Testimony of

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Statement regarding the "Agricultural Consolidation and the Smithfield/Farmland Deal" before the U.S. Senate Subcommittee on Antitrust, Competition Policy, and Consumer Rights hearing July 23, 2003 by Luther Tweeten, Professor Emeritus of Agricultural Policy and Trade, Ohio State University, Columbus, 43210

The pending acquisition of Farmland Food, the pork division of Farmland Industries, by Smithfield Foods offers greater benefits than costs. The immediate impact will be minimal. Smithfield Foods agreed to maintain existing contracts of Farmland Food with farmers and with labor (including union representation), continue current production at all facilities and purchasing the past portion of hogs on the cash open market, keep Farmland management and the Farmland brand, and maintain competition in the market. While a merger or absorption of Farmland Food by a smaller but viable firm other than Smithfield in the industry would have advantages, there appears to be no alternative other than for Farmland Food to soldier on if the $363.5 million bid by Smithfield is rejected.

A principal argument for the acquisition is that Farmland Food is unlikely to be a financially viable firm as a stand-alone operation. A weak, small Farmland Food firm would provide no countervailing market power. It would not serve its workers, hog suppliers, creditors, or consumers as well as would its acquisition by Smithfield Foods.

Four firms (Tyson, Smithfield, Swift(Conagra), and Excel) dominate pork processing. After the acquisition, Smithfield Foods' industry sales share will increase from 20 percent to 27 percent. The expanded firm, though large enough to achieve economies in production and marketing and hence compete effectively, will not dominate the industry. Exit of Farmland Food will enhance competition among remaining firms in the industry.

The financial trouble of Farmland Industries is evidence that American agribusiness is competitive. If agribusinesses were exploiting farmers and their profit margins were large, Farmland Industries as a cooperative would have prospered. It does not take many firms to have a competitive industry. The four largest firms in the meat packing industry accounted for 67 percent of industry sales but they earned operating income of only 1.4 cents on each dollar of sales in 1999 (American Meat Institute, p.33). Thus the meat processing industry operates on small profit margins.

I find it useful to divide the impact of greater concentration in an industry into two components: economic power and economies of size. These determine the marketing margin, the difference in price between producer and consumer. Concentration into fewer, larger firms can increase the margin because of greater firm marketing power, or can decrease the margin because of economies attending larger size. Persaud and Tweeten (pp. 131-38) report empirical results from various studies showing that increasing concentration in the hog (also in cattle and turkey) processing industry lowers marketing margins because the economies of size effect dominates the market power effect. That's the good news. The bad news for farmers is that the benefits of lower margins are passed to consumers as lower food prices rather than to farmers as higher hog prices.

That result is consistent with economic theory. No processor, whether a coop, competitive, oligopsonist (one of few firms), or monopolist firm, gratuitously provides farmers a price premium. However, processors must pay adequate sized, competent hog producers their full cost of production on average over time or processors will have no hogs for their plants. That they are doing so is supported by a recent study by Tweeten and Hopkins (Fig. 1), which found that hog as well as other types of farms of commercial size more than covered full costs.

Popular opinion that a competitive or cooperative processing firm pays farmers a better price than does an oligopsonist firm such as Smithfield is unjustified. Conventional analysis holds that an oligopsonist firm (one of few buyers) of hogs uses market power to force producers to sell farther down their supply curve--at a lower price and quantity--than would a competitive firm. This line of reasoning ignores that a competitive firm and industry cannot afford to advertise and perform research. The oligopsonistic food marketing sector has innovated and advertised so effectively that Americans chronically overeat as apparent in nearly two-thirds of adults being overweight and nearly one-third being obese. That is unfortunate indeed from a nutritional standpoint but the important point here is that oligopsony expands food demand so that farmers operate higher on their supply curve--at a higher price and quantity--than they would with a processing-marketing sector made up of many small cooperatives or private firms.

