manufacturing milk changed significantly over the 32 years of the Young Act.

Understanding these and other market changes is required for understanding the development and eventual fall of the Young Act.

During World War II, subsidies affected milk markets, but the impact was temporary. The period of greatest interest and major market changes began in the 1950s. After the War, “prices of other products, including input factors such as feed, labor, and equipment, which are costs to dairymen, as well as the prices of Class I milk, increased at a more rapid rate [than the manufacturing milk price].” (Clarke, *et al.* p7)

The Chief of the Marketing Division of the California Department of Agriculture William J. Kuhrt reported to the California Assembly Interim Committee on Livestock and Dairies some problems observed in the fluid milk market. Before addressing the issues related to the market milk industry, he began by looking at the manufacturing milk industry. He noted that manufacturing milk had fallen to less than 35 percent of total milk production. He also observed that close to 1300 Grade B (manufacturing milk) producers (about 10 percent of Grade B producers) had left the industry over the period 1955 to 1956. Kuhrt argued that given the facts using manufacturing milk price as the basis of market milk might not be sensible anymore. (Kuhrt, 1956)

In the midst of the changing markets, the Acting Director of Agriculture W. C. Jacobsen stated that the minimum market prices are to be adjusted up or *down* as economic conditions dictated. He elaborated, "Lower feed costs, lower manufacturing milk prices, and excess supplies are important factors which may require a downward adjustment in prices." (Jacobsen, p. 4)

The problems in the manufacturing milk market led to changes in the Young Act. An amendment, effective September 1955, allowed the Director to adjust the price for market milk by taking into consideration the differential between the manufacturing milk price and cost of production. The amendment called for a more comprehensive cost of production survey for both market and manufacturing milk. (Kuhrt, 1965) With the cost of production surveys and manufacturing milk price, the Director could adjust the minimum price for market milk as he saw fit.

More specifically, the amendment gave the Director of Agriculture the freedom to choose which factors would be used to determine the minimum market milk price. Kuhrt stated, "It must be obvious that especially under present conditions, the Director, and our Bureau of Milk Control, must have considerable freedom to exercise discretion in evaluating the importance of each of the standards of the law so that a proper fluid milk price can be established." (Kuhrt, 1956, p. 4-5) Although not clearly announced, Kuhrt's stance suggests that the Director was to intervene in the market and ensure a "proper" price. This stance is different from the original Young Act and the stance of Acting Director Jacobsen. Data presented in a following section provide evidence to support the claim that the state raised the minimum market milk price above what economics conditions would allow.

Table 1 shows that the state average market milk price was greater than the manufacturing milk price for several years from 1950 to 1967. Notice that from 1955 to 1960 the difference between market and manufacturing milk increased. The increase in the difference or price premium came mostly from the increase in market price. In the latter years, the price premium fell.

Changes in the cost of production for regions producing both market and manufacturing milk point to significant changes in milk production. Throughout this period, three of the four major market and manufacturing milk regions showed an inversion of the normal pattern of the cost of production for market and manufacturing milk (see table 2). Although the difference between the market and manufacturing milk prices declined, the market milk price still earned a regulated premium although market milk cost less to produce than manufacturing milk.

A comparison of the state average prices with the cost of production for the various regions suggests a "cost-price squeeze" in the manufacturing milk market. After 1960, the market milk cost of production declined, while the manufacturing milk cost of production increased, but the premium for market milk over manufacturing milk remained significant. Even when the premium was at its lowest, market milk producers maintained high net gains.

For the four regions with significant manufacturing milk production, the average difference in the cost of production for market and manufacturing milk from 1955 to 1968 (the beginning of the data series to the end of the Young Act) was \$0.14/cwt. for North San Joaquin, \$0.32/cwt. for South San Joaquin, \$0.44/cwt. for North Bay, and \$0.79/cwt. for Del Norte-Humboldt. The state average milk price difference was \$1.28. Thus, the state average premium for market milk tended to be much greater than the extra cost of producing market milk in any region. Clearly, without barriers, producers would enter the market milk industry, and the

additional supply would lower the price. In this case, the price premium relative to the cost of production did not disappear because of the minimum price law.

Observed Problems in Marketing

According to Joe Gonsalves (1998), who had been a dairy farmer in the Los Angeles basin in the 1950s and 1960s, the law allowed distributors to set the quantity of milk to purchase from producers. The law allowed a 30-day notice for cancellation of contracts by either party, making producers vulnerable to contract cancellations.

Contractual problems were common throughout the State. In another interview, one dairyman from Kings County (1998) stated producers simply wanted "a home for their milk. " Under the Young Act, once a contract was established, a producer typically would not move to another distributor because of the precarious position producers had relative to the distributor. As stated by a Humboldt County (1998) producer, a variant of contract cancellation was contract reduction. In this case, the distributor would cut back on the amount of market (or total) milk purchased from a particular producer. If a producer lost his contract, another contract of equal value (quantity and price) was difficult to find. Banks were hesitant to grant loans to some dairy producers because the source of their income could be canceled in 30 days.

