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Paper Abstract:

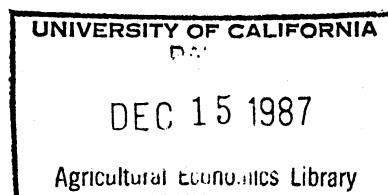
Constitutional challenges are continuing to thin the ranks of state milk regulation at a time when intellectual and popular support are waning. This paper reviews recent court decisions, which have been uniformly critical. Empirical examination does not reveal significant differences in price variability between regulated and unregulated states.

Key words:

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Paper Abstract

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DEREGULATION OF MILK AT THE STATE LEVEL

The prevalence of state milk regulation (SMR) continues to recede due to unsympathetic court decisions, reluctant legislatures, and voluntary non-enforcement by milk authorities. Even though there is a general drift away from SMR, some dairy interests continue to benefit and would be harmed by deregulation. Since most people are unaware of the effects of SMR, and groups that benefit are tightly organized, such regulation continues to persist in some states.

Much state milk regulation began during the 1930s when milk markets were unsettled. With the advent of the Great Depression, demand for fluid milk products milk declined significantly. Producer groups, in particular, and other dairy interests clamored for government intervention (Black). At the federal level the response was the Agricultural Marketing Agreement Act which is the enabling legislation for the Federal milk marketing orders. Currently about 70 percent of Grade A milk produced in the U.S. is regulated by Federal orders and most of the rest is subject to state regulation (Ippolito and Masson).

State Regulation

The response of States has been more variegated than the federal, which only regulates milk at the producer level. In some States all phases of milk marketing are regulated including raw product sales, as well as wholesale and retail sales, while in others only producer prices are regulated. There are other States in which only wholesale and retail sales are supervised. State regulation of producer pricing is similar to federal regulation in many respects. All States require classified pricing (Grade A milk that is used to produce fluid dairy products receives a higher, Class I price than Grade A milk used to produce manufactured dairy products such as butter, cheeses, and ice cream (which are Class II products)) and provide auditing services (verification that purchasers of raw milk actually produce Class II products

with the lower priced, Class II milk) to producers.

The operation of an order requires some means of rewarding regular suppliers or else it is meaningless to pool milk receipts. The converse of rewarding regular suppliers is that it is also necessary to discourage irregular suppliers who may be tempted to take advantage of temporarily high prices. In State-regulated markets out-of-State shipments are often discouraged by imposing "regulatory" taxes upon importing handlers. These regulatory taxes, often labeled compensatory payments and down allocation provisions, essentially make imported milk more expensive to buyers. The proceeds of the "tax" are distributed to in-State producers as "compensation" for the displaced sales to outsiders. The few sentence description of transfer regulations immediately above does not reveal an iceberg of details, exceptions, and whereas which exist, but which can be happily ignored here (for discussion see Baumer, 1985).

Alternatively, some States limited entry through licenses.¹ In States that required licenses, an applicant could be denied a license if milk authorities determined that granting a license would not be in the "public interest" or would promote "ruinous competition". Definitions of public interest and ruinous competition are subject to interpretation and ambiguity which frustrate planning.

Beyond the producer level, some States regulate wholesale and retail transactions. A very few States still set wholesale and retail prices, though during the 1930s over 20 States set retail or wholesale prices (Manchester). As resale (wholesale and/or retail) price setting has declined, a number of States have enacted regulations that require price filing, prohibit sales below costs, and other "objectionable" trade practices particularly price discrimination (Table 1). Although identical regulations may appear in several States,

¹The past tense is used with reference to restrictive State licensing because the last State to use such laws, New York, had its licensing statute declared unconstitutional in January 1987.

enforcement varies from vigorous to nonexistent. For example, California has prohibited below cost pricing for 19 years but by 1986 no prosecutions have occurred because milk authorities have not yet defined "cost". In North Carolina, to aid milk officials and others in determining cost, a 15 page manual that rivals the IRS code in complexity defines "cost".² In addition, most States have dating requirements, identity standards, and sanitation regulation.

Objectives of State Milk Regulation

The stated objectives of most milk regulation appear in the preambles to their milk sales acts. Terms such as "ruinous competition", "stability", "destructive competition", and "essential product" appear frequently. The general notion is that an adequate supply of wholesome milk at reasonable prices can be maintained more easily if "destructive" competition is prevented. Presumably if "destructive" competition is allowed to run its course then ultimately only one (or a few) firm(s) would survive and so monopoly pricing. SMR is also directed towards promotion of price stability. Price wars are also generally regarded as undesirable and are inhibited by minimum price regulation, price filing requirements, prohibitions on sales below cost, and restrictive licensing.

