The Era of Contract Agriculture

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THE ERA OF CONTRACT AGRICULTURE
— by Neil E. Harl*

The signs of increasing use of contracts are everywhere—especially on the production side of agriculture.\(^1\) Specialty grains, feeder livestock, even vegetables, are being produced under contract and have for some time. So what's the concern about the rising tide of contract agriculture? Basically, the concern is the possible shift in bargaining power as input suppliers gain greater economic power at the expense of producers.\(^2\)

**Concentration in seed companies**

Mergers, alliances and various other forms of arrangements are reducing the number of players in input supply, particularly in seeds, and increasing the level of concentration.

But that's not the entire story. The revolution in ownership of germ plasm, the feature of cells that determines the characteristics of offspring, also is moving rapidly toward concentration in a few hands. The high-profile alliance (and now merger) between DuPont and Pioneer Hi-Bred International, the Monsanto acquisition of DeKalb and the Monsanto acquisition of Delta and Pine Land Company are recent examples of how the ownership and control of genetic material in crops are falling into the hands of a few, economically powerful players. Increased concentration is also leading to control by a few firms over the major processes by which genetic manipulation occurs, thus enabling those controlling the technologies to block use by other firms.

This development is partly related to the changing role of the land grant universities, partly to the ability in recent years to manipulate germ plasm through genetic engineering, and partly to the consequence of the ability to obtain a monopoly-like position over unique life forms and over the process of genetic manipulation.

- For decades the land grant universities developed the basic genetic lines and made those lines available to the seed industry. Because of limitations on university funding and the near-revolution in genetic engineering, the private sector began pouring more money into basic research.
- The advent of genetic engineering meant that scientists could manipulate genetic composition—not through conventional crop breeding techniques but through laboratory procedures—to change the genetic makeup of plant and animal life. That has produced herbicide-resistant crops, for example.
- Finally, the U.S. Supreme Court in a 1980 landmark case determined that life forms could be patented.\(^3\) In addition to federal Plant Variety Protection (PVP)\(^4\) and simply shrouding research efforts with secrecy, the ability to patent life forms provides a powerful tool to keep competitors at bay.

**Effect of contracts**

So what effect will concentration in the seed business and control by the few resulting firms over germ plasm likely have on contract negotiations with producers? It depends on the options open to producers who don't like the terms of contracts offered to them. With numerous contract possibilities available from input suppliers, each offering...
inputs of roughly equal productivity and cost, the answer is perhaps "not much."

But if there are just a few options, with the next best offering a much less attractive set of inputs in terms of cost and productivity, the answer is "take what you're offered." The outcome is likely to be a tilting in the terms of contracts in favor of the input supplier. The division of revenue from production would be expected to shift over time in favor of the party with the monopoly or near-monopoly position. Seed companies and other input suppliers can be expected to drive the best possible bargain which means, in the case of seed, capturing the greatest possible percentage of the value from any yield premium.

• The outcome would be a smaller share of the revenue from production going to the producer, resulting in less compensation to the producer and less to capitalize into land values.

• Seed companies would end up with a larger share of the pie with more to capitalize into the stock of the input supply firms. Even if unique corn derivatives produce revenue of $2 million per acre, it's fairly clear that whomever holds the rights to the technology involved will capture the lion's share of the revenue, not the producer.

A good argument can be made that this perception of potential profits in the future is part of what is driving the intense push toward concentration in control over germ plasm now occurring.

Other shifts may follow
The negotiating power of seed firms could well have other impacts.

• In an effort to control the germ plasm more completely, seed companies are likely to negotiate for ownership of the product with the producer under contract having only a contract right to payment, short of ownership of the crop or livestock involved.

• Similarly, the contract may contain what would appear at first glance to be an attractive feature—the input supplier bearing the price risks.

These seemingly innocent shifts would mean, however, that the economic position of the producer would be transformed from that of a risk-taking entrepreneur into a relatively riskless world of fixed compensation. Thus, a shift not only of compensation would occur in favor of the input supplier but also a shift of management functions in the same direction. The outcome would be reminiscent of the limited role played by growers under broiler contracts.

Barriers to entry
In general, one would expect high handed economic behavior by near monopolists to be met by entry of new competitors attracted by the generous terms of contracts in favor of the input suppliers. And that would likely occur if entry were possible. However, barriers to entry may be fairly high.

• One barrier is capital needed to mount the kind of research effort needed to maintain a product flow similar to that of the firms pressing for monopoly-like concentration levels. The capital needed is very substantial.

• Also, existing patent and plant variety protection may mean that potential competitors are frozen out of competition as a practical matter for the duration of the patent or PVP certificate (20 years).

• One possible strategy for farmers is to forge alliances among producers (which is specifically allowed by federal law so long as it does not "unduly enhance" price). The push to achieve such countervailing power was the driving force behind the formation of labor unions a century ago. Historically, however, farmers have been unwilling to accept such a disciplined approach to achieving bargaining power.

