

What Are Agricultural Contracts?

Formal contractual arrangements cover a growing share of U.S. agricultural production and are increasingly employed on large commercial farms. Increased reliance on contracting is closely tied to other features of ongoing structural change in agriculture, including shifts of production to larger farms, increased specialization on farms, and greater product differentiation. USDA's Economic Research Service (ERS) analyzes the use of contracting and related developments in agriculture. This bulletin follows a more comprehensive ERS report on agricultural contracting that relied on data through 2001.¹ It uses data gathered in USDA's 2003 Agricultural Resource Management Survey (ARMS) to update information in the previous report and exploits new survey questions to explore recent developments in contract terms.

Economists commonly distinguish three broad methods for organizing the transfer of commodities from farms to the next stages of food production: spot markets, vertical integration, and contracts. *Spot (or cash) markets* provide the traditional means of transferring products and determining prices in agriculture. In spot markets, producers are paid for their products at the time ownership is transferred off the farm, with prices based on prevailing market prices at the time of sale, under agreements reached at or after harvest. Buyers may pay premiums for products of superior quality, based on factors observable or agreed to at the time of sale. Farm operators participating in spot markets control production decisions, such as the types of farm inputs to buy, as well as when and how to apply them. Operators also make financing decisions (often in concert with their bankers) and arrange for selling their products, including finding a seller, determining a price, and delivering the product. Spot market exchanges continue to govern most transactions for farm products.

Product transfers could also be organized through *vertical integration*, which combines the farm and downstream users of a commodity under single ownership. For example, many wineries own and operate vineyards, while citrus processors may own and operate orange groves. Meatpackers may own hog farms or cattle feedlots, and dairy farmers may choose to purchase feed or integrate the production of feed onfarm. Under vertical integration, markets do not determine commodity prices, and internal decisions drive product transfer. Farm operators in vertically integrated firms are employees of much larger organizations. Vertical integration that links farms with processors or retailers is still relatively uncommon.

More and more, farm product transactions are organized through agricultural contracts, agreements between farmers and buyers that are reached prior to harvest (or before the completion of a production stage, as in the case of livestock), and which govern the terms under which products are transferred from the farm. Contracts provide for much closer linkages between farmers and specific buyers than other methods of transfer and may provide the contractor/buyer with greater control of agricultural production decisions.

¹MacDonald et al. (November 2004).

ERS distinguishes between two types of agricultural contracts—production contracts and marketing contracts. Under a *production contract*, the farmer provides a set of services to the contractor, who usually owns the commodity while it is being produced. The contract specifies the services to be provided by the farmer, the manner in which the farmer is to be compensated for the services, and specific contractor responsibilities for provision of inputs. For example, the farmer provides labor, equipment, and housing under many livestock production contracts, while the contractor provides other inputs, such as feed, veterinary and livestock transportation services, and young animals. The farmer's payment is based on the costs of farmer-provided inputs, the quantity of production, or both, and usually resembles a fee paid for the specific services provided by the farmer, instead of a payment for the market value of the product (because the contractor-provided inputs may account for a large share of production costs, the fee paid to the farmer may be a small fraction of the commodity's value). Under such contracts, farmers often cede substantial control over production decisions to contractors. Because of the nature of the agreement, farmers and contractors agree upon the terms of production contracts before production begins.

Marketing contracts focus on the commodity as it is delivered to the contractor, rather than on the services provided by the farmer. They specify a commodity's price or a mechanism for determining the price, a delivery outlet, and a quantity to be delivered. The parties in a marketing contract agree to its terms before harvest or, for livestock, before removal. The pricing mechanisms may limit a farmer's exposure to the risks of wide fluctuations in market prices, and they often specify price premiums to be paid for commodities with desired levels of specified attributes (such as oil content in corn, or leanness in hogs).² The farmer owns the commodity during production and retains substantial control over major management decisions, with limited direction from the contractor, and hence retains more autonomy of decisionmaking than is available under production contracts.

²Some crop marketing contracts tie input purchases and commodity delivery by setting price and delivery schedules for specified seed and chemical inputs, as well as prices and outlets for harvested crops.