Income Enhancement and Costs of State Milk Regulation

Several economic studies have contended that a major purpose of State milk regulation is to benefit in-State dairy interests at the expense of consumers and out-of-State suppliers of milk (Bartlett, Masson and DeBrock). In several studies the results of econometric testing reveal that States with resale price regulation have higher retail and producer prices and lower rates of innovation (an annotated bibliography is compiled in Baumer, Fallert and Sleight). More

²"User's Manual and Guide to the North Carolina Milk Commission's Uniform Procedure for Determining the Cost of Processing and Distributing Milk." 4 NCAC 7.0514.

recent evidence of price enhancement in States with resale price setting is provided by Table 2. Other studies have contended that SMR provides a shelter for small, inefficient milk processors which would be eliminated with more competition (Masson and DeBrock). Because SMR has the potential for benefiting some dairy interests (before the New York licensing law was declared unconstitutional in January of 1987, milk prices in New York City exceeded Newark's by \$.70 per gallon) large amounts of resources are used to promote and maintain such regulation. In addition, there are sizable enforcement and compliance costs associated with SMR. A study by Masson and DeBrock estimated the social costs of resale price setting at over \$100 million annually using 1969 data.

Price Stability

An economic efficiency argument can be made for SMR. If sellers are risk averse, price stabilization can lower prices by causing a rightward shift of the supply curve (Just). Although there is a theoretical case to be made for SMR based on price stabilization, until recently there has been no investigation of whether prices are actually more stable in State-regulated areas. A recent study by Baumer, Fallert, and Sleight examined this issue using a variety of measures of price variability. The basic equations used in the econometric comparisons are:

$$(1) \quad RP_m = A + B(\text{TIME}) \text{ and}$$

$$(2) \quad RM_m = A' + B'(\text{TIME}),$$

where RP_m and RM_m are monthly retail prices and margins, respectively and TIME is a monthly trend variable. The maintained hypothesis was that through time, factors other than regulatory control affecting milk prices and margins should tend to be similar in both regulated and unregulated markets.

A control group of 15 cities was assembled. Comparisons of mean square errors and trend variables were made among States that had, in the alterna-

tive, resale price regulation, price filing requirements, below cost prohibitions, and licensing regulations (Table 3).

It is apparent that price variability as measured by mean square errors, is not significantly different in regulated and unregulated States, though the square root of the mean square error is about 25 percent lower than the control group for states that set resale prices during the 1975-80 period. On the other hand, at least for the 1975-80 period, the trend coefficients for retail prices and margins were higher in regulated than in unregulated States. Although these tests of price risk and margins are crude, the study does nothing to allay the contention that the main purpose of SMR is income enhancement for in-State dairy interests.³

CLASH: STATE MILK REGULATION AND THE INTERSTATE COMMERCE CLAUSE

Historians generally agree that a major cause of the failure of the Articles of Confederation was economic Balkanization among the States. In-State economic interests persuaded State legislatures to enact favorable legislation that gave them competitive advantages over sellers from other States. In recognition of this serious problem Article I Section 8(3) (better known as the Commerce Clause) gives the federal government exclusive authority to regulate interstate commerce. In interpreting the Commerce Clause, the Supreme Court has held that a State law (whether it be a State constitution, statute, or administrative regulation) which discriminates against interstate commerce or places an undue burden on interstate commerce is unconstitutional.

A clash between SMR and the Commerce Clause was inevitable. As mentioned above, effective management of an order requires a reward for regular suppliers of milk and barriers against shipments from occasional suppliers. In the federal system compensatory payments and allocations provisions are legal because

³A 1985 study by Hallberg and Kirkland reaches the same conclusion, namely that while resale price setting may lower price variability slightly, it also causes higher retail prices, lower innovation and market efficiency.

the Commerce Clause is not a constraint on federal regulation.⁴ For a State to erect a barrier at the State line is unconstitutional. The fact that interstate barriers are unconstitutional has not prevented State legislatures and milk authorities from enacting such laws particularly when prompted by in-State dairy interests. As SMR enhanced in-State prices (producer and retail) interstate arbitrage became more profitable. In enforcing State milk laws, milk authorities attempted to stop or tax interstate milk shipments but were often trumped in federal court by constitutional rulings on SMR. As distant transportation of fluid milk become more feasible the challenges multiplied.

