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NEW DECISIONS FARMERS MUST MAKE IN CONTRACT FARMING

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M. L. Upchurch 1/
Assistant Chief,
Agricultural Adjustments Research Branch

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American agriculture is in the midst of two revolutions. They are going on simultaneously, and each is having a major impact on the structure of farming and on the welfare of farmers. One of these is the technological revolution. It has been widely publicized and is well known to all of you. For an official of the Department of Agriculture to say that agriculture is in a technological revolution is, to say the least, redundant.

But, perhaps you have not thought of the other revolution that is going on in agriculture. For want of a better term, I shall call it an economic revolution. It is the revolution in ways of doing business in American agriculture. You will note that I used the term "in American agriculture" rather than "farmers", because farmers do not operate independently and the economic revolution affects all levels of farm production and marketing. It affects farmers as primary producers, the assemblers, distributors, processors, and marketers of farm products, and the suppliers of farmers.

The technical revolution includes new crops, new practices, new machinery, and new ways of doing things. But most important is the fact that in the technological revolution we are learning how to discover things. We have discovered the ways of discovering. This may seem like tautology, but one of the most important aspects of our technological revolution is the fact that we have learned how to call on the techniques of science, engineering, and other basic disciplines in discovering new ways of doing things in agriculture. The art and the science of bringing new knowledge to bear on empirical problems is as important in our economic as in our technological revolution.

To list all the things involved in the current economic revolution would be far too tedious for a seminar of this kind. But, to get some perspective on the current changes, let us think backward for a moment to some of the rules of thumb or customs that prevailed in our agricultural economy only a relatively few years ago.

1/ The opinions expressed in this paper are those of the author and do not necessarily represent the views of the Farm Economics Research Division, ARS, or the U. S. Department of Agriculture.

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Even when I was a boy, most farmers believed that they should be self-sufficient. They prided themselves on the number of things they did not have to buy. They prided themselves on staying out of the commercial market. They grew their own meat; they did their own butchering; they cured their own hams; and the farmer's wife canned foods from the garden. Many farmers went into commercial channels for very few items.

Correlated with this idea of self-sufficiency was the idea that a farmer should buy only what he couldn't make. There was also the idea that a farmer should not hire anyone to do anything that he could do himself. Another part of this general thinking was the idea of diversification.

Part of this idea of self-sufficiency also was the idea that a farmer should stay out of debt. I recall as a boy a poem in one of the farm papers, which read in part: "Worm or beetle, drought or tempest, on a farmer's land must fall, but for first-class ruination, trust a mortgage 'gainst them all."

This poem illustrates a principle under which farmers operated to a large extent. This and other principles affected the way farmers thought about their business and the way they operated their business.

In the modern world, blind adherence to these principles, as good as they may have been 40 years ago, does not necessarily lead to successful farming. To be sure, our measures of success are changing. Where at one time farmers thought they were successful if they has to buy relatively few things on the market and stay out of debt, now a farmer feels successful if he can make some financial progress and maintain the standard of living he deems satisfactory.

A successful farmer today is more likely to concentrate on the production of the things he can produce best, the things at which he is most efficient. He uses credit as a tool in production. He buys whatever he cannot make cheaper. We have lost, fortunately I think, much of the idea of self-sufficiency on the farm that prevailed only a few decades ago. As in the technological revolution, we are discovering that the modern commercial farmer must be adept in finding ways of doing business if he is to survive and prosper.

No attempt will be made here to evaluate the factors that cause this economic revolution. Many changes, both within agriculture and outside the agricultural segment of our economy, are interrelated to such a degree that the causes of the revolution in ways of doing business cannot be pinpointed.

This is beside the point. I merely want to emphasize that in my mind we have two equally important revolutionary trends going on in agriculture, the technological revolution and the economic revolution. The technological revolution is concrete; it is empirically observable; all who look can see what is happening. We can recognize it and publicize it. The economic revolution is more subtle and less distinctive in form, but I believe that it is equally important.

"Contract farming", the term used in the title of this seminar topic, is one attribute of the economic revolution in agriculture. Let us think for a moment about a contract. A contract is a legal instrument that puts the force of law into an agreement between two or more persons. We must remember also that contracts always relate to future acts and events. Contracts put the force of law into an agreement between two or more people, to perform or to deliver on a future course of action.

