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James MacDonald and Penni Korb

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Agricultural Contracting Update, 2005

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Abstract

More than half of all transactions for U.S. agricultural products are still conducted through spot market exchanges, in which commodities are bought and sold in open market transactions for immediate delivery. But a growing share of U.S. farm production is produced and sold under agricultural contracts. Such contracts between farmers and their buyers are reached prior to harvest (or before the completion stage for livestock) and govern the terms under which products are transferred from the farm. The shift of production to contracting coincides with shifts of production to larger farms. Contracts are far more likely to be used on large farms than on small ones. Marketing and production contracts covered 41 percent of the value of U.S. agricultural production in 2005, up from 39 percent in 2003, 36 percent in 2001, and a substantial increase over 28 percent in 1991 and 11 percent in 1969.

Keywords: Production contracts, marketing contracts, farm structure, farm size, contracting, Agricultural Resource Management Survey, ARMS, risk analysis

Contents

Summary

Most transactions for U.S. agricultural products are conducted through spot market exchanges in which commodities are bought and sold for immediate delivery. But a growing share of U.S. farm production is produced and sold under agricultural contracts. Such contracts between farmers and their buyers are reached prior to harvest (or before the completion stage for livestock), and govern the terms under which products are transferred from the farm.

What Is the Issue?

Contract use is growing. Agricultural contracts covered 41 percent of the value of U.S. agricultural production in 2005, up from 39 percent in 2003, 36 percent in 2001, 28 percent in 1991, and 11 percent in 1969. Use of contracts is closely tied to farm size; large farms are far more likely to use contracts than small farms.

Contracts lower the costs of large-scale commercial agriculture, and hence help to drive production toward larger operations. Contracts are also widely used to guide the production of differentiated agricultural products, such as specialty grains, organic poultry, or heirloom hog breeds. Contract production is expected to continue to expand, as consumer demand for differentiated products grows, and as large family farms encompass growing shares of production.

What Did the Study Find?

Formal contractual arrangements cover a growing share of U.S. agricultural production. Contracting is closely tied to other features of structural change in agriculture, including:

- Shifts of production to larger farms;
- Greater product differentiation; and
- More onfarm specialization.

Agricultural contracts compete with spot markets. Farm commodities may be traded under contracts when spot markets do not function well, so choices between contract and spot markets reflect spot market performance as well as contract features.

Contracts can be used to manage price risks, smooth the flow of commodities through the marketing system, provide stronger incentives to produce specific product varieties or qualities, or elicit the capital investments necessary to realize economies of scale in production. But contracts can also create new risks for producers, and they can extend a buyer's market power by driving commodity prices below competitive levels.

Contracts cover some commodities much more than others. Taken together, hogs and poultry (including broilers, turkeys, and eggs) account for nearly 40 percent of all contract production. That is nearly double the hog/poultry share of all agricultural production. The pattern is reversed for major field crops (corn, cotton, soybeans, rice, and wheat). The major changes in the

organization of livestock and poultry production in the United States also encompass important shifts to various kinds of contractual relationships.

Hog and poultry production rely heavily on production contracts, but with important distinctions between the two. Hog contract enterprises are usually part of larger, diversified farming businesses, with the hog enterprise providing a relatively small share of the farm income. The farm operators typically have a range of alternative outlets for hog production and for the operators' time. Farm households that engage in contract hog production have relatively high incomes compared with other households—both farm and nonfarm.

In contrast to contract hog operations, contract broiler enterprises are likely to be part of smaller and less diversified farm businesses. Most broiler operations report that they are dependent on a single contractor for broilers. The households that operate broiler farms depend far more, on average, on off-farm employment and income than do households who operate hog enterprises.

As for field crops, most producers do not use contracts. But the corn, cotton, rice, soybean, and wheat producers who do use them tend to be larger producers who use marketing contracts to cover a substantial share of production. While marketing contracts may be used for specific thinly traded products, they also can smooth out price fluctuations and reduce income risks for producers of more widely traded commodities.

Because larger farms tend to earn higher returns than smaller farms, production would be expected to continue to shift to larger operations and to contracts. However, contracting is not driven only by expanding farm sizes, but often results from market developments that alter farmers' marketing risks. For example, contract production in peanuts and tobacco increased sharply after Federal marketing quotas for those commodities were terminated, increasing the likelihood of sharp market price fluctuations that would increase price risks. By contrast, spot market transactions for cattle increased at the expense of contract transactions after mandatory price reporting improved spot markets by providing deeper information. Thus, farmers' use of contracts also depends on the efficacy of spot markets in handling risks and providing incentives to produce specific products at desired times.

How Was the Study Conducted?

The analysis primarily draws upon data from the Agricultural Resource Management Survey (ARMS), which is USDA's primary source of information on the financial condition, production practices, and resource use of farms, and the economic well-being of U.S. farm households. The survey asks farmers about the use of production or marketing contracts and the volume of production and receipts for each commodity under contract. ARMS has been conducted annually since 1996. The Farm Costs and Returns Survey (a predecessor to ARMS) provides contract data back to 1991, and the Census of Agriculture, conducted by USDA's National Agricultural Statistics Service (NASS), provides contract data back to 1969.