Contracting

Although few nonfamily corporations—large or small—directly operate farms, they often make contracts with farmers to provide the commodities they need for processing or wholesaling. ERS identifies two types of contracts in ARMS:

- **Production contract.** A production contract is a legal agreement between a farm operator (contractee) and another person or firm (contractor) to produce a specific type, quantity, and quality of agricultural commodity. The contractor usually owns the commodity being produced and the farm receives a service fee.
- **Marketing contract.** Under a marketing contract, the contractor buys a known quantity and quality of a commodity from a farm for a negotiated price. The farm owns the commodity while it is being produced and receives a price reflecting the value of the commodity.

Contracts can provide benefits to both producers and contractors (MacDonald and Banker, 2005, pp. 52-53; MacDonald et al., 2004, pp. 24-30). Farmers get a guaranteed outlet for their production with known compensation, while contractors get an assured supply of commodities with specified characteristics, delivered in a timely manner.

Production Under Contract

Although production and marketing contracts account for about two-fifths of U.S. agricultural production, the share varies by commodity (fig. 17). For example, U.S. farmers produce virtually all sugarbeets and poultry under contract. Contracting also accounts for at least half of the production of cotton, tobacco, fruits, dairy products, and hogs. At the other extreme, only a small portion of wheat, soybeans, or corn—all traditional field crops—is grown under contract.

The aggregate data show slow and steady growth in contracting over the years, but change can be more rapid for some commodities. For example, the share of tobacco production covered by contracts went from 1 percent to 50 percent between 1995-96 and 2004. Cigarette manufacturers replaced cash auctions with contract marketing because contracts better enabled them to acquire enough of the specific types of tobacco they needed. The contracting share of hogs also increased rapidly over this 10-year span, from 31 percent to 71 percent, driven in part by product differentiation. Processors wanted more control over the characteristics of the hogs they acquired, which helped them provide a consistent quality of meat to consumers (MacDonald and Banker, 2005, pp. 55-59).

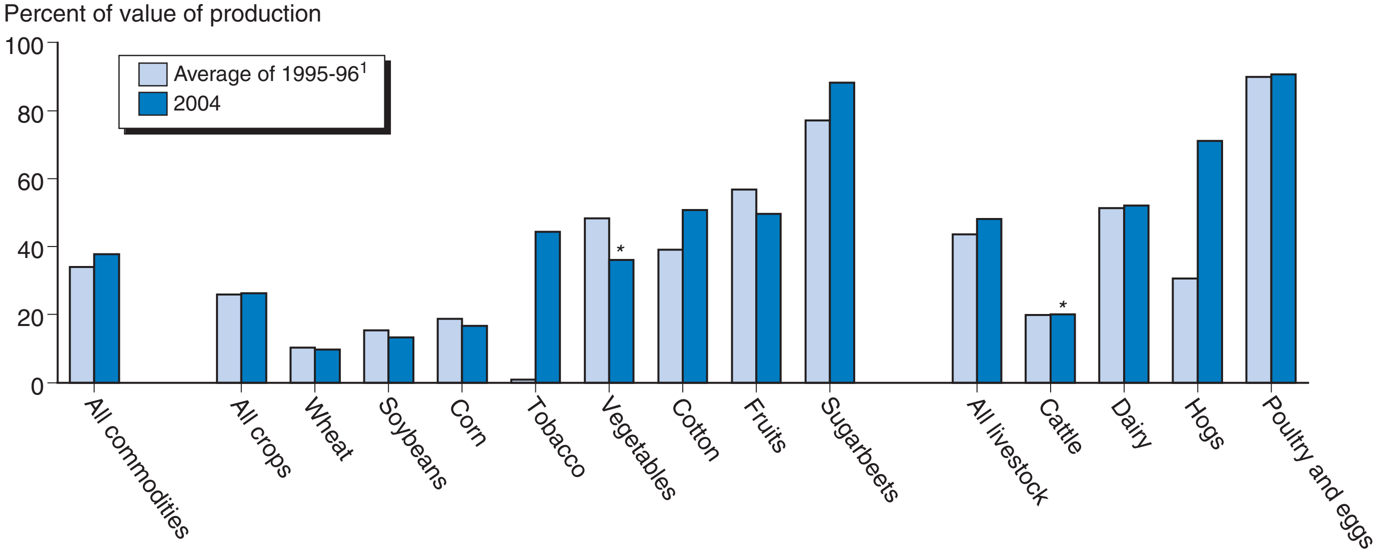
Variation by Type of Farm

Use of contracts also varies by farm type. The share of limited-resource, retirement, and residential/lifestyle farms using contracts is just 3 or 4 percent (table 13). For the remaining types of family farms, the use of contracts increases with sales, ranging from 9 percent of low-sales farms to

Figure 17

Share of value of production under marketing or production contracts for selected commodities, 1995-96 and 2004

Share of tobacco and hogs sold or removed under contract increased dramatically



*=Standard error is between 25 percent and 50 percent of the estimate.

