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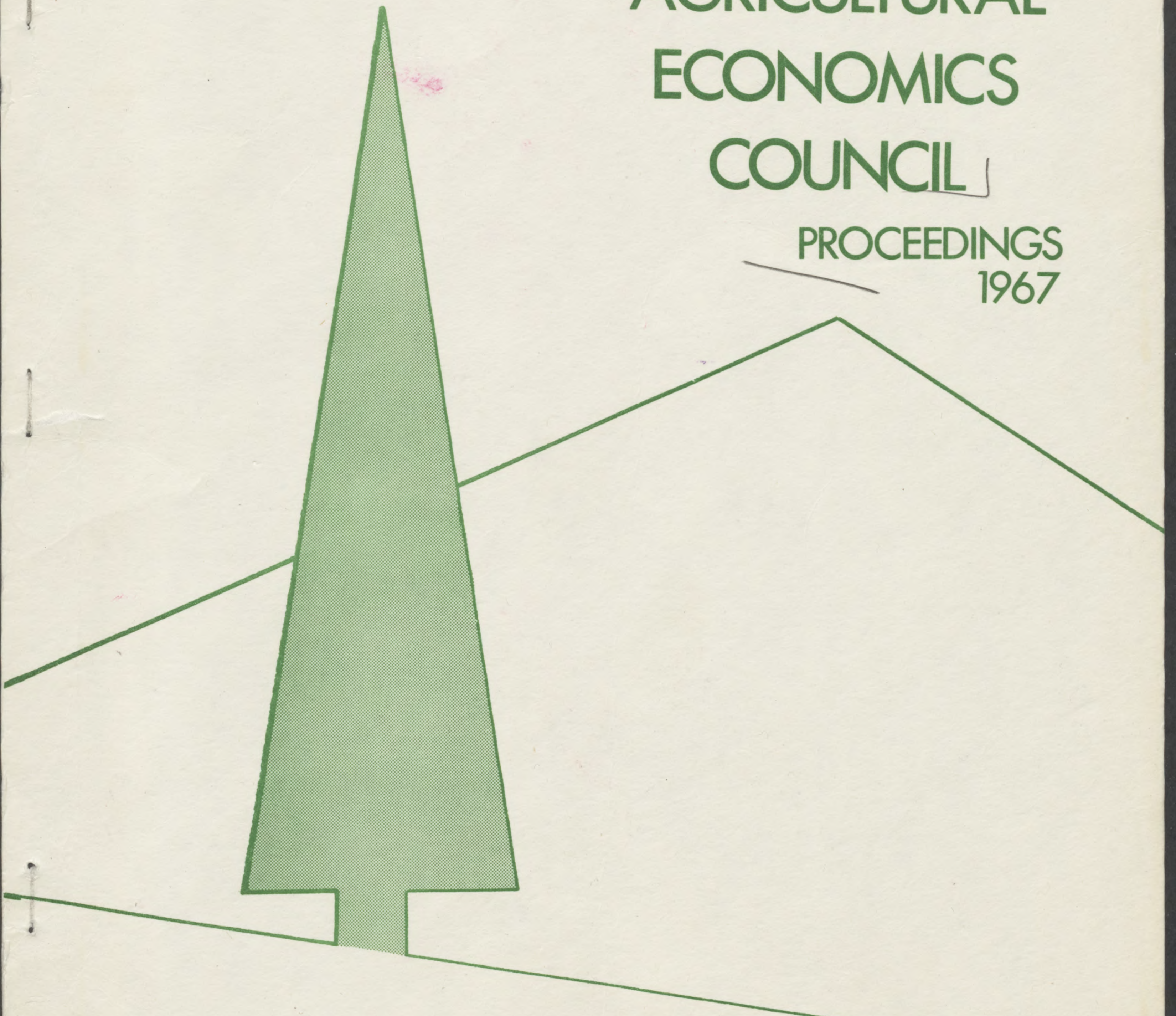

