

***Alternative Policy Options: Federal and State***

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**The Problem.** The essential problem with consolidation and vertical integration, when taken too far, is that such trends provide certain players with significantly more bargaining power than other players. This power stems from the fact that these trends reduce choice in the marketplace. With unequal market power, the more powerful firm will almost always take advantage of the weaker party, by squeezing price, shifting liabilities, or demanding certain things without paying an associated price. If the players had equal power, then the one player would find it impossible to write one-sided contracts or demand onerous requirements. This is because the other player would simply refuse to deal with the bad actor because the other player would have other choices. Problems arise when one player has choices and the other player does not. Consolidation and vertical integration provide this type of setting.

**The Policy Challenge.** The question for policy makers is how to deal with the real possibility of abusive practices stemming from consolidation. A number of ways exist to approach this policy challenge. One could examine state policies versus federal policies, or one could look at the problem in a sector specific manner, i.e., food retail versus the livestock industry versus the grain industry. The outline below takes yet another approach. It presents this policy question in terms of different ways to affect the power imbalance found in the food and agriculture sector as a whole. The first two techniques go to the heart of the problem by attempting to equalize the bargaining power of the players, either by (1) reducing the power of the stronger party by affecting the structure of the industry, or (2) increasing the power of the weaker party by encouraging collective bargaining. The second two techniques are closely related, but in a way accept the fact that the power imbalance exists. These techniques try to minimize the negative consequences by (3) regulating the behavior of the participants, and (4) improving the enforcement of laws already on the books.

- I. **Affect the structure of the industry.** The main argument in support of this approach is that it will decrease the power of one of the players because it will provide more choices in the market place. These policies do this by limiting what certain firms may own or control. The main argument against this policy is that the government might hinder the most efficient means of production, and in any case, the government should not be in the business of dictating who owns what. Because these policies tend to have the greatest effect on the market participants, they can also be the toughest measures to pass into law.

- a. Prohibit certain types of businesses owning certain types of other businesses. The example here is prohibiting packers from owning livestock. (S. 27, 108<sup>th</sup> Cong.). A similar approach was utilized in 1920 when the federal government forced packers to agree to no longer own or control the marketing channels of that day, including the railroads and stockyards. This policy against certain types of vertical integration attempts to thwart market manipulation and encourage access to the market. A similar approach are the merger provisions included in the Clayton Act where the Department of Justice may require that for a firm to acquire another firm, it must spin off certain assets first.
- b. Institute a moratorium on mergers in a sector of the economy. The idea here is to stem the tide of consolidation. In 1999, Senator Wellstone and other Midwestern Senators brought to a vote a measure that would have stopped all merger activity by large agribusinesses for 18 months. (S. Amdt. 2752 to S. 625, 106<sup>th</sup> Cong.). The measure garnered only 27 votes.
- c. Break up firms. This approach may be the most drastic because it forces firms to divest interests that it already owns. The Sherman Act provides the Department of Justice this power, which it has exercised in various degrees in cases such as the break up of AT&T and in the ongoing Microsoft case.

## II. **Increase bargaining rights.**

- a. Capper Volsted Act. (7 USC 291). This law provides that producers of agricultural products have the right to collectively bargain, and in essence, agree to prices among themselves, so long as the agreement does not “unduly enhance” prices. The law provides limited immunity from the antitrust laws. The trade-off is that (1) the coop must operate in a democratic manner, i.e., one member-one vote, regardless of the amount of investment *or* (2) the return on investment is limited to 8% per year; and in any case, the majority of the coop’s business must come from members. Another advantage to coops is that the income for a coop is only taxed on either the coop or producer level. This differs from regular subchapter C corporations that pay tax on income at both levels. Many feel that producers seriously underutilize the opportunities afforded under the Capper Volsted Act. Nevertheless, critics of cooperatives complain that some coops are not responsive to producer’s needs. While coops point out that with the burgeoning of such business organizations as limited liability companies, coops have had trouble attracting capital. Both state and federal policy makers may consider these issues in the future.

- b. Agricultural Fair Practices Act. (7 USC 2301). Congress passed the AFPA to protect a producer’s right to join an association of producers. The Act generally prohibits processors from discriminating against or intimidating producers who want to join or are members of an association. A major limiting factor in the AFPA has become known as the “disclaimer clause.” This clause states that a processor can refuse to deal with a producer for any reason other than the producer’s relationship to an association. This provision has largely gutted the law because processors can usually point to some reason that it chooses not to deal with a producer. Legislative attempts have been made to address this problem. (S. 1628, 107<sup>th</sup> Cong.).

