

# Policy Responses to New Methods of Vertical Coordination

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Perfectly competitive markets provide an ideal standard against which one can compare actual market behavior. The theory underlying perfect competition assumes that there is a large number of independent producers and consumers (so that no individual can influence prices), firms can freely enter and exit the industry, and producers and consumers have perfect information about prices and the quality of goods. In a perfectly competitive market, entrepreneurial actions of independent sellers and buyers will yield an equilibrium price and quantity that maximizes aggregate economic welfare of producers and consumers.

Firms with market power can influence prices to their benefit, so that prices and resource allocations are no longer representative of a competitive equilibrium.<sup>27</sup> When market prices do not convey proper signals, producers and consumers are not able to make profit-maximizing or utility-maximizing decisions.

Firms may vertically integrate to enhance market power by limiting entry into existing markets or by expanding their influence.<sup>28</sup> According to Mighell and Jones, large horizontal size serves as the original means for market power, which can then be enhanced by vertical integration. Firms may continue to grow beyond what is needed to capture scale economies, to increase their influence on adjoining stages. Some firms may try to limit competition by excluding competitors from certain areas or by reducing available markets. Firms can achieve similar market power-enhancing results with less capital investment through use of contracts, even though contracts are specified for only a limited time.

As open market coordination is replaced by contracts or vertical integration, market prices may become less

representative of competitive equilibrium supply and demand conditions because they are based on fewer purchases and sales. They may also become highly volatile and subject to manipulation. These markets are commonly referred to as *thin markets*. Price signals in thin markets may lead to misallocated resources and lower social welfare relative to the standard of perfect competition.

Concerns about market power stemming from the rapid structural changes in the pork and other red meat industries prompted funding for a USDA study on concentration in the red meat industries. The study found a continual need to monitor and analyze structural change in the industries (USDA[i]). A USDA advisory committee, formed later to analyze the concentration study and other relevant studies (USDA[h]), suggested that the public role may be one of ensuring that negotiating parties are well informed of market conditions, and establishing penalties for exploitative behavior. In 1997, USDA expressed its intent to strengthen fair trade practices, including an investigation of pricing and procurement methods, procurement areas, and contractual agreements by several major hog slaughter plants.<sup>29</sup>

Contracting arrangements between hog producers and packers have been an area of focus because of the substantial increases in these arrangements. Smaller independent hog producers complain they cannot compete when large packers contract only with large producers and do not make public the premiums they pay. In addition, an increasing share of hogs is being sold through marketing contracts that include formula pricing. For example, marketing contracts between producers and packers in North Carolina include a formula for pricing the hogs based on the Midwest quoted price adjusted for quality premiums or discounts. With fewer sales based on negotiated prices by large numbers of buyers and

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<sup>27</sup>“Market power” refers to the ability of firms to influence price and other terms of trade.

<sup>28</sup>A recent example is Tyson’s acquisition of the Cobb Company to prevent competitors from monopolizing the Cobb 500 strain of birds (Bugos).

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<sup>29</sup>USDA is also examining potential anticompetitive practices in poultry procurement, including the effects of production contracts on broiler growers.

sellers (thin markets), the prices may become less representative of a competitive market equilibrium.

The commercial broiler industry faced changes in vertical coordination years ago. Yet, the industry has been relatively free of government intervention. Before 1961, government's role in the broiler business was that of "helpful, but benign, mentor and aid to the industry" (Tobin and Arthur, p. 83). By 1961, there was increased interest by policymakers in dealing with problems faced by producers, namely broiler price depressions and market volatility. There were failed attempts by the Kennedy Administration, for example, to support prices and regulate production to "stabilize" the industry. There appears to have been less concern about the nature of competition.<sup>30</sup> Any market advan-

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<sup>30</sup>Potential problems associated with contracting and vertically integrated structures were certainly recognized. In a 1966 report by the National Commission on Food Marketing (NCFM), issues were summarized regarding the accuracy and representativeness of the base used in formula pricing arrangements between buyers and sellers, and the quality of market information. In addition, the National Broiler Marketing Association, which was a cooperative formed by broiler integrators in 1970 to promote market stability, was found to be in violation of antitrust regulations and was later disbanded as an illegal conspiracy (Alden Manchester, ERS, contributed this point).

tage potential in the broiler industry may have been disguised by the rapid changes that occurred. More significant factors may have been new technology, rapid growth in production, and expanded market demand (Mighell and Jones). In addition, the broiler industry has been one of the least concentrated industries in the food system (Rogers, 1992).<sup>31</sup> Moreover, there had never been a large core of independent broiler producers, as in the pork industry, so price discrimination and a decline in the number of market outlets were less important issues.

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<sup>31</sup>Economic theory suggests that in markets characterized by imperfect competition (monopoly, monopsony, oligopoly), firms may contract or vertically integrate to increase profits. In most cases considered by Royer, however, vertical integration increased output, lowered consumer prices, and increased social welfare.