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IMPLICATIONS OF THE NATIONAL FOOD COMMISSION REPORT FOR COMMERCIAL AGRICULTURE

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The National Commission on Food Marketing studied the food industry to appraise the effectiveness with which it performs the services the public has a right to expect from any major sector of the economy. This approach differs from focusing attention solely on the interests of farmers, consumers, or the industry itself, although of course, it can have important implications for all three. Today I want to look at the study from the standpoint of commercial agriculture and to see what it implies about farm marketing, pricing, and efforts to develop agricultural bargaining power. I shall have to generalize a great deal and to neglect many important exceptions to typical situations; both the food industry and agriculture are far too large and varied to permit a detailed discussion in a short paper.

The farm-retail price spread

What are the chances that farm prices can be improved by reducing the spread between the price the consumer pays and the price the farmer receives? In judging whether price spreads were unduly wide, the Food Commission asked three questions: (a) Are the functions for which marketing costs are incurred necessary ones? (b) Are the functions efficiently performed? and (c) Are profits reasonable? The Commission found that costs of promotion--advertising, trading stamps, etc.--often were higher than warranted by any value rendered in the processing and distribution of food. Inefficiency was noted in the distribution of bread and some other foods from processors' plants to retailers' shelves. Profits in a few parts of the industry clearly reflected monopolistic tendencies. But the average rate of return on owners' equity in the food industry as a whole was no higher than in American industry at large and most operations seemed to be efficiently performed.

The Commission's general conclusion was that farm-retail price spreads would remain high even if unnecessary costs and profits were eliminated, because "processing and distribution are costly even when efficiently performed." Moreover, one can hardly be optimistic that all unnecessary costs will be eliminated; promotion, for example, is firmly entrenched in all of industry, and farmers, looking at their specific products, often are among the first to urge more promotion. Price spreads are likely to widen further as time goes on. As a generalization subject to exceptions, reducing farm-retail price spreads is not a likely means of improving prices farmers receive.

Market power and its use

Market power is unevenly distributed over the food industry. One highly significant development has been the strengthening of the position of retailers. This has been due to the growing importance of chains and of group wholesalers serving so-called independent retailers, to the greater merchandising value of direct access to the consumer, to displacement of small stores by supermarkets, and to various other causes. Associated with the greater market power of retailers has been rising emphasis on mass merchandising techniques. Except for national brand name products, retailers increasingly specify what they want rather than simply re-selling whatever their suppliers offer them.

The principal manifestation of market power of retailers has been their ability to modify the channels and methods by which supplies reach them. Long ago the chains began to integrate retailing with wholesaling, and retailers affiliated with group wholesalers have in large measure followed their example. Retailers engage in shipping-point procurement of fresh fruits and vegetables, buy meat from packing plants, and otherwise make the route from farm to consumer shorter and more direct. Retailers' specification buying of beef has been an important reason for the rise of large-scale feedlots. The strength of retailers has forced, or is now forcing, revision of inefficient into-store distribution of milk, bread, and some other products. Both vertical integration into processing and private label programs avoid manufacturers' high promotion costs and sometimes effect substantial savings in other respects. In short, the greater power of retailers has contributed to substantial rationalization of the system that supplies products to retailers.

Channel market power of this sort does not necessarily result in unusually high levels of profit. In recent years, earnings on the net worth of the larger retailers collectively have been close to the average for American industry as a whole. Gains from savings in procurement have been largely competed away. Unfortunately, an important form of competition has been, not a reduced price spread, but a substantial increase in promotion costs such as trading stamps, games, and advertising. An ironic aspect of the food industry is the extent to which hard-won social gains in physical efficiency are offset by rising selling costs of little or no value to consumers.

The second principal location of market power in the food industry is among large manufacturers with strong national brands. Highly developed selling skills, massive promotion, and a high degree of product innovation (some significant and some trivial) enable these manufacturers to reach over the head of the retailer and to establish strong consumer preferences for their products. The conglomerate character of most such manufacturers makes it difficult to determine average profits realized by all firms in a specific field. Apparently, however, the principal examples of unusually high average profits in the food industry exist in those fields where product differentiation is high and a few manufacturers do most of the business.

