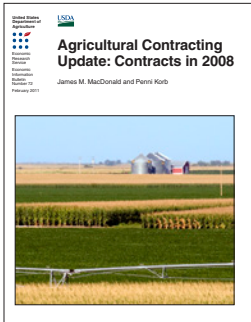


# ERS *Report Summary*

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This is a summary of an ERS report.

Find the full report at [www.ers.usda.gov/publications/eib72](http://www.ers.usda.gov/publications/eib72)

ERS is a primary source of economic research and analysis from the U.S. Department of Agriculture, providing timely information on economic and policy issues related to agriculture, food, the environment, and rural America.

## Agricultural Contracting Update: Contracts in 2008

James M. MacDonald and Penni Korb

### What Is the Issue?

Formal contractual arrangements in agriculture are substitutes for spot market (cash) sales of farm commodities and now account for 40 percent of the value of U.S. agricultural production. Marketing and production contracts are reached prior to harvest (or before the completion stage for livestock). *Marketing contracts* govern the terms of exchange for sales of products from the farm—the product to be delivered; the quantity, location, and time window for delivery; and a price or pricing formula. *Production contracts* govern an entire production process—farmers are paid a fee to grow an animal or crop for a contractor who provides some production inputs and who removes the product from the farm for processing or marketing at the close of the production cycle.

Contracts can have many beneficial effects. They can help farmers manage price and production risks, they can elicit the production of products with specific quality attributes by tying prices to those attributes, and they can smooth flows of commodities to processing plants, thus encouraging more efficient use of farm and processing capacities. But contracts can also have less benign effects. They can introduce new and unexpected risks for farmers—in some circumstances, they can extend a buyer's market power—and they can effect fundamental changes in how farming is organized and carried out.

This study updates previous ERS research by tracking the use of contracts in U.S. agriculture through 2008. It also provides detailed analyses of contract use in three areas:

- Hog and poultry production, where production contracts predominate.
- Major field crop production, where the use of marketing contracts has expanded.
- Peanut and tobacco production, which has experienced a shift to marketing contracts following major changes in Government programs.

In each case, ERS analyzes the functions filled by contracts, their design, and their adoption and impacts.

### What Did the Study Find?

- Agricultural contracts covered 39 percent of the value of U.S. agricultural production in 2008, compared with 28 percent in 1991 and 11 percent in 1969. In 2005, however, contracting covered 41 percent of production. The inter-year decline in the use of contracts after 2005 largely stemmed from a change in the composition of agricultural production, as prices and revenues rose for commodities less reliant on contracts.

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- Contracts are more widely used in some commodities than in others. In 2008, contracts covered 90 percent of poultry production and 68 percent of hog production. They also covered 90 percent of sugar beet and tobacco production. Contracts are much less prevalent in corn (26 percent of production), soybeans (25 percent), and wheat (23 percent), although use of contracting in each of those field crops grew by at least 10 percentage points between 2001 and 2008.
- Hog and poultry operations rely heavily on *production contracts*—which specify services provided by producers—but with important distinctions between the two industries. Hog contract enterprises are usually part of larger, diversified farming businesses, with the hog segment providing a relatively small share of the farm income. The farmers typically have a range of alternative outlets for contract hog production, and farm diversification provides a range of alternative uses for their own time. Farm households that engage in contract hog production have relatively high incomes compared with other households—both farm and nonfarm.

In contrast, contract broiler enterprises are likely to be part of smaller and less diversified farm businesses, and many broiler operations have only a single contractor in their area. As a result, their farm businesses are much more dependent on contract production, and their income from contract production is much more dependent on a single buyer. Operators of broiler farms have lower household incomes, on average, than operators of hog farms, and they depend far more on off-farm employment and income.

- Corn, soybean, and wheat producers who use contracts tend to be larger producers who use marketing contracts to cover a substantial share of production. For these producers, marketing contracts—which focus on the commodity delivered rather than the services provided—are used to manage price risks in combination with cash sales, financial hedges, and storage options. Less than 20 percent of corn, wheat, and soybean production comes from farms that are fully exposed to cash markets for marketing options.
- Because larger farms tend to earn higher returns than smaller farms, production is expected to continue to shift to larger operations and to contracts. Contracting, however, is driven not only by expanding farm sizes but also by market developments that alter farmers' marketing risks.

For example, Federal marketing programs for tobacco and peanuts limited price fluctuations for those commodities. Marketing contracts also help farmers to manage price risks; but as long as Federal programs limited such risks, farmers had little interest in marketing contracts. After Federal programs were terminated, however, and producers faced significant spot market price risks, contract production in peanuts and tobacco increased sharply. Marketing contracts in tobacco are also designed to better align prices to product qualities that buyers desire, and this feature played a role in processors' desire to shift to contracts. Thus, farmers turn to contracts when they perceive the efficacy of spot markets to be inadequate in handling their risks, and processors turn to contracts as a way to encourage farmers to produce specific products at desired times.

### **How Was the Study Conducted?**

The analysis primarily draws on data from USDA's Agricultural Resource Management Survey (ARMS), a joint effort conducted annually by ERS and USDA's National Agricultural Statistics Service (NASS). ARMS is USDA's primary source of information on the financial condition, production practices, resource use, and 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 NASS, provides contract data back to 1969.