Farmers' Use of Marketing and Production Contracts. Farm Business Economics Branch, Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Agricultural Economic Report No. 747.

Abstract

Contracts are an integral part of the production and marketing of selected livestock commodities, such as broilers, turkeys, eggs, and milk. Such crops as fruit, vegetables, and sugar beets and cane are mostly produced under contracts. In the past, farm receipts were assumed to be distributed across all farm families in proportion to their production. Today, contractors receive a large share of farm receipts, formerly assumed to go to the operator's family. Contractors typically bear a large share of production and price risk, and earn the majority of net income from the commodity's production. Farmers may benefit by being able to expand their operations more rapidly than otherwise possible—perhaps, with less debt and fewer financial risks.

Keywords: Marketing contracts, production contracts, net farm income, Farm Costs and Returns Survey, farm financial condition, production specialty, livestock, region, farm financial characteristics

Preface

This report provides a detailed perspective on the use of marketing and production contracts on U.S. farm businesses, with specific detail on processed vegetables, dairy, and poultry farms. Data come from the Farm Costs and Returns Survey, which USDA has conducted since 1984.

This report was prepared by the Financial Structure and Performance Team, Farm Business Economics Branch, Rural Economy Division, Economic Research Service. Principal contributors and information sources are:

Branch Chief: Jim Johnson . . . .(202) 219-0001

Team Leader: Mitch Morehart 219-0100

Publication Coordinator: Janet Perry 219-0803

Contracts in American Agriculture: David Banker 219-0004

Processed Vegetable Contracts, Broiler Contracts, and Livestock Contracts: Mitch Morehart and Janet Perry 219-0100

Implications for Financial Measurement: Jim Johnson 219-0001

Washington, DC 20005-4788 December 1996

Contents

Summary v

Introduction 1

Background 1

Data Sources 2

Contracting in American Agriculture 2

Factors Influencing Use of Contracts 3

Magnitude of Contract Arrangements 5

Farms With Contracts 6

Use of Contracts by Size of Farm in 1993 6

Use of Contracts by Type of Farm in 1993 6

Distribution of Cash Operating Expenses in 1993 8

Farms with Marketing Contracts 8

Use of Marketing Contracts by Fruit and Tree Nut Farms 10

Farms With Production Contracts 10

Characteristics of Production Contracts 11

Broiler Contracts 12

Processed Vegetable Contracts 15

Farmers as Contractors 15

Livestock Production Contracted Out 15

Implications for Financial Measurement 17

Costs and Returns Sharing 19

Contracting and USDA's Farm Sector Information System 19

References 21

Summary

About $47 billion (32 percent) of the total value of U.S. agricultural production in 1993 was produced under contract arrangements. Although most agricultural products are still produced and marketed in an open market, contracting has been a significant and growing part of U.S. agriculture since at least 1960.

USDA’s 1993 Farm Costs and Returns Survey reported that more than 83 percent of the total value of production under contract was accounted for by vegetable, fruit, nursery, cattle, hog, dairy, and poultry products. There are generally two types of contracts—marketing and production. In 1993, more than 185,000 farms reported having at least one marketing contract. Production contracts were used by almost 44,000 farms. Farms can, and do, report having both kinds of contracts.

Contracts are important not only as a source of income, but they also provide for multiple payments that may extend beyond 1 calendar year. In most cases, this is helpful to farmers in managing their cash flow because many of these operations are not diversified. In 1993, 40 percent of marketing contracts were structured so that total compensation carried across calendar years.

The form of a contract, specific provisions, and terms can vary greatly among commodities and among producers of the same commodity. The degree of control that a contract has over a farmer’s production decisions varies depending on the type of contract.

Marketing contracts are verbal or written agreements between a contractor and a grower setting a price and an outlet for the commodity before harvest or before the commodity is ready to be marketed. Production contracts specify in detail the production inputs supplied by the contractor, the quality and quantity of a particular commodity, and the type of compensation to the grower for services rendered.

Production contracts are used more on larger farms than are marketing contracts—and are more likely to be for livestock. In most cases, production contracts typically contain provisions for the contractor to reimburse a portion of the farm’s operating expenses. In 1993, $8 billion of all expenses of livestock producers were paid for by contractors, 63 percent of which were for feed expenses. An advantage of production contracts is that the grower and contractor share risks of both production and marketing of the commodity, one reason why the use of contracts has become so popular in the farming industry.

Most studies of contract arrangements or vertical integration have attempted to discover the factors motivating participation of growers and processors. Many of the circumstances leading to the use of contract arrangements are specific to a commodity. However, USDA studies show that some general observations can be made. Evidence suggests that farmers’ reasons for entering into contracts include income stability, improved efficiency, market security, and access to capital. Reasons for processors entering into contracts include input control supply, improved response to consumer demand, and expanded and diversified operations. All of these reasons reflect the practice and effort to bring a uniform product to market.