PolicyPennings by Dr. Daryll E. Ray

On compensating producers who contract production

Contracting in US production agriculture has grown by leaps and bounds over recent decades. At one time, contracting was primarily limited to vegetables and specialty crops. Not anymore. Broiler production was among the first meats to experience the growth of contract production.

In the mid- to late-90s, hog production changed from an industry dominated by independent operators selling into a relatively-competitive open market to one in which contract production became the dominant production and marketing method. As contract production increased in hog production, the problem of price discovery became more difficult for the remaining independent producers.

The agricultural sector that has probably made the quickest switch from independent production to contract production is tobacco. Today around 85% of US tobacco production is under contract.

Let us take a few minutes to look at one of the inevitable issues that arises when it comes to contracting: How is compensation to contracting producers set in the absence of an open marketplace with a number of buyers and sellers?

As we consider that question, let's begin by looking at contracting for the production of seed corn. In a nutshell, the seed corn company needs to offer a premium that makes it worthwhile for the farmer to take on the added work and responsibility over and above that which would be exercised in the production of an alternate crop like number 2 yellow corn. The additional capital investment that is needed by the farmer is minimal, so if she doesn't get the contract, she can always plant yellow corn or soybeans. The price then is set by the premium the seed company must pay to bring in enough acres to meet their needs.

Now let us look at what happens with broiler production. To attract new producers the company has to offer a price that will allow the producer to pay all of the variable costs and some return for management and risk. In addition, a new operator will need enough income to pay principal and interest on the loan that has to be taken out to build the facilities. At that point the farmer has nothing at risk and can walk away from the first contract if the offer does not cover the variable costs, the fixed costs, and a reasonable return for management and risk. The farmer can continue to grow corn and beans.

What happens when the contract is up for renewal? The producer usually still owes some money on the original loan, plus he has the equity from the investment in the original facilities. If the company decides to reduce the price offered for the birds, the grower is in a difficult position, given his investment in the barns and remaining debt. If the company offers a lower price for the birds or does not offer some increase to cover increased labor costs, the grower has no leverage. Unlike in the original negotiations, given his investment, he cannot walk away from the table. He is a captive of the company. This is what many contract growers call "hold-up."

In most cases the farmer cannot negotiate with another company because there is usually only one company in a given area. In this situation the farmer is not negotiating in a free-market environment. Rather he is selling into a monopsony, where the company has all of the negotiating power. In this situation the producer is in a take it or go bankrupt situation.

So what considerations establish, and could establish, producers' remuneration? In the case of broiler production two things seem important. First, the demand for chicken is growing and the companies are continually adding new growers. In most cases, the company has to offer more to the new growers than it offers to the existing growers, in order to attract them. Second, Section 202 of the Packers and Stockyards Act makes it unlawful for the company to discriminate among growers for the same quality product. It would seem that the authors of this section of law understood monopsony power and thus indirectly established a fair pricing mechanism. When a grower's contract is up, he should be able to receive the same price for his birds as the company is paying to get the last person to become a grower.

That is what standard economic theory says. The price is set by the cost of bringing online the last unit of production. Those who are lower cost producers earn an increase in what in what economists call producers' surplus. If the company does not have to pay the cost of bringing in that last unit of production to all, but can discriminate between the new grower and the old growers, the company is able to capture producer surplus that otherwise would have gone to old growers.

Because of the investment to begin production and because he is selling into a monopsony, the producer has no bargaining power at contract renewal time. The producer may be forced to choose between moderate and consistent losses, and the higher cost of foreclosure on the land and buildings and exiting the business. Either way the producer loses. Exit is far from costless; rather exit is likely to be a financial catastrophe. The investment in the barns is useless if the grower does not get more birds from the company.

The Packers & Stockyards Act of 1921 (PSA) was designed to prevent market problems arising from deception, unfairness, price discrimination and price manipulation. Should one or more of these prohibited actions occur, experience has shown it is often not easy to establish convincing evidence that is sufficient to

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