Landmark Cases

The controlling cases on the constitutionality of SMR are: Baldwin v. Seelig (1935) and Hood and Sons v. Du Mond (1949). Both of these cases involve unconstitutional uses of SMR to insulate in-State dairy interests from outside competition.

In Baldwin, a New York milk regulation required in-state New York processors to pay minimum prices set by the New York Commissioner of Agriculture and Markets. A milk distributor in New York City was obtaining milk from Vermont farms at less than the minimum price set for New York farmers. This minimum pricing regulation was an attempt to extend New York's pricing authority beyond State lines. The U.S. Supreme Court struck down the New York law. In an opinion written by Justice Cardozo the minimum price requirement on out-of-state milk was likened to a regulatory tax equal to transportation costs. Since transportation costs on out-of-state milk were generally higher (it is normally transported a greater distance), purchases of out-of-state milk were

⁴In Lehigh Valley Cooperative v United States, 370 U.S. 76 (1962) the Supreme Court held that compensatory payments in Federal orders equal to the difference between Class I and Class II prices were in contravention of the Agricultural Marketing Agreement Act. Subsequent to that decision compensatory payments were made equal to the difference between Class I prices and blend prices. To date, there have been no successful challenges to this form of compensatory payments in the Federal order system.

penalized by the statute.

In H. P. Hood and Sons v. Du Mond, a Boston area milk distributor obtained much of its milk from New York. In coordinating supplies, Hood sought to establish a receiving depot in Greenwich, NY, for which it would have to obtain a New York license. The criteria for issuing a license required the applicant to satisfy the New York Commissioner, "... that the issuance of the license will not tend to a destructive competition in a market already adequately served, and that the issuance of the license is in the public interest." Pursuant to these criteria the Commissioner denied a license to Hood. The U.S. Supreme Court viewed the license denial as a barrier to interstate commerce and ruled the licensing statute was unconstitutional. Subsequent to the Du Mond ruling, New York reinstituted its licensing law with some modifications.

The consistent theme of the Supreme Court rulings is that economic barriers created by SMR to protect in-State dairy interests will not be tolerated under the Commerce Clause. The Court has struck down producer pricing barriers, licensing barriers, and health barriers where the purpose or effect was to insulate in-State producers from out-of-State suppliers of milk.

Producer Pricing Regulation in the South

Since 1960, almost all of the milk commissions in the Southeastern States have had key regulations declared unconstitutional because their producer pricing regulations operated as barriers to out-of-State milk (Table 4). Following World War II, many Southeastern States regulated producer prices without Federal marketing orders. As interstate shipments became more prevalent, State milk authorities attempted to extend their pricing authority beyond State lines. These regulations were invariably declared unconstitutional under the principles elucidated in Baldwin v. Seelig. At present, only the Virginia Milk Commission retains authority to set producer prices, and that authority applies only to the areas not federally regulated. In several Southeastern States,

Federal milk marketing orders were enacted following the demise of the State milk commission.

Recent Decisions Involving State Milk Regulation

In recent years the courts have continued to strike down SMR and the grounds for rulings of unconstitutionality have multiplied. In both Nevada and Kentucky regulations involving price posting and below cost prohibitions were declared in violation of federal antitrust laws and thus unconstitutional.⁵ In North Carolina a federal court prohibited the milk commission from setting prices for milk moving into and out of the State.⁶ This is the first time a court has held that milk commissions do not have the power to set prices for in-State producers whose milk is destined for out-of-State processors. In South Carolina a state court declared that since the milk commission did not have the power to set minimum producer prices on milk produced out of State but processed in State, the commission could not set prices for in-State producers as well because it would violate the Equal Protection Clause of the 14th Amendment.⁷ In both Hawaii and New York licensing regulations that allowed State officials to prevent sales from out-of-State sellers if the officials considered entry not in the "public interest" were declared unconstitutional.⁸

Actions of State Legislatures and Administrative Authorities

Table 5 shows that the last State to establish resale price control did so

⁵Knudsen Corporation v Nevada State Dairy Commission, 676 F.2d 374 (1982); Kentucky Milk Marketing and Antimonopoly Commission v The Kroger Company, (1985) 691 S.W.2d 893 (1985).

⁶Flav-o-rich, Inc. v North Carolina Milk Commission et al, No. 83-2066 (1984).

⁷State Dairy Commission of South Carolina v Pet, Inc. et al, Calendar No. 83-CP-40-2192.