Another possible area of protection against a sharp tilt in the economic terms of contracts is vigilance by federal (or state) anti-trust agencies. Certainly the Federal Trade Commission and the U.S. Department of Justice should be sensitized to the potential for economic abuses down the road. It's been well established for decades that firms with monopoly power over a product should not be able to "tie" other products to the transaction and extend the monopoly position. Such arrangements, which involve tying products over which a firm does not have monopoly power (such as financing, insurance or risk management) to a product over which the firm does have monopoly power (such as a seed variety), are illegal per se unless it can be demonstrated that the product in monopoly status wouldn't work as well with other firms' products. And, that is rarely the case. FTC and the Department of Justice should scrutinize all seed industry mergers carefully for anti-competitive consequences and all practices by seed companies in tying credit, insurance, risk management or other needed inputs to seed availability. In a 1936 U.S. Supreme Court decision, IBM was prevented from requiring purchasers of its calculating machines to buy punch cards for data entry from IBM. Similarly, in United Shoe Machinery Corp. v. United States, a seller occupying a "dominant position" in the shoe machinery industry, without more, violated the Clayton Act by contracts tying to the lease of its machines the purchase of other types of machinery and incidental supplies. In a 1947 U.S. Supreme Court decision, conditioning the leasing of patented machines for dispensing industrial salt on the lessee's purchase of the lessor's salt, the court said that it is "unreasonable, per se, to foreclose competitors from any substantial market" if the seller enjoys a monopolistic position in the market for the tying product or if a substantial volume of commerce in the "tied" product is restrained.

In conclusion
Agricultural production may never be transformed as dramatically indicated by the scenario outlined in this article. But, it's well within the range of feasibility.

In the meantime, the prudent course would suggest careful evaluation of mergers and alliances now occurring in rapid succession.

FOOTNOTES
ADVERSE POSSESSION

COTENANTS. The plaintiffs first received the farm property as remainder holders after a life estate, created in 1968, held by the plaintiffs’ father. The father received the life estate upon the death of the plaintiffs’ mother who had received the property from her parents in 1955. However, the plaintiffs discovered, in a title opinion in 1996, that the 1955 transfer from the grandparents to the mother was actually to the mother and father as tenants in common. Thus, the father owned one-half of the property in fee and that one-half interest passed, in part, to other heirs of the father. The plaintiffs sought to clear the title, arguing that the plaintiffs acquired title by adverse possession from 1968 to the present action. The plaintiffs actively farmed the land and paid the taxes. The defendants argued that adverse possession did not apply between cotenants unless there was an ouster of one cotenant. The court held that an exception to this rule applied in that the mother’s will transferred the entire fee, first as a life estate to the father, and then as a remainder to the plaintiffs. The court held that the transfer of an entire interest by the creation of the remainder to the plaintiffs acted as an ouster of the father’s cotenancy interest, allowing the plaintiffs to acquire title by adverse possession of the property. This case was submitted by Roger McEowen, Associate Professor of Agric. Econ. and Ext. Specialist, Agric. Law and Policy at Kan. State Univ. Buchanan v. Rediger, __ P.2d __ (Kan. Ct. App. 1999).

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].

DISCHARGE. The debtor owed taxes for 1985-1988. The debtor did not file the returns for those years until after the IRS had made an assessment based on substitute returns constructed by the IRS. The IRS’s returns used the figures from the substitute returns. The IRS argued that the discharge of taxes provision under Section 523(a)(1)(B) did not apply because the IRS had made an assessment and constructed substitute returns prior to the debtor’s filing of the tax returns. The Bankruptcy and District Courts held that Section 523(a)(1)(B) had no exception for returns filed after assessment. In addition, the courts held that the returns were valid and were not affected by the substitute returns constructed by the IRS. The appellate court reversed, holding that the debtor’s return was not a valid return because it served no purpose once the IRS constructed substitute returns and assessed a deficiency In re Hindenlang, 164 F.3d 1029 (6th Cir. 1999), rev’d, 214 B.R. 847 (S.D. Ohio 1997), aff’d, 205 B.R. 874 (Bankr. S.D. Ohio 1997).

SECURED CLAIMS. The debtor’s Chapter 13 plan provided that, upon payment of a claim as required by Chapter 13, any lien securing the claim would be released. The plan did not provide for full payment of several tax claims which were secured by tax liens against the debtor’s residence. The court held that lien could not be extinguished merely by a provision in the plan but had to be avoided or modified in an affirmative action in the bankruptcy case. To the extent a claim is not paid in full, the security interest survives the bankruptcy discharge and continues in rem, although the debtor’s personal liability for the debt is discharged. In re Deutchman, 228 B.R. 829 (D. Md. 1998).

The debtor had filed a previous Chapter 7 case. Because the trustee declared the case a no-asset case, the IRS did not file a secured claim for employment taxes owed by the debtor. The debtor received a discharge in that case. The debtor then filed the current Chapter 13 case and the IRS filed a secured claim for the same employment taxes. The debtor argued that the taxes were secured in the first case and, therefore, discharged under Section 727 because no claim was filed. The court held that, in the Chapter 7 case, the taxes were nondischargeable, whether a claim was filed or not; therefore, the tax claim remained viable in the Chapter 13 case and was still secured. In re Gust, 229 B.R. 44 (Bankr. S.D. Ga. 1998).

SETOFF. The debtor filed for Chapter 7 on April 12, 1996 and filed the debtor’s 1995 income tax return on April 15, 1996, claiming a refund. The IRS filed a claim for 1990, 1991, and 1992 income tax deficiencies and offset the debtor’s refund by the amount of the tax claims. The 1990 and 1991 claims were discharged. The debtor argued that the current Chapter 13 case and the IRS filed a secured claim for employment taxes owed by the debtor. The debtor had listed the income tax refund as exempt property and no creditor challenged the exemption. The IRS sought retroactive permission to execute the offset. The court acknowledged that prior decisions were split as to whether the offset provision, Section 553(a), or the exemption provision, Section 522(c), took precedence. The court followed the majority of courts in holding that exempt property was not subject to the setoff provision and the setoff was not proper. Although the IRS refusal to return the refund was a violation of the automatic stay, the court held that the IRS did not need to return the amount of the 1992 tax claim because that claim was not discharged. In re Jones, 99-1 U.S. Tax Cas. (CCH) ¶ 50,366 (M.D. Ala. 1999).