

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Subcommittee on Health and Technology
From: Committee Staff
Date: May 9, 2014
Hearing: "Room to Grow: The Benefits of Partnerships in Small Agriculture Business Development"

On May 13, 2014 at 10:00 a.m. at the Livingston County Government Center, 6 Court Street, Geneseo, New York, the Subcommittee on Health and Technology will meet for a hearing titled, "Room to Grow: The Benefits of Partnerships in Small Agriculture Business Development." The hearing will examine the new phenomenon of small agriculture producers entering into contracts and other supply arrangements with large processors and retailers. These arrangements enable small and large agricultural entities to enter niche markets while offering additional opportunities for small producers to access wider markets.

I. A Brief History of the Agriculture Sector of the Economy

Like other sectors of the economy, the agriculture sector has undergone profound changes over the past century. In 1900, farms were largely comprised of a great number of small-scale enterprises growing an average of five different commodities.¹ More than 40 percent of the workforce was employed in agriculture,² indicating it was a significant share of Gross Domestic Product (GDP). In 2012, less than 20 percent of the population lives in rural areas and agriculture accounts for less than 1.6 percent of jobs and 1 percent of GDP.³

To understand these shifts, it is first important to review how technological developments, beginning with the industrial revolution and proceeding through the information technology age, have affected agriculture. Prior to 1900, most work done on farms, such as planting and harvesting, was done by hand or with the assistance of animals. Over time, as industrialization progressed,

¹ CAROLYN DIMITRI, ANNE EFFLAND, AND NEILSON CONKLIN, ECONOMIC RESEARCH SERVICE, UNITED STATES DEPARTMENT OF AGRICULTURE (USDA), THE 20TH CENTURY TRANSFORMATION OF U.S. AGRICULTURE AND FARM POLICY 2 (2005), available at <http://www.ers.usda.gov/publications/eib-economic-information-bulletin/eib3.aspx>. [hereinafter ERS Study].

² *Id.*

³ <http://www.ers.usda.gov/data-products/ag-and-food-statistics-charting-the-essentials/ag-and-food-sectors-and-the-economy.aspx> This figure accounts for the GDP share of farm output; it does not account for the agriculture sector's total contribution to GDP.

modern machinery, such as tractors, began to replace less efficient animal-powered machines and human labor. As a result, during the early 20th century there was a decline in agriculture's share of both total employment and GDP.⁴

This decline accelerated in the decades following World War II due to rapid developments and improvements in plant and animal genetics; mechanization; fertilizers; pest control chemicals; and plant and animal growth. These advancements allowed agriculture producers to grow more crops and raise more animals on the same acreages with fewer labor inputs, thus reducing the need for a large agricultural workforce.⁵ Biotechnology, geographic information systems, soil mapping and other technological advances (including those resulting from transmission of large datasets made affordable by Internet access) continue to increase the output efficiency of farms.⁶

These modern production practices emphasize achieving economies of scale over diversification. Instead of the average of five commodities grown on farms in 1900, today's agriculture operations typically specialize in the production of one or two commodities.⁷

Similarly, the processing and retailing industries have sought economic efficiencies through scale economies which has led to additional consolidation in both industries.⁸ Pressure by their customers has led to further specialization by agricultural producers in an effort to find further economies of scale that could meet the price demands of processors and retailers. The cumulative effect of all these changes has been to: reduce the price consumers pay for food; increase consumers disposable income; and enable workers to seek occupations off the farm. All of these changes have led to broader economic growth and development.⁹

The increased income for consumers enables them to spend a smaller portion of their income on food. But the increased income also enables a growing number of consumers to base their dietary choices on attributes other than price.¹⁰ These shifts may provide opportunities to small producers and large processors to meet the demand for these products.

II. An Emerging Food Market Paradigm

⁴ ERS Study, *supra* note 1, at 2. By 1930, the workforce employed in agriculture dropped by almost half from 41 percent to 21.5 percent and further declined to 16 percent in 1945. *Id.* Not all of the reduction was related to the mechanization of agriculture production; some of it resulted from the problems facing agriculture in the decade after World War I. See Barry Pineles, *Marking Orders and the Administrative Process: Fitting Round Fruit into Square Baskets*, 5 SAN JOAQUIN AGRIC. L. REV. 89, 90-91 (1995) (discussing economic problems facing agriculture in the 1920s).

⁵ ERS Study, *supra* note 1, at 6.

⁶ <http://www.american.com/archive/2013/december/big-farms-are-about-to-get-bigger>.

⁷ ERS Study, *supra* note 1, at 2. It should also be noted that agriculture commodity support and producer safety net programs base payments to producers on their historic production of specific commodities, thus further incentivizing specialization in a few commodities. *Id.* at 7.

⁸ DEBRA TROPP, EDWARD RAGLAND & JAMES BARHAM, AGRICULTURE MARKETING SERVICE, USDA, THE DYNAMICS OF CHANGE IN THE U.S. FOOD MARKETING ENVIRONMENT 1 (2008), available at <http://www.ams.usda.gov/AMSv1.0/getfile?dDocName=STELPRDC5070995> [hereinafter AMS Study].

⁹ ERS Study, *supra* note 1, at 2.

¹⁰ The rapid growth of food retailers like Whole Foods demonstrates that consumers are no longer solely focused on price. See AMS Study, *supra* note 8, at 12.