Food manufacturing tends to break down into two groups of firms, (1) those having strong brands and substantial market power and (2) those supplying fairly standard products to retailers under conditions of active price competition. Several branches of so-called grocery manufacturing are in the first group; poultry processing and meat packing (especially fresh meat) are examples of the second. Some fields, such as fruit and vegetable canning, have both an advertised brand sector and another sector dependent mainly on private label sales. And some conglomerate manufacturers have operations in each group.

Market structure

The extent to which a few large firms dominate the market varies widely from one field of the food industry to another. Concentration in local markets, as in retailing, bread baking, or fluid milk processing, usually is fairly high. Noting exceptions, the Food Commission concluded that "Concentration in much of the food industry is not yet high enough to impair seriously the effectiveness of competition."

The long-term trend of concentration in food retailing on the national level has been upward, but between 1958 and 1963 the trend was checked. Because retailers often band together in purchasing, the procurement of food for retail sale has become increasingly concentrated. Concentration is rising in some fields within food manufacturing, declining in others, and staying about the same in still others. There is a strong trend toward the conglomerate firm, especially by merger, and for this reason concentration in food manufacturing as a whole is definitely increasing even though trends in particular fields are diverse.

Mergers involving small firms often are clearly necessary for operating efficiency. But in no part of the food industry do economies of scale in processing or distribution require firms to be so large that there is room in the national market for only a few. There may be significant advantages for the giant firm in selling, especially in advertising, however, and this, together with market power, managerial ambition, and other considerations, may cause firms to expand far beyond the scale needed for operating efficiency. Such reasons for large size appear to have little or no corresponding value to the general public. Antimerger policy that prevents high concentration in national markets costs the public practically nothing in terms of food industry performance, and it may do a great deal to maintain effective competition.

Vertical integration is one of the most interesting aspects of market structure. The top 40 retailers as a group do not seem to be significantly increasing the proportion of the food they sell that is manufactured in their own plants. They are, however, manufacturing more of their own requirements in certain product areas, notably milk, ice cream, frozen fruits and vegetables, meat, and baked goods. Manufacturers are integrating successive steps in processing in some instances, but except for special cases such as milk they seldom find it feasible to integrate forward into retailing.

Frequently vertical integration involving some or all of retailing, wholesaling, and manufacturing achieves economies that improve the performance of the industry. Economies in physical distribution and even processing may be obtained, and often manufacturers' selling costs are avoided. In some cases, vertical integration by retailers has been the big stick that has persuaded manufacturers to supply products under private label or to revise inefficient distribution methods.

Integration involving farming

In discussing agriculture, I especially want to distinguish vertical integration through ownership control of successive steps of production, processing and distribution from vertical coordination by contract, close trading relationships, and other non-ownership means. The usual situation in the broiler industry involves ownership of birds by nonfarm firms, so I call it vertical integration.

The broiler industry has provided the most dramatic example of vertical integration into farming. The striking advances in production technology that came in the postwar years could not have failed to revolutionize production of chicken meat. There were clear efficiencies in closely coordinating hatching, production, processing, and feed manufacturing; feed was a large proportion of the total cost of producing a broiler; capital for rapid expansion was needed; improved production practices could be adopted more rapidly by integrators than by many independent growers; and broiler production readily lent itself to factory-like production. The industry was still in its formative stage--there was no strongly entrenched conventional system to be displaced--and vertical integration soon came to be the dominant form of organization. Several of the same characteristics apply to turkey and egg production, and vertical integration has become important in these products as well.

Poultry production is sufficiently unique that the pattern established there seems unlikely to spread widely over all of agriculture in the near or intermediate future. But it will grow selectively. Fruit and vegetable processors now produce about 10 percent of their raw materials on land they own or rent, and this percentage is likely to grow slowly. Numerous meat packers feed some cattle in their own feedlots or have cattle custom-fed by others. Some economies seem likely from more stable slaughtering operations and reduced procurement costs. Many shippers of fresh fruits and vegetables have moved into production, and many growers have become shippers; the grower-shipper is the dominant kind of shipping point firm. A few retailers produce their own eggs, mainly in an attempt to obtain high, uniform quality.