Jerome Siebert (1998) University of California economist brought up a different reason for a new policy. Siebert stated that many contractual agreements included indirect and unreported payments from producers to distributors. The payments were a way for distributors to recoup expenses made to buy market milk at the minimum price. Producers and others have argued that a common use of rebates was to prevent loss of contracts, especially in Southern California. During the 1960s, producers in Southern California were beginning to lose their contracts to producers from the South San Joaquin Valley.

Bob Horton (1998) and Glen Gleason (1998), both long-time employees of the California Department of Food and Agriculture, noted that the movement of milk from the San Joaquin Valley into the Los Angeles basin and the Bay Area was the result of changes in the cost of production for the various regions. Milk from the San Joaquin Valley flowed into the urban areas when the Los Angeles basin and San Francisco Bay Area producers did not meet local demand. Therefore, some producers in the San Joaquin Valley had greater access to Class I milk prices compared to their neighbors. The overall outcome was a widened price spread among producers.

The price distribution among producers was a cause of concern for many producers (see figure 1). The histograms in figure 1 shows that the South Metropolitan (Los Angeles basin), the San Francisco Bay Area, and the Sacramento Valley all had a higher share of producers with high prices than North and South San Joaquin Valley areas (data were not available for Del Norte-Humboldt). The widening price spreads contributed to increasing producer discontentment.

Producers from Humboldt County (1998) stated that the wide price spreads were significant to them; during the 1950s and 1960s, they wanted "a fair share of the fluid [milk market] in the state." Close proximity to large populations usually signified large fluid milk demand. Therefore, distributors in the Los Angeles or San Francisco areas often had more Class I milk contracts to grant than distributors in Humboldt or the San Joaquin Valley.

Economist Clarke (1967) named four problems: first, an increasing supply of Grade A milk beyond the demand for Class I milk; second, widely different average blend prices; third, a growing military consumption of milk at prices below the state regulated minimum price; and

fourth, the producer-handler issue. Siebert (1967) added discriminatory transportation rates as an additional problem.

If marketing conditions were so bad, why did the policy last as long as it did? The longevity of the policy maybe traced to the diverse opinions occupying in the industry. Improvements in production and transportation technologies, and population growth were the basis of the differing opinions. Problems in milk marketing developed slowly and were in part the negative result of forces that allowed the industry to grow and prosper.

Solutions Sought

The problems with the Young Act rest on three points: market power, contracts, and state regulated minimum price. Under a regulated minimum price, market power of the distributors generated opportunities to require a net price that was below the regulated minimum price. The minimum price, and expectation of continued Class 1 sales growth encouraged expansion of Grade A milk beyond Class 1 demand. The abundance of Grade A milk strengthened the ability of distributors to extract rents, through the threat of contract cancellation. The minimum price law for market milk and the contracts created the problem of widely differing producer prices because distributors could offer contracts with varying amounts of Class 1 milk.

Producers wanted to have more control over contractual agreements and higher net prices. Revenue pooling with a blend price would have resolved the problems of contractual agreements because it would have removed the need for contracts. Thus, a Federal Milk Marketing Order (FMMO) was appealing to many producers. However, producers felt that the California Department of Agriculture would be more responsive to producers than the U. S. Department of Agriculture. (Gleason, 1998) Given how milk markets developed in California, pooling would generate benefits for some producers but costs for other producers. Producers

with Class 1 contracts wanted to maintain their high prices so a single statewide (or even possibly an area wide) blend price would not be acceptable. The solution for removing contracts would have to pool revenues, maintain high prices for traditional Class 1 producers, and allow for more producers to be get higher prices through greater access to Class 1 sales.

Solution Found

A creative solution derived from the work of producer meetings and research from the University of California prompted Assemblyman Joe Gonsalves to introduce Assembly Bill 910 March 6, 1967. After receiving emergency status, the bill moved quickly through both houses. Governor Ronald Reagan signed the Gonsalves Act into law July 7, 1967. The Gonsalves Act created a marketing policy that pooled milk revenues. To reduce or eliminate losses for those with Class 1 contracts, the state distributed quota in relation to Class 1 sales and base in relation to historical production.

The policy worked as follows: The state pooled revenues, then disbursed the pool revenue according to the quantity of quota, base, and overbase milk a producer owned. Given the total production of market milk, distributors purchased quantities of milk to satisfy demand in each of the various use-classes of milk. As regulated through minimum prices, Class 1 (fluid milk and cream) was the highest value, then Class 2 (soft products), Class 3 (frozen products), and Class 4 (butter, powder, and cheese). (*Statues of California*)

As pointed out earlier, a simple pool would never resolve the conflicts in the state. The pool with quota resolved two contentious issues: Producers with more Class 1 contracts would maintain their price because the state gave all producers quota equal to 110 percent of their Class 1 contracts before 1967. Producers with fewer Class 1 contracts would obtain a higher price over time because the state gave new quota to eligible producers as Class 1 sales increased.