⁸Safeway Stores, Inc. v Board of Agriculture of the State of Hawaii, 590 F.Supp. 778 (1984); Farmland Dairies and Fair Lawn Dairies, Inc. v Commission of the New York State Department of Agriculture and Markets et al, CV86-1933.

in 1966. In five States (Florida, Georgia, Louisiana, South Carolina, and Alabama) resale price controls were declared in violation of the State constitutions, while in at least three states (California, Vermont, and New Jersey) political authorities revoked the regulation. Since State constitutions can be changed, essentially all of the terminations are political decisions. Johnson claims that producer support for resale price regulation faded in the late 1960s as the correlation between producer prices and retail price controls, which had previously been positive, became negative.

Concluding Comments

The decline and elimination of SMR is not a pleasant sight but it appears inexorable. New York agricultural officials continued to defend the State licensing statute as being in the "public interest" until its court-ordered demise, even though the Newark-New York retail price difference was 70 cents per gallon. When the Hawaiian licensing law was declared unconstitutional in 1983 there were fewer than 20 dairy farmers in the State and yet it had a milk commission. The Nevada Milk Commission presides over fewer than 60 dairy farmers. Some contend that state milk commissions are little more than State-operated cartels while there are those who appear to believe that SMR is necessary to preserve competition. Those who subscribe to the former view are more persuasive to the courts, legislatures, and economists.

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Table 1. Extent of various types of State milk regulation

Year	Resale : price : regulation	Below : cost : pricing : limits	Price- : filling : required	Producer : price : regula- : tion	Producer : base : pricing	Milk : dealer : area : licensing	Trade : practice : control
	Number of States						
1955	12	8	1	15	7	3	12
1956	12	9	1	15	7	3	13
1957	12	14	2	15	7	3	19
1958	11	14	2	15	7	3	19
1959	12	14	2	15	7	3	19
1960	12	14	3	15	7	3	19
1961	13	14	5	16	7	3	19
1962	12	14	5	16	7	3	19
1963	13	14	5	17	7	3	18
1964	13	14	5	17	7	3	18
1965	13	13	5	16	6	3	17
1966	14	13	7	16	6	3	18
1967	14	13	7	17	7	4	17
1968	14	12	7	19	8	4	21
1969	14	12	7	19	8	3	22
1970	14	12	7	19	8	3	22
1971	13	12	7	18	9	3	22
1972	13	12	7	18	9	3	22
1973	12	15	5	17	9	2	25
1974	12	15	5	17	9	2	25
1975	10	15	5	17	9	2	26
1976	10	20	8	17	9	2	27
1977	8	21	8	17	9	2	27
1978	8	21	8	17	9	2	27
1979	7	20	8	16	8	2	27
1980	6	20	7	16	8	2	28
1981	5	22	9	15	8	2	28
1982	5	21	9	13	8	2	27
1983	5	21	9	12	7	2	27
1984	5	21	9	12	7	1	27
1985	5	20	8	12	7	1	26

SOURCE: Baumer, Fallert, and Sleight.

Table 2. Prices and margins, markets with and without sale regulation, deflated prices, 1/ by year

Item	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	All years
Dollars per gallon (or number---N)													
Markets in 5 States with resale price regulation:													
N ^a	36	59	56	76	96	60	66	61	120	122	123	37	912
Retail price	1.02	.98	.96	.89	.92	.85	.80	.76	.76	.77	.74	.75	.83
Farm price	.53	.51	.52	.51	.49	.49	.48	.46	.43	.41	.39	.38	.45
Absolute margin	.49	.47	.44	.38	.43	.36	.32	.30	.33	.36	.35	.37	.38
Relative margin ^{aa}	48.3	47.8	45.2	42.7	46.2	41.2	39.9	39.5	43.2	46.7	47.0	48.9	44.7
Markets in 30 States without resale price regulation:													
N ^a	175	265	298	297	227	198	259	245	416	429	414	135	3,358
Retail price	1.01	.96	.95	.91	.84	.83	.78	.73	.71	.68	.66	.65	.80
Farm price	.56	.53	.54	.51	.50	.51	.49	.47	.45	.43	.41	.40	.48
Absolute margin	.45	.43	.41	.40	.34	.32	.29	.26	.26	.25	.24	.25	.32
Relative margin ^{aa}	44.0	44.4	42.9	43.3	40.0	38.1	36.8	34.7	36.1	36.4	38.0	38.1	39.1
Markets in 35 States:													
N ^a	211	324	354	373	323	258	325	306	536	551	537	172	4,270
Retail price	1.01	.96	.96	.91	.86	.83	.78	.73	.71	.70	.68	.68	.80
Farm price	.56	.52	.54	.51	.50	.50	.49	.47	.44	.42	.40	.40	.47
Absolute margin	.45	.44	.42	.40	.36	.33	.29	.26	.27	.27	.28	.28	.33
Relative margin ^{aa}	44.7	45.0	43.3	43.2	41.8	38.8	37.5	35.6	37.7	38.7	40.1	40.4	40.3