A contract may designate that a certain quantity of goods be supplied to a farmer, or it may specify that the farmer supply a certain commodity to someone else. A contract may require certain services to be performed or certain work to be done. A contract can provide for almost any legal transaction that involves things of value. You and I might enter into a contract that would provide for you to sweep out my basement once a week, and for me to mow your lawn once a week. Such an arrangement could be an enforceable contract. We would be exchanging services; they would be services of value. If I did not mow your lawn, you could bring a civil suit in a court on the strength of this contract. The only point I am trying to make is that contracts can be made to cover many things. Contract farming is simply farming in which some of the functions of the business are performed under contractual arrangements.

You have heard the terms "vertical integration" and "contract farming" used somewhat synonymously. I think this is an unfortunate use of our language; they are not synonymous. Vertical integration is an amalgamation of two or more steps in a chain of productive processes. Vertical integration can be effected through contracts or by contracts, but contracts are simply a device.

For purposes of our discussion, contracts may be of two types. One that I shall call "standard contracts" means those that are prepared well in advance of any decision on them. They may be offered by one party to a prospective second party on a take-it-or-leave-it basis. This type of contract is used by sugar mills to contract with beet producers. It is used also by feed dealers in contracting with broiler producers. Under the standard contract, a feed dealer may offer to furnish farmers with feed and baby chicks while the farmer may grow the broilers and deliver them as specified in the contract. The arrangement has been drawn up beforehand; the prospective contractor examines the deal offered and he may take it or leave it. In other words, he usually doesn't negotiate the provisions of this contract.

The other major type of contract might be called "special contracts." Under special contracts, the contracting parties negotiate the terms of the contract at the time the agreement is reached. Many contracts providing for services to be performed for farmers are of this type.

Both of the main types of contracts require that farmers make many different kinds of decisions. The kind of information they need in making them may differ with each decision. The standard contract exists on a take-it-or-leave-it basis, so the farmer must decide whether the deal that is offered is to his advantage. Certainly, he should know the costs of the various resources used in production which both he and the contractor will provide. He should know the expected value of the product and how this value will be shared. He should know the risks involved and who is going to bear them and how.

The farmer must evaluate also the choices he may have. On this point, the farmer and those who advise him, must be aware at all times of the fundamental economic principle of opportunity costs. What does this farmer give up in the way of other opportunities if he engages in this contract? The value of opportunities foregone must be included as a part of the costs to the farmer of entering into a contract.

Opportunity costs for some farmers are relatively low. Let us visualize for a moment the Georgia hill farmer who has relatively little capital and low farm income. He has an opportunity to contract with a feed dealer to produce broilers, under which the feed dealer will supply him with capital and technical information. His opportunity costs for entering into the contract may be relatively small. But the farmer may be doing pretty well without the contract, or he may have other opportunities. The opportunity costs of entering into any one contract may be high. This, I would say, is something that county agents and others who advise farmers on contractual arrangements must keep in mind at all times. It is not enough today that a contract venture pay the farmer or be profitable to a farmer, but it must be more profitable than anything else that he is doing or may do, in order to be advantageous. This is a simple economic principle, and we need not dwell on it further.

Under special contracts -- those contracts in which the provisions are negotiated at the time the agreement is reached -- the main things for the farmer to evaluate are the conditions he will have to meet in the future by virtue of his participation in the contract. As with the standard contract, the farmer must know his costs and prospective returns for any course of action provided in a proposed contractual arrangement. He needs information on costs of inputs and value of products and on input-output relationships. He needs such information when he is negotiating the contract, as he may be able to set the provisions in such a way that they are advantageous to him.

In contract farming, one of the questions that the farmer must ask himself is, "Can I meet the contract specifications?" If, for example, a contract calls for him to deliver a carload of carrots of a specified size and quality, packed in a certain way, and loaded into a car by 6:00AM every morning for a period of 3 weeks during harvest, can he meet the contract specifications? Many factors enter into whether he thinks he can. Does he have the resources needed for production? Does he have or can he get the land he needs for the carrots? Can he set up planting dates in such a way that a carload can be loaded out each day for a 3-week period? Can he get the seed, the fertilizer, the labor, and all the other things that go into performance under the provisions of this contract.