Conclusion and the Recent Story

For the last thirty years, the legislature and regulators have amended the Gonsalves Act and the associated regulations. While the law continues to function as a method to distribute pool revenues, the perception of the quota has changed significantly. A producer in Kings County (1998) argued that the quota is now the equivalent of a stock certificate because quota generates a monthly return, the premium of quota over the overbase milk price, and quota can be traded with some restrictions (also see Sumner and Wilson). Several producers have stated that quota is a retirement plan. Virtually no one views quota as an instrument to distribute pool revenue.

The Young Act lasted over three decades. The Gonsalves Act has lasted another three decades. Both evolved and both withstood economic and political pressure. We shall see how much longer the Gonsalves Act is able to continue.

Table 1. State Average Milk Prices

(in dollars per hundredweight of milk at 3.8% fat)²

	Market Milk	Manufacturing Milk	Difference
1950	4.36	3.19	1.16
1955	4.62	3.23	1.38
1960	4.77	3.23	1.55
1965	4.66	3.43	1.24
1967	4.97	4.04	0.93

Source: California Crop & Livestock Reporting Service, *Manufactured Dairy Products, Milk Production, Utilization, and Prices*, various years.

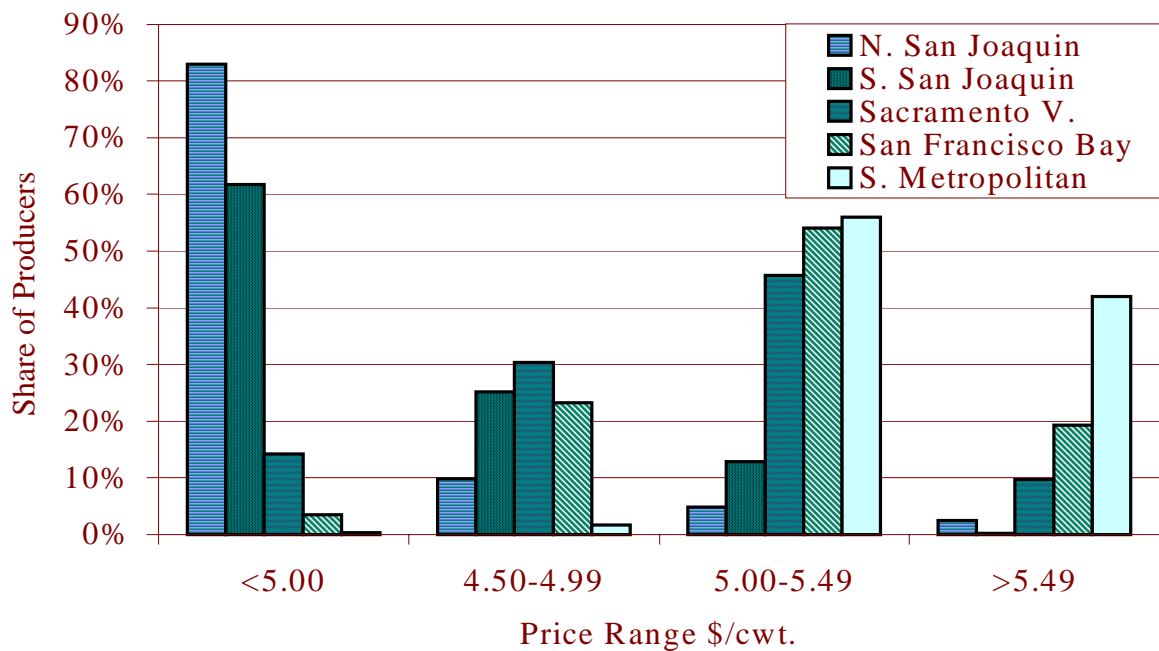
Table 2. Difference between Cost of Production of Market and Manufacturing Milk

(in dollars per hundredweight of milk)

	North Bay ³	North San Joaquin	South San Joaquin
1955	1.27	0.64	0.64
1960	0.79	0.38	0.32
1965	-0.03	-0.03	0.11
1967	-0.02	-0.54	-0.36

Source: California Department of Agriculture, Milk Stabilization Branch, *Standard Production Cost Survey for Market and Manufacturing Milk*, various years. Each quarter the cost of production is All Cost & Allowances less the Return on Investment and Return on Management.

Figure 1. Share of Milk Producers Shipping Milk to Proprietary and Cooperative Fluid Milk



Plants, According to Blend Prices Received by Regions for September 1963

Source: Special Survey of the Bureau of Milk Stabilization, unpublished data

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¹ *Hill v. Darger* S. F. Sup. 189 (1934); *Darger v. Hill* 76 F. (2d) 198 (1935); and *Berdie v. Kurtz* 75 F. (2d) 898 (1935). Kuhrt (1965) also reported a case of a large chain store that obtained an injunction against the Agricultural Adjustment Act of 1933, but I found no explicit record of the events in federal court records.

² State average f.o.b. prices by the California Department of Agriculture. Prices reported are simple averages of monthly prices.

³ The counties included in Del Norte-Humboldt are Del Norte and Humboldt Counties; in North Bay are Mendocino, Marin, Napa, and Sonoma Counties; in North San Joaquin are Madera, Merced, San Joaquin, and Stanislaus Counties; and in South San Joaquin are Fresno, Kern, Kings, and Tulare Counties.