[1]An average of 1995 and 1996 was used to provide a more statistically reliable estimate.

Source: USDA, Economic Research Service, 1995 Farm Costs and Returns Survey and 1996 and 2004 Agricultural Resource Management Survey, Phase III.

Table 13

Farms with contracts and value of production under contract, by farm type, 2004

	Small family farms					Large-scale family farms			
				Farming-occupation					
Item	Limited-resource	Retire-ment	Residential/lifestyle	Low-sales	Medium-sales	Large	Very large	Nonfamily farms	All farms
	Number								
Total farms	197,734	338,671	837,542	395,781	133,299	86,087	71,708	47,103	2,107,925
	Percent of group								
Farms with contracts[1]	*2.7	3.3	4.2	9.0	34.5	50.3	63.7	15.4	10.9
Value of production under contract[2]	*10.1	13.3	10.4	*18.2	21.4	34.5	51.0	35.1	37.8
	Percent of U.S. total								
Farms with contracts[1]	2.3	4.9	15.3	15.5	20.0	18.9	19.9	3.2	100.0
Value of production under contract[2]	0.3	0.7	1.5	2.7	6.1	13.5	61.2	14.1	100.0

* = Standard error is between 25 and 50 percent of the estimate.

[1]Includes farms with production contracts, marketing contracts, or both.

[2]Includes commodities under production or marketing contracts.

Source: USDA, Economic Research Service, 2004 Agricultural Resource Management Survey, Phase III.

64 percent for very large family farms. The share of their production under contract also increases with sales, from 18 to 51 percent.

Although a small percentage of each small farm type has contracts, small farms make up 58 percent of the farms with contracts, reflecting their large numbers. Value of production under contract, in contrast, is concentrated among very large family farms, which account for 61 percent of the total.

The value of commodities removed under production contracts is counted in the farms' gross sales, often used as a basic measure of farm size. But the value of commodities removed is not included in gross cash income (equivalent to gross revenue) received by the farms, because they never owned or sold the commodities. Only the fees that the farms receive under a production contract are included in gross cash income. As a result, gross sales are much higher than gross cash income for farms with most of their output under production contracts, such as poultry farms. If gross cash income were used to measure farm size, only 11 percent of poultry farms would be classified as large-scale—using a $250,000 cutoff—compared with 56 percent if gross sales were used (see box, "Gross Sales or Gross Cash Income?").

Gross Sales or Gross Cash Income?

Gross farm sales (or gross sales) is an indicator of farm size. It measures what the farm produces, regardless of who has a claim on that production. Gross sales is calculated as the farm's crop and livestock sales plus the shares of production received by any share landlords and production contractors. The measure also includes all government payments received by the farm and its landlords.

In contrast, ***gross cash farm income*** (or gross cash income) is the total revenue received by the farm business alone, excluding any shares accruing to share landlords and contractors. Gross cash income is the sum of livestock sales, crop sales, government payments, and "other farm-related income" received by the farm business. Other farm-related income includes income from a variety of sources: custom work, machine hire, livestock grazing, timber sales, outdoor recreation, contract production fees, etc.

For farms with no production contracts and no landlords, gross sales and gross cash income will generally be the same, both calculated as the sum of crop sales, livestock sales, and government payments received by the farm. In some cases, however, gross cash farm income is higher than gross sales, due to the additional miscellaneous items making up other farm-related income.

For farms with production contracts, gross cash income may be substantially less than gross sales. Commodities removed under production contracts are excluded from gross cash income but are included in gross sales. Fees received from contractors are included in gross cash income—as part of other farm-related income—but these fees are small compared with the value of the commodities removed.

Farms specializing in poultry or hogs have especially small gross cash income, relative to gross sales (see text table below). The ratio of gross cash income to gross sales is lower for poultry farms (34 percent) than for hog farms (72 percent) because poultry farms produce more under product contracts.

Our perception of the size of poultry farms would change if we measured size by gross cash income instead of gross sales. Only 11 percent of poultry farms would be considered large-scale—applying the $250,000 cutoff to gross cash income—instead of 56 percent.

For poultry farms, gross cash farm income was only one-third of gross sales in 2004

Item	Poultry farms	Hog farms	Other farms	All farms
		Number		
Total farms	**34,149	33,292	2,040,485	2,107,925
		Dollars per farm		
Gross farm sales	*685,750	435,882	88,342	103,509
Gross cash farm income	*231,239	314,701	93,574	99,297
		Percent		
Ratio of gross cash farm income to gross farm sales	33.7	72.2	105.9	95.9
Share of production under production contract	85.7	58.9	5.5	18.2
Farms with gross farm sales of $250,000 or more	*55.5	32.0	6.8	8.0
Farms with gross cash farm income of $250,000 or more	*11.3	21.4	7.4	7.7

* = Standard error is between 25 and 50 percent of the estimate.

** = Standard error is between 51 and 75 percent of the estimate.

Source: USDA, ERS, 2004 ARMS.