### III. **Regulate the behavior of the participants.**

- a. Contractual limits. This approach addresses the problem of lack of bargaining equality because it regulates what can or cannot be in a contract. The model act that a number of states have looked to for legislative examples has become known as the Producer Protection Act. (see [www.flaginc.org/pubs/poultry/poultrypt5.pdf](http://www.flaginc.org/pubs/poultry/poultrypt5.pdf)). The following highlights some of the provisions of that model act.
  - i. Implied obligation of good faith. This obligation generally requires that the parties to the contract deal with each other honestly.
  - ii. Disclosure of risks. This requires that the contract must be accompanied by a clear written disclosure statement setting forth the nature of the material risks faced by the producer if the producer enters into the contract. For instance, the contract might need to make clear who bears responsibility for possible environmental liability.
  - iii. Readability. The contract must clearly disclose basic facets of the contract, such as contract duration, factors to be used in determining payment, and renegotiation standards.
  - iv. Right to review the contract. The producer will have at least three days to review and cancel the contract. This provides the producer protection from being pressured into a contract without the ability to seek counsel. This approach does not work well for spot market sales, as the buyer may need to hedge at the same time as the purchase or may want to sell the product within the three day window.
  - v. Confidentiality Provision Prohibited. Prohibits the use of any type of confidentiality clause. Federal law now provides that no matter what livestock or poultry contract says, the parties to the contract have the right to share the contract with advisors and family.
  - vi. Production contract liens. This allows the producer to file a lien that will have a priority over other liens, much like a veterinarian’s or mechanic’s lien. The key to this provision is that the farmer must take the affirmative step of filing the lien. (Iowa Code §579A).

- vii. Investment requirements. If the producer makes a certain amount of investment in relation to the contract (\$100,000), the firm may not terminate the contract without providing at least 90 days notice. If the contractor does terminate the contract, it would need to reimburse the farmer for his or her lost investment.
  - viii. Right to join associations. Producers may not be discriminated against for choosing to join a bargaining association.
- b. Prohibit unfair practices. The most familiar example here is the Packers and Stockyards Act of 1921. (7 USC 181). This law generally prohibits packers, livestock auction markets and livestock dealers from engaging in unfair, unjustly discriminatory or unduly preferential practices. The scope of this law has been narrowed by federal court application of the “rule of reason” to determine what is unfair. Essentially, this analysis looks at intent and the likelihood of competitive injury to decide whether a practice violates the Act. *Armour & Co. v. United States*, 402 F.2d 712 (7<sup>th</sup> Cir. 1968). This rule assigns the plaintiff the daunting task of proving likelihood of injury, which can be rebutted by a case made by the defense that the practice is simply a legitimate business practice. For example, a producer may argue that a packer unduly prefers another producer when it provides premiums based solely on volume. The packer would argue that the practice is justified because it wants a large, consistent supply for its plants. Courts have also limited the scope of the P&S Act by stating that the P&S Act was not intended to affect parties’ freedom of contract. *Jackson v. Swift Eckrich, Inc.*, 53 F.3d 1452 (8<sup>th</sup> Cir. 1995). Nevertheless, critics of the USDA’s Packers and Stockyard’s Program point out that legislative history indicates that Congress intended the P&S Act to be used more aggressively than any other law in protecting producers and consumers. Some argue that USDA could more aggressively utilize the rulemaking process to make clear what practices are unfair. Federal policy makers could also amend the Act to make it more effective. The 2002 farm bill did make one significant change to the P&S Act by providing producers with hog production contracts P&S Act protections.
- c. Limit what types of contracts a firm may enter into. For instance, a law could provide that a firm cannot buy more than a certain percentage of their supplies in closed contracts, i.e., the firm must buy a certain amount on the open market. This approach attempts to ensure a market for producers who choose not to use contracts. The approach also would stem the tide of a spot market becoming so thin that it is no longer reliable. An example of this approach in state law is the “qualified processor” exemption in Iowa’s packer ownership law. This exemption provides that a processor may own hogs if, among other things, it purchases at least 25% of its supply from the open market. (Iowa Code §§ 9H.1(19A)(c) and 9H.2(2)). The idea has also been discussed at the federal level.

- d. Provide more transparency in the marketplace. One of the essential elements in any competitive market is access to information. Given increasing consolidation and vertical integration, many producers fear that they no longer have access to critical market information. In the late 1990's a strong movement to improve price reporting in the states resulted in the federal mandatory price reporting law. (7 USC 1635). Reception of the enforcement of the law has been mixed with some producers concerned that even less information about certain markets is now available. Nevertheless, the USDA and federal policy makers continue to look for ways to provide producers with better information about the marketplace. The 2002 Farm Bill addressed the transparency of contract information by providing that no matter what the contract says, parties to a livestock or poultry contract have the right to share their contract with their advisors and family members.