The farmer must know also what resources will be furnished by the contractor. Will the contractor furnish the cars? Will they be at the specified siding ready for loading? Will he furnish any of the seed or fertilizers? Will he furnish any of the labor?

An additional question is, How do the expenses incurred or the income expected under this contract fit in with the farmer's financial resources? The farmer should ask himself, Do I have the money to finance this business deal? Do I need credit? If so, how much, and at what times will it be available to me? Will my banker stand behind me?

He should ask also whether workers are available with which to fulfill this contract? Do I need labor, can I hire it, can I contract for it? How about special services? What risks do I take on insects and diseases? If I need airplanes twice a week over a 3-week period to spray for bugs, will they be available?

The advantages of contract farming lie in the fact that a contract specifies a series of future events. This permits the farmer as the primary producer to contract for certain things that he will need in meeting these specifications. If he knows that he will enter into a contract to deliver 20 carloads of carrots over a given period, he may, in turn, contract for labor, insecticides, irrigation water, and other production items or services. A contract may protect the farmer from price risks, if prices are specified, or it may held to hedge against price variations.

Contract farming forces the farmer to look ahead as he has never been forced to do before. It forces him to schedule the resources, the timing, the financing, and the other things he will need if he is to deliver under his contract.

The farmer must be aware also of his liabilities under a contract. What happens if he does not perform? What recourse does the contractor have against the farmer, if he does not deliver? Frequently, under building contracts, the contractor establishes either a trust fund or a bail of some kind to insure his delivery on the contract. If the farmer enters into a contract, must he obligate his assets to insure delivery to the person with whom he is contracting?

Further, what are the liabilities of the man with whom the farmer contracts? What recourse does the farmer have against him if he does not perform? Suppose he doesn't pay the prices agreed to in the contract. Suppose he does not accept delivery? Suppose there is some question about the quality of the item specified in the contract. Does the contract provide for any adequate way of negotiating differences in quality? Will he accept commodities that may be a little off quality on a negotiated price rather than on the contract price? These kinds of provisions become important when a man puts his signature on a piece of paper that has legal force.

As a result of an increasing trend toward contract farming, the farmer's role as a coordinator in production is becoming relatively more important. Conceivably, the farmer could become the coordinator of a number of contractual arrangements that specify the various steps in a highly integrated and highly scheduled series of events that result in efficient production.

Moreover, farmers are not abdicating their role as managers because of contract farming. Their role as a managers is becoming even more important. To be sure, some of the decisions formerly made by farmers in the course of production of a particular commodity may now be made for them, as specified under contract or under some other obligation. But the farmer may have an even greater responsibility, in making sure that the specifications he agrees to in this contract are proper and adequate and to his advantage. At the same time, because contracts obligate him in the future, his role as a manager, a coordinator, an organizer of future events, becomes even more important, more specific, more demanding.

Farmers can learn much from commerce and industry to held them with contract farming. In this country, industry has developed free from many of the inhibitions and customs farmers have had. The use of contracts to specify the various steps in production, the way in which these steps will be performed, and the returns to be received by each participant has permitted industry to be highly specialized, highly organized, and relatively efficient. Contracts that specify future events permit production planners to proceed with added confidence about the future. They led to specialization and efficiency for those who could fit into and participate in the complex series of contractual obligations.

Contract farming is not a new way of doing business. Rather it is an adaptation to agriculture of methods and techniques commonly used in other sectors of our economy. Properly prepared production contracts help farmers "nail down" the future. With a good production contract, a farmer may more confidently obligate himself for labor, credit, or other items needed to produce the kind and quantity of goods specified in the agreement. Use of the contract as a business tool is as much of an innovation in farming as adoption of a new machine or a new insecticide.

The technological revolution in agriculture is working a relative hardship on farmers who have not been able to participate in the technological changes. The competitive position between farmers who can innovate and farmers who cannot innovate is widening. I submit that this is also true with respect to our economic revolution. Farmers who cannot innovate in their ways of doing business will become less and less able to compete with farmers who do innovate. Contract farming is one form of innovation that will increase in importance.