California Without The Milk Stabilization Act

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Editor's Note: *Ms. Roberts just completed her Ph.D. examinations in the Department of Agriculture Economics at U.C. Berkeley. She worked on the 1970 Nader report on* Power and Land in California, *writing on California agriculture with emphasis on subsidy and marketing order programs. She spoke in May before the Senate Water and Agricultural Resources Committee at the request of the Public Interest Economics Center in Berkeley. She is both a consumer and an economist. Her interpretation of the economic validity of the present milk pricing structure deserves the careful consideration of the dairy industry.*

I recognize that as a matter of political reality, the system of state regulation of milk prices and quotas may be with us to stay. Consumer and producer groups have consequently addressed the question of how can the system be made more equitable. I shall nevertheless argue that the best way to make the system more equitable is to do away with it.

The dairy industry, from producer to consumer, shares a problem with other U.S. industries: increasing concentration of ownership and vertical integration of firms. Concentration and vertical integration give monopoly power to a few firms, at the expense of consumers and disorganized suppliers. These monopolistic firms also tend to become economically inefficient. Large firms are harder to manage, and monopoly profits take away some of the incentive to cut costs. Firms making monopoly profits typically build up excess upper level staff, who enjoy a variety of "perquisites" such as luxurious offices.

Vertical integration is not efficient either. **When there is a series of intermediate markets–dairyman to processor, processor to wholesaler, wholesoler to retailer, retailer to consumer–competition at each step of the way keeps the costs down and ensures that new more efficient methods are rapidly adopted. Intermediate markets also make it much easier for new people to come into the industry by starting small. Vertically integrated firms get locked into high cost sources of supply and inefficient methods.**

Extensive mechanization and low operating costs, incidentally, do not necessarily make a firm efficient. The often staggering expense of building a highly automated plant must be counted too. For a variety of reasons, including tax incentives, many big U.S. firms are overmechanized.

Before getting into dairy industry price regulation, let me suggest a few reasons for the trend to concentration and vertical integration in the food industry.

1. Urban sprawl has led Americans to shift from shopping on foot at a number of small nearby markets, to shopping by car at giant shopping centers. These giant centers may be a great deal more efficient in themselves than Mom and Pop groceries, but they require a lot more time and energy from the customers who drive to them. Mom and Pop stores take the food to the consumers; supermarkets make the consumers come to the food.

2. Firms, according to size, have very unequal access to capital. Firms with substantial assets can borrow money much more cheaply than small firms, even though the small firms often can put that money to more productive use. Large firms with substantial cash flow can finance investments without having to borrow money at all. In effect, they get money for investment at below the prime rate.

Tax loopholes give large firms an even greater advantage. For example, the depreciation loophole permits firms to deduct from current taxable income an (often wildly inflated) estimate of the deterioration in value of buildings and equipment, long before these assets come due for replacement. The greater a firm's assets, and the more skillful its accountants, the more cash it gets through the depreciation loophole. Depreciation is also an incentive to overmechanization; firms which employ a lot of people but do not hold substantial assets enjoy no such tax favors.

3. Tax loopholes like reduced rates for capital gains and expensing–deducting capital investments from taxable income as current expenses–attract tax shelter operations and large corporations like Tenneco into agriculture. These compete unfairly with independent farmers and bid up the price of land. High land prices in turn favor large firms with easy access to capital and hurt small firms, who have a hard time getting credit.

In short, the dairy industry is becoming more concentrated and vertically integrated due to general conditions in the American economy. However, I believe the extensive regulation and other government interference in the dairy industry have hastened the process.

Effect of Regulation in the Dairy Industry

The dairy industry is regulated in a number of ways. First, the state sets health standards for Grade A milk and Grade B "manufacturing" milk, which may be produced under less stringent sanitary conditions. Within Grade A there are four classes, 1, 2, 3 and 4, for which producers are paid four prices, depending not on production cost–it is all the same milk–but on the use to which the milk is put. This is monopolistic price discrimination, charging "what the traffic will bear" for each milk product. Individual Grade A producers are assigned "quotas" by the state, allowing them to market a given amount of their milk at the high Class 1 price. The quotas are very unevenly distributed among producers, with the result that some farmers may receive 25% more for their milk than those with small quotas.

In addition to setting required prices

and allocating quotas to producers, the state also sets minimum wholesale prices with built-in volume discounts and a single minimum retail price. The Federal Government enters indirectly into the California dairy industry by exempting co-ops from anti-trust prosecution under the Capper Volstead Act and by supporting milk prices nationwide by buying up storable products, notably butter and cheese.