Whatever its immediate promises for maintaining the status quo as noted in the opening paragraph of this statement, Smithfield Foods is a dynamic firm, hence it will change as necessary to remain competitive. Several considerations suggest that the parties to this acquisition will be best served by changes discussed below that Smithfield is likely to undertake over time. The firm is likely to move to larger and more widely spaced plants and to greater use of production and marketing contracts. At issue is whether that is a bad thing for producers, consumers, and the environment.

Many farmers understandably are concerned about the trend to fewer and larger processing plants and to fewer cash markets. Hog producers have access to large trucks and hard surface highways that allow economical shipping a hundred miles or more to hog processors. Thus not having several processing facilities within a few miles does not condemn a hog producer to no competition for hogs and low economic returns.

Smithfield Foods has a tradition of contract production and is likely to expand that strategy used also at Farmland Food. Cash markets are likely to continue to shrink. An important point is that cash open markets are not essential to a competitive, efficient market. Production and marketing contracts are subject to the same laws of supply and demand that govern cash markets. If farmers do not cover costs over time with contracts, they will find other marketing arrangements or exit the industry. Farmers are far more competent and need less cosseting than populists give them credit for. Farmers are adept at finding their best opportunities, whether they be near or far, with hogs or other enterprises, with a large or small processor, with a stand-alone or conglomerate operation, with a cooperative or private firm, or in a contract or cash market. Contract production is standard in many industries outside of agriculture. Such contracts are a useful way of doing business where coordination through contracts is cheaper than through the price system operating at each stage of the marketing chain.

A related concern is that contracting has contributed to the trend to fewer and larger farms to gain countervailing market power. In Ohio, a typical hog barn (module) in an integrated production operation finishes 1,000 hogs. Each barn requires about one hour of a worker's time per day. A farmer can work part time by having just a few modules. Serving eight modules is a full time job for one person and that person can finish 2.5 generations of hogs per year. Hence one farmer can finish 20,000 hogs per year.

My father worked pretty hard to send 300 hogs to market each year. Although today's integrated operation is not directly comparable to my father's farrow-to-finish operation, the example does illustrate how an integrated operation replaces many traditional family hog farms. On the other hand, production contracts used widely by Smithfield and its subsidiaries reduce risk and managerial demands while increasing availability of credit to farmers, thereby helping to preserve many family farms. Thus vertical coordination is a mixed blessing to the family farm. Labor efficiency was advanced by vertical coordination, but the underlying structural change in agriculture traces more to technology than contracting. The shift away from traditional small farms to labor-saving technology would have occurred, albeit belatedly, without vertical integration and even if pork processors would have remained small.

A final issue is whether acquisition of Farmland Food will damage the environment by increasing farm and processing plant size. The implicit assumption is that large operations are more damaging to the environment than are small operations. Some knowledgeable economists contend that environmental problems can be dealt with more cheaply on large farms than on small farms (see Tweeten and Flora, p. 30). More analysis is essential to resolve that issue. It is notable that Smithfield Farms has been a leader in funding research on better ways to control flies and odors and dispose of waste on hog farms.

In conclusion, benefits overshadow costs to hog producers and consumers from the acquisition of Farmland Food by Smithfield Foods. The acquisition is another manifestation of a worldwide structural change that frees labor from producing food to supplying education, health care, entertainment, and other manifestations of an advanced economy. Increased efficiency of labor and other resources in agriculture over time accounts for our high current living standard, and, indeed, for civilization itself. Government interventions could attempt to preserve the status quo in agriculture but at high cost in lost living standards.

I made the case that farmers are adept at seeking out their best opportunities to improve their economic situation. Public reporting of terms of production and marketing contracts would facilitate that effort. The challenge of transparency is great because contracts often have unique features, but a joint effort between farmers, agribusiness firms, public administrators, and academics holds promise to develop a reporting procedure. Full reporting would improve immediate market information as well as research into how payoffs differ among regions, firms, and farmers in a world of contract production.

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