1/ Prices deflated using Consumer Price Index, All Items (CPI). ^aNumber of monthly market observations. ^{aa}Margin as percent of retail price. Data for some months not available in some markets. All calculations made with unrounded numbers. Appendix table 1 gives corresponding nominal information.

SOURCE: Baumer, Fallert, and Sleight.

Table 3. Variability of Retail Prices and Margins in States in unregulated and regulated States, 1975-1985.

Retail Prices					
	Trend	1975-80		1980-1985	
	Coefficient	Square Root		Square Root	
		of Mean Sqr. Error		of Mean Sqr. Error	
Control Group	.008	.0812		.0021	.0582
Resale Price Setting	.0104	.0607		.0026	.0537
Price Filing	.0077	.0919		.0022	.0631
Below Cost Pricing	.0104	.0738		.0027	.0739
Licensing	.0094	.0826		.0022	.0494
Margins					
Control Group	-.0044	.0751		-.0049	.0636
Resale Price Setting	.0022	.0351		.0011	.0213
Price Filing	.0078	.130		.0116	.09632
Below Cost Pricing	-.0019	.0696		-.0021	.0521
Licensing	.0039	.0609		.0010	.0305

SOURCE: Baumer, Fallert, and Sleight

Table 4. Types of Regulation and Rulings on Southeastern State milk commissions

State	Current regulation			CFR No. 1	Former regulation	
	Type	Date			Provision type ruled unconstitutional	Date
Alabama	Federal Order	1981	1093		Requirement to purchase from Alabama base holders	1980
Florida 2/	Federal Order	1966	1012		Down allocation of out-of-State producers	1964
Georgia	Federal Order	1969	1007		Entire regulation	1968
Louisiana	Federal Order	1976	1096		Uniform minimum prices for out-of-State producers	1974
Mississippi 3/	Federal Order	1976	1094			
North Carolina	State Comm.	1953			Uniform minimum prices for out-of-State producers	1985
South Carolina	State Comm.	1953			Uniform minimum prices for out-of-State producers	1984
Tennessee 4/	Federal Order	1949	1011			
Virginia 5/	State Comm.	1934				

1/ Code of Federal Regulations. 2/ Southeastern Florida has been federally regulated since 1957; Upper Florida became federally regulated in 1967. 3/ The Mississippi Federal Order was reinstated in 1976 after 3 years of unregulated competition. 4/ Knoxville is the first area in Tennessee to be federally regulated. Subsequently, four Federal orders merged to form the Tennessee Valley Order. 5/ About 60 percent of Virginia's milk production is pooled and priced under Federal milk marketing orders.

SOURCE: Baumer

Table 5. Effective Dates of Retail Price Control 1954-1982

State	Control Established	Control Discontinued
Alabama	1935	January 1977
California	1937	1976 ^b
Florida	1933	1957 ^b
Georgia	1937	October 1967 ^c
Louisiana	March 1963	1973
Maine	1935	in force
Mississippi	May 1960 ^d	June 1970 ^d
Montana	1935	in force
Nevada	1959	in force
New Hampshire	1935	in force
New Jersey ^a	1933	September 1, 1967 ^e
North Dakota	January 1, 1968	November 1980
Oregon	1933	in force
Pennsylvania	1934	1954
Rhode Island	1934	in force
South Carolina	June 1966 ^f	1961
South Dakota	July 1, 1966 ^g	January 31, 1975
Vermont	1933	November 1978
Virginia	1934	August 1979
		July 1974 ^h

Notes

^a New Jersey had periods of intermittent regulation during the late 1950s. The regression results for those time periods were not significantly affected by New Jersey's classification as regulated or not.

^b Florida was considered decontrolled for all of 1957.

^c Georgia was considered controlled for all of 1967.

^d Mississippi was considered controlled for all of 1960 through 1970.

^e New Hampshire was considered controlled for all of 1967.

^f South Carolina was considered controlled for all of 1966.

^g South Dakota was considered uncontrolled for all of 1966.

^h Virginia was considered controlled for all of 1974.

SOURCE: Johnson