It is argued that this system ensures consumers an abundant supply of milk and producers a higher income. In fact, the system defeats these objectives, while encouraging concentration and vertical integration, inefficiency and special interest favoritism.

1. The system fails to ensure a more abundant supply of milk and higher producer income.

a. Raising the price of milk and milk products obviously encourages more production. But at higher prices consumers, especially poor consumers, will buy less. So the higher prices mean that less milk gets to consumers–unless taxpayer-financed government purchasing agencies are regarded as consumers.

b. The increased income to dairymen from government-fixed prices is capitalized into the quotas. I have seen an estimate that quotas cost $250,000 to $500,000 for an average size dairy farm–300 to 400 cows. Quotas are worth $500 to $900 per pound of butter fat. At a conservative capitalization rate of 10%, this comes out to about 3¢ on a half gallon of milk. At a more reasonable 20%, it comes to 6¢. This is equivalent to a sales tax on milk. The quota provides a windfall to farmers who got the quota free and sell out, but it represents a dead loss, a totally unnecessary extra cost to producers entering the dairy business, and to consumers. The state would do better to set up a dairymen's retirement fund. Increased income from government-fixed high prices also becomes capitalized into land prices, again providing a windfall to retiring farmers at the expense of new farmers.

c. Artificially high prices, even with quotas, encourages the development of excess capacity, pushing up costs. If the government sets prices above those that consumers would pay in a free market, producers will expand their operations, and new producers will come in until the amount of milk produced exceeds what consumers will buy at that price. The government must then buy and store or destroy the surplus. When the government assigns quotas in an effort to reduce overproduction, it normally assigns them on the basis of producers' existing capacity. This gives producers an incentive to increase their capacity in order to be assigned more quota. In other words, producers will invest in a bigger setup than presently necessary to get a better shot at future quotas. Like capitalization, overexpansion of capacity eats up any temporary gains from artificially high prices.

d. In the long run, artificially high prices will permanently shift consumers' tastes to other cheaper products. Let me mention an article about the citrus industry, "The Lemon Prorate in the Long Run." The citrus industry tried to increase profits on lemons by restricting marketing of fresh lemons, and diverting the surplus to frozen lemonade and lemon concentrate. In the long run, consumers came to *prefer* the cheaper processed lemon products and bought fewer fresh lemons. Artificially high prices for whole milk will shift consumer tastes to powdered milk and nonmilk drinks.

2. The regulatory system encourages concentration and vertical integration in the dairy industry, chiefly by making it more expensive for small operators to get in or expand.

a. The quota value and increased land costs give the edge to large operations with easy access to capital.

b. The extra cost of building and maintaining excess capacity similarly gives the edge to large, well-financed operations.

c. Excessive health standards, which require more expensive equipment, also give the advantage to large well-financed firms. Grade A standards are not required for any but fluid milk (Class 1), yet 90% of California milk production is Grade A; in 1971, 37.2% of this went into manufactured products. This is up from 80% Grade A in 1960, with 23.5% going into manufacturing. Some Grade A milk would inevitably go into manufacturing during the cows' most productive season, but beyond that, the use of more expensive Grade A for manufacturing represents another dead loss.

d. Fixed prices encourage vertical integration. If, for example, the state sets minimum wholesale prices too high, a supermarket chain has an incentive to integrate with a processor in order to avoid that artificially high price. Once those firms controlling a large share of the market in a given area have integrated, the rest must integrate to survive. Knudsen is apparently integrating with supermarket outlets to compete with supermarkets that have integrated backwards to include processing.

e. Vertical integration in turn encourages concentration by increasing the amount of capital necessary to get into the business. It obviously costs vastly more to set up a milk processing plant *and* a chain of supermarkets than just to set up a processing plant.

3. The system is inefficient. I have already described why concentrated, vertically integrated firms are inefficient, and why, with or without these firms, artificially high prices lead to inefficiency by encouraging excess capacity. To this inefficiency I would add the expense of a government bureaucracy to run the whole show.

4. Due to the murkiness of criteria for setting prices and handing out quotas, such a regulatory system invites special interest favoritism and outright corruption. I don't know enough about the history of the California system to say how extensive such problems have been, though I gather that pooling was instituted in response to abuses of the quota system by processors.

In conclusion, it may not be politically feasible at present to deregulate milk prices. However, in the interest of consumers and independent producers and processors, reforms should move in that direction.