While vertical integration through ownership by nonfarm firms is likely to grow selectively, vertical coordination by other means is likely to develop more rapidly. As the following section attempts to explain, the pressures for some form of vertical coordination are increasingly asserting themselves.

Administrative coordination replacing the classical price system

The blunt truth seems to be that the classical way of coordinating the decisions of many independent entrepreneurs solely by means of the price system under conditions approaching pure competition is less and less satisfactory as farming is pulled more completely into the orbit of the industrial economy. It is often less effective to obtain desired qualities of farm products by a system of price premiums and discounts for grades in open markets than by some administrative coordination that causes production practices to be such that the desired qualities are forthcoming. The lag of production response to price, and the frequent overadjustment when response finally comes, causes instability of output and prices that the food industry, consumers, and farmers themselves have reason to dislike. The recent strong cycles in cattle and hogs are clear examples of inefficiency, and they contributed to consumer protests when prices rose, to farmer protests when prices receded, and to imposition of import quotas on beef. Advantages through administrative coordination may be gained in prescheduling the timing of production, in reducing unwanted and unnecessary seasonal variations of production, and in avoiding procurement and selling costs.

The markets farmers face

What does the foregoing discussion say or imply about the markets farmers face? I have four major points to propose.

1. There are no great potential gains for farmers from capturing excess profits of so-called middlemen or otherwise narrowing farm-retail price spreads. Not much water exists to be squeezed out of price spreads, and most of the water in them is likely to stay. Probably there are exceptions in a few products and in some local markets. If the generalization is true, then higher prices for farmers will have to be added to consumer prices. The "painless" solution of reducing consumer prices and raising farm prices by reforming the marketing system is mostly an illusion.

2. Competition in the food industry typically is competition among the strong. While most price spreads are not seriously excessive, retailers' and manufacturers' margins ordinarily are well protected. Oligopolists do not impoverish themselves for long by price competition. Buying at low prices and on favorable terms in other respects is an important source of competitive advantage and profit where it can be done. Any weakness in the price structure, for whatever reason, is quickly passed back to the farm level. Buyers commonly seek to arrange the terms on which they procure farm products to their own advantage. If farm production responded so sensitively

and promptly to unfavorable prices or conditions of sale that products were not available on such terms, farmers would be adequately protected. But farm production in conventional free markets does not adjust nearly as precisely as this.

3. The food industry is less willing than it used to be to accept the uneven flow of variable quality farm products typical of agriculture in the past. Pressures are rising to pre-schedule the quantity, quality, and timing of farm production, especially of perishable products. The ability of processors and retailers to enforce their demands is growing; increasingly, they can offer sufficiently attractive contract terms to line up farmers or in some instances can integrate backward into agriculture and produce their own products.

4. The price consequences for farmers of failing to match farm production to the market are growing more severe. Demand is becoming less elastic; low quality products are heavily discounted. Prices fall sharply when markets are oversupplied. Of course, prices often rise steeply when supply is short, but this is not the usual situation in our highly productive American agriculture.

Farmer response to changing market conditions

In one way or another, and more slowly in some products than in others, agricultural production and marketing will be rationalized and vertically coordinated with nonfarm industry to satisfy market demands more adequately. This can and probably will be done in a variety of ways, some representing initiative outside of agriculture and some representing initiative by farmers.

Two important reasons exist for group efforts by farmers. The first is to organize production and marketing to fit the changing pattern of market demand. This may involve supplying a stable flow of uniform quality products, adjusting harvesting and delivery methods to fit the schedules of processing plants or retail stores, and reducing buyers' procurement costs. This stimulus to group effort will be especially prominent as farmers in one region of the country consider how they can best compete with farmers in another region.