- IV. **Change the enforcement mechanism.** Many argue that strong laws already exist and that the most effective approach to improving competition policy is not to change the substantive law, but to improve the enforcement regime.
  - a. Current enforcement regime. Currently, three different agencies in the federal government serve as the primary enforcers of competition and trade practice policy. The Department of Justice enforces the Sherman Act and Clayton Act, the Federal Trade Commission enforces the FTC Act (designed primarily to protect consumers) and the USDA enforces the P&S Act and the Agricultural Fair Practices Act.
  - b. Possible changes in federal enforcement. Some have suggested that certain laws should be handed over to different agencies. For instance, in the past some have argued that the Department of Justice should enforce the Packers and Stockyards Act because of its expertise in antitrust litigation. Others, however, point out the fact that DoJ does not promulgate rules and that given the other sectors on which DoJ focuses, it may not spend the required resources for effective enforcement. The Senate Chairman's Mark of the 2002 Farm Bill (S. 1628, 107<sup>th</sup> Cong.) included a provision that would have reorganized enforcement within the USDA by creating the Office of Special Counsel for Competition Matters. This office would have provided the Secretary the ability to consolidate the enforcement of competition and trade practice laws under one roof. Another suggestion is to allow the USDA to seek outside counsel for large, complex competition cases.

- c. Private enforcement. Some argue that as an alternative to government enforcement of the laws, policy could encourage private actors to enforce the law and serve as “private attorneys general.” These parties point to the Sherman Act and some state consumer protection laws that provide for attorney’s fees or treble damages if the plaintiff is successful. These types of provisions would encourage the private bar to take cases that otherwise may not be economically viable. For instance, if a farmer suffers \$5,000 of injury caused by a practice prohibited by the P&S Act, but it would cost \$6,000 in legal fees to litigate the matter, the farmer is likely to simply take the \$5,000 loss. If, however, the award includes attorney fees, the farmer is much more likely to defend his statutory right against unfair practices.
- d. Dispute resolution issues. State or federal policy can affect how a matter is resolved if a dispute arises. These policies attempt to address the possibility that agricultural contracts written by a more powerful party may make it difficult for the weaker party to enforce its contractual rights. For instance, federal legislation has been introduced to prohibit the use of mandatory arbitration clauses in livestock and poultry contracts. (S. 91, 108<sup>th</sup> Cong.). This responds to concerns that a producer may feel compelled to enter into contracts that take away the farmer’s right to go to court and would force the parties into arbitration. Some have complained that some of the arbitration programs are skewed in favor of the writer of the contract. The chief criticism of this approach is that it takes away the parties’ right to limit the risk of high litigation costs. Other proposals that ensure that producer dispute resolution rights are protected include (1) requiring that certain contracts are controlled by the producer’s state law; or (2) requiring that if the dispute goes to court, the case must be held in the producer’s state, as opposed to the processor’s state which may be hundreds or thousands of miles away.

**Strategic considerations.** In general, the U.S. Congress has more leeway to address these matters than states because the Interstate Commerce Clause in the U.S. Constitution does not hamper Congress from making broad policy changes. The federal district court in Des Moines recently highlighted this issue in Smithfield’s constitutional challenge to Iowa’s ban on packer ownership. The Interstate Commerce Clause generally prohibits states from passing laws that discriminate against outside economic interests, although an important exception sometimes exists when the state law has the goal of a legitimate state interest. Although constitutionally the federal government may not be as limited as state government, politically the job can be much more difficult at the federal level. This is primarily because of the incredibly diverse interests in the fifty states. The starkest example is a prohibition on packer ownership. Although most policy makers in Iowa find it very easy to support this measure in an effort to preserve rural Iowa

as we know it, many other states are loath to embrace such a policy, for precisely the same reason. For instance, much of the North Carolina rural economy is based on packer owned livestock and production contracting. Policy makers there shudder to think of the ramifications if this type of economy was prohibited, raising concerns about lack of producer capital and foreclosing one of the only options it sees for young farmers. The result is much less homogeneity in policy support in the nation's capitol.

Another important strategic point when considering the relationship between state and federal policy is that states many times can pressure the federal government to act. The best example of this in recent times is the mandatory price reporting legislation. When farm and commodity groups attempts to pass federal legislation were frustrated, they focused their energies on state legislatures. Within two years, most of the states in the Midwest (which included many of the nation's most important livestock producing states) had passed different versions of state price reporting laws. This quilt work of regulation essentially forced the opponents of the law to the table in Washington, D.C. The opponents preferred consistent policy across the states to the different programs found throughout the states.

**Conclusion.** Proponents of stronger competition policy face great challenges at both the state and federal levels, but this does not mean that the opportunity for policy change does not exist. As the 2002 farm bill debate highlighted, these issues are now at the fore of agricultural policy discussions. These proponents face two primary tasks: (a) analyze what type of policy proposals would be most effective in protecting a competitive environment, and (b) given political realities, decide which proposals have the greatest chance of success. At the end of the equation, people may determine that the best approach will be to have a mix of four categories outlined above: (1) decreasing the market power of certain actors; (2) increasing the market power of other actors; (3) regulating the relationship between certain actors; and (4) improving the enforcement of current competition laws.