The modern food production and marketing system is largely organized around achieving economies of scale. In this system, transaction between producers, processors, wholesalers and retailers involving largely undifferentiated products and commodities are primarily price oriented,¹¹ which, holding all else constant, indicates their competitive strategy is desire to supply consumers at the lowest possible price.

However, in recent years, consumers have demonstrated an increased willingness to pay a premium and visit multiple establishments to purchase agricultural products that possess certain attributes.¹² Examples include products certified as organic, those which can demonstrate area of origin, artisanal products, and those that appeal to the nation's growing population of foreign-born consumers.¹³ While the market for these products remains small relative to the overall market for agriculture products, it is expected to increase and is likely to remain a permanent part of the market for farmers and livestock producers.¹⁴

The demand created by this emerging market creates several opportunities and challenges for small and large businesses across agriculture supply chains. While a complete description of the changes necessary to serve this market is beyond the scope of this memorandum, these changes will require various agribusinesses to undertake new investments in production, product acquisition, processing, and transportation systems.¹⁵ For small businesses, accessing the capital necessary to undertake these investments could be a challenge; however, small firms partnering with larger companies may be a solution to this problem.

III. Small and Large Agribusiness Partnerships

As previously mentioned, the business model of many large processing and retailing establishments is price oriented and based on achieving economies of scale. In order to ensure a consistent supply of inputs of appropriate quality, large processing establishments often contract with producers, including small producers, for all or a portion of their output.¹⁶

The primary benefit to small producers in contracting with large processors is the minimization of risk associated with unfavorable price changes in the market for their output.¹⁷ In obtaining a

¹¹ *Id.* at 1.

¹² *Id.* at 3.

¹³ *Id.* at 2.

¹⁴ *Id.* at 3.

¹⁵ *Id.*

¹⁶ UNITED STATES DEPARTMENT OF AGRICULTURE, ECONOMIC RESEARCH SERVICE, FARMER'S USE OF MARKETING AND PRODUCTION CONTRACTS 2, (1996), available at <http://www.ers.usda.gov/publications/aer-agricultural-economic-report/aer747.aspx>. Although the premise of the hearing is to explore the benefits of large processors contracting with smaller producers, some have argued that producers are disadvantaged by such contracts. See Peter C. Carstensen, *Concentration and Destruction of Competition in Agriculture Markets: The Case for Change in Public Policy*, 2000 WIS. L. REV. 531, 539.

¹⁷ At the same time, while contracting reduces risk associated with low market prices, it likewise reduces the profit potential if market conditions become more favorable to the producer. MICHAEL BOLAND, DAVID BARTON, MATTHEW DOMINE, DEPARTMENT OF AGRIC. ECON., KAN. ST. U., ECONOMIC ISSUES WITH VERTICAL COORDINATION 2, (2002), available at http://www.agmrc.org/media/cms/ksueconvert_CAE50F732337E.pdf.

contract, a producer knows how much they will be paid for their output and under what terms, reducing some of the price uncertainties inherent in commodity and livestock production.¹⁸

In terms of diversifying their sources of income and encouraging entrepreneurship, the greater sense of financial security that contracting provides may encourage a small business agriculture producer to explore opportunities for new lines of business. For example, a dairy producer who is a member of a larger dairy cooperative may decide to use a portion of their milk -- purchased back from the co-op -- to make artisanal ice cream or to sell milk to local retailers and restaurant establishments. As the dairy producer has a secure market for all of their milk production, the dairy producer may perceive less risk in pursuing these other opportunities. Similarly, a producer under contract may be able to build equity in land and equipment to finance the acquisition of additional lands and equipment to serve the emerging food paradigm.

Another potential benefit in contract production is how it improves access to affordable capital. Many small businesses, including farmers and livestock producers, find it difficult to access affordable capital to finance their business development and expansion plans. In entering into a contract with a larger processing entity, these small firms may find it easier to access operational or business development capital from lenders to finance ongoing or future enterprises.

Finally, large agribusinesses may be able to provide smaller agribusinesses with operational support to supplement their existing efforts in marketing and processing. For example, large business processors and packers often provide growers with all or a significant portion of the inputs necessary to raise the crops or livestock. They also may provide other support services, such as fertilizer and pesticide applications, in addition to arranging the pickup and delivery of farm inputs and outputs, thus freeing the small agriculture producer to dedicate more of their time and resources to managing those portions of their land or livestock they intend to sell in specialty markets.

IV. Conclusions

Today most specialty agriculture products do not currently lend themselves to the economies of scale that suit the needs and purposes of larger agribusinesses. This creates opportunities for small and mid-size agribusinesses interesting in serving this emerging market.

Contracting production with larger processing and packing firms has been a mutually beneficial means for many small business farms and ranches to manage their risk. In addition, should consumer demand for specialty products continue to grow, large business processors and retailers may need to adjust their own operations to meet the specifications of these markets.

Congress and federal agencies should continue to monitor how the market for specialty agriculture products continues to develop, the impacts it has on small agribusinesses and whether changes to existing federal programs are necessary to assist small agribusinesses in meeting these challenges.

¹⁸ Agricultural producers also may purchase crop insurance or other financial service products to hedge price risk, though these may come at an additional cost to the producer. ECONOMIC RESEARCH SERVICE, USDA, MANAGING FARM RISK: ISSUES AND STRATEGIES 4 (2000), available at <http://www.ers.usda.gov/topics/farm-practices-management/risk-management/readings.aspx>.