The second reason for group effort is to obtain bargaining power about prices, contracts, and other terms of sale. Isolated adjustments by individual producers dealing with strong buyers presenting a narrowing range of alternatives will not consistently result in equity for producers--or, in more pragmatic terms, in the best the market can pay. Farmers' attitudes as well as economic circumstances are moving agriculture toward group action to achieve market power.

The two reasons for group effort by farmers conflict in an important sense. In trying to adjust production and marketing to suit changing demands, farmers will be serving the interests of the food industry. But in asserting bargaining power, farmers will be opposing the interests of the food industry. The managers of farmer groups will frequently be trying to strike a delicate balance, pushing bargaining power as far as they can without making it attractive for buyers to make other arrangements for procuring raw product.

Marketing cooperatives are familiar forms of group effort. Once cooperatives were regarded as agents obligated to sell whatever members chose to deliver to them. To do the job required of them, marketing cooperatives probably will have to exercise increasing discipline over members: assure deliveries, control type and grade of product, adjust timing of deliveries, and even control production. This shift to a market instead of producer orientation will increase the attractiveness of closed membership cooperatives and further obscure the distinction between cooperatives and ordinary corporations.

Bargaining associations will be a growing form of group effort by farmers, as their activities in fruits and vegetables for processing, in poultry, and in dairy suggest. A wide range of contract terms rather than price alone will be at issue.

Government instruments

American farmers' individualism and opportunism do not suggest that strictly voluntary group efforts will be adequate in all cases. Something like a market order probably is necessary in a number of situations to get sufficient farmer participation and to provide an administrative and legal framework for a joint program. The Food Commission proposed that marketing orders be authorized for all farm products on a regional basis. It further proposed that expanded marketing orders, which it called marketing boards, should be authorized to regulate production or marketing and to negotiate prices. Various other arrangements, often ones patterned on collective bargaining in labor, are frequently proposed. Some combination of government sanctior and farmers' own efforts toward group action probably will be necessary.

Some farm groups have urged sweeping exemption for farm cooperatives from the antitrust laws, going beyond those provided by the Capper-Volstead Act. My guess is that future developments are more likely to take the opposite direction--that large cooperatives will be increasingly scrutinized and in some cases restrained by the antitrust agencies. Commercial farmers are moving out of the class of underprivileged Americans, and some farmers' cooperatives have become very big business indeed. Future policy is more likely to sanction farmers' group efforts under a government instrumentality like a marketing board, which at least in principle can protect the public interest, than to grant hunting licenses for unregulated monopoly.

The great storable, basic crops such as wheat, soybeans, and feed grains will be among the last to be controlled by farmers' group efforts or vertical integration. If price stability and close adjustment of output to demand at stable prices if forthcoming in the future, it will be through national farm programs.

Limits on farm bargaining power

While a number of potential advantages in marketing efficiency and market power point to more group effort by farmers, it is not likely that farmers will achieve unquestioned dominance in markets. Sufficient agreement among individualistic farmers does not seem possible. Rivalry among regions of the country will continue. In some cases, substitution is close enough among products to act as an important restraint on the exercise of monopoly power in any of them.

A farmer cooperative engaged in processing or distributing farm products is likely to be hemmed in by the competition of private firms in the same field and by the buying power of retailers. The latter point probably is one reason for the current unpopularity of retailers among farmers. If farm returns are pushed to high levels by bargaining associations, vertical integration by buyers may undercut them. This is a good possibility in poultry, for example. Finally, antitrust actions may restrain any gross exercise of farmer monopoly power.

Many farmers would like to see vertical integration into agriculture by nonfarm firms made illegal. But farmers are already vertically integrated forward through marketing cooperatives and in some cases by their own individual marketing activities. It will not be easy to rule out vertical integration backward but permit vertical integration forward. Probably all forms of vertical coordination will vie for a place in the sun, and the extent to which farmer-controlled coordination wins out will depend on whether farmers can do the job well enough to leave little room for other forms of integration.