



Extreme Demands—Extraordinary Products: What's In It for Midwestern Agriculture?

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Demands on corporations to focus their objectives on more than the financial bottom line have never been as forceful and effective as they are now. These demands come from groups such as PETA and Greenpeace, which have a long and confrontational history, as well as more mainstream groups, such as the trustees of California's Public Employee Retirement Program (CalPERS). What the groups have in common is their belief that they can force corporations to adopt business practices that further their particular social agendas. Currently, PETA is pressuring Burger King to force its suppliers to adopt animal welfare standards. PETA praised McDonald's after it adopted minimum-welfare standards for the hens that produce McDonald's eggs. Greenpeace continues to pressure countries and corporations on a range of issues, and the group has extended its target to food companies that use ingredients derived from genetically modified crops. CalPERS has pressured corporations in which it is a major shareholder to adopt guidelines that guard against use of child labor and that enhance environmental quality.

An increasing number of corporations are adopting corporate responsibility codes that guide international business practices in terms of their environmental and social impacts. And, increasingly, both government and non-governmental organizations are backing certification programs that enable consumers to choose products verified as meeting one or more standards in the production process. For ex-

ample, the Forest Stewardship Council recently gave Anderson Windows effusive praise for agreeing to purchase only wood from forests that have been certified by the Council as being "well managed," based on certain environmental criteria.

Some deride these efforts as simple blackmail by un-elected, elitist organizations that do not have the general public's interests in mind. Companies are forced to cave in to such demands because of the well-founded fear that resisting will tarnish their corporate images. But, to the extent that these groups are pursuing the objectives of their members, one could also say that these efforts are simply a reflection of consumers' interest in buying products that give their lives meaning. That is, many consumers will feel better about themselves if, for example, they make their morning coffee from "fair trade" coffee, whereby a greater proportion of their coffee dollar goes to the primary coffee producer in exporting countries. Or Iowans can feel better about food they've purchased at a farmers' market because they know a local grower produced it.

As these two examples illustrate, "extreme" consumer demands are becoming more commonplace in agriculture and the food industry. These demands are extreme only relative to traditional demands for food that is nutritious, quick to prepare, and good tasting. But now, consumers want food that not only saves them time but also promotes health, instead of just providing nutrition, by protecting them against heart disease and cancer. And increasing numbers of domestic and foreign consumers are demanding food that promotes social objectives, such as environmental



quality here and abroad or support for small family farms.

The first reaction of most in agriculture and the food industry is to resist these demands because they are not based on sound science. For example, most U.S. observers vilify the European Union (EU) for its ban on U.S. hormone-treated beef, because no harm has been demonstrated to people who eat this beef. Similarly, the EU labeling requirement for products made with genetically modified organisms (GMOs) is resisted because GMOs have not been shown to harm consumers. The sound science argument is quite persuasive when it comes to government policy regulations. But suppose the consumer, whether in the European Union or in the United States, really does not want to eat hormone-treated beef, or products made with Roundup Ready soybeans? Maybe producers' rejection of these preferences as nonscientific

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is simply self-defeating, because no one can force consumers to buy these products. That is, it might be more fruitful to think of these preferences as opportunities instead of barriers. Did McDonald’s adopt its new animal welfare guidelines because sound science showed that laying hens would be positively affected by more space, or did the company adopt the regulations because it was a good business decision from a marketing standpoint?

Is it in the interest of U.S. agribusiness and agriculture to respond to extreme demands as a marketing opportunity? Or should the sector try to limit change and carry on with business as usual? The answer depends in part on the cost of meeting new consumer demands and on whether the trend toward increased demands will continue to grow. And it depends on the outlook for agriculture under a business-as-usual scenario.

ECONOMICS OF BUSINESS-AS-USUAL AGRICULTURAL PRODUCTION

Business-as-usual agriculture is characterized by many farmers producing a nearly identical product, with price set by traders in exchanges such as the Chicago Board of Trade or the Chicago Mercantile Exchange, with the most successful producers being those who focus on attaining the lowest per-unit costs of production over a long period of time. That is, traditional agriculture is a 100 percent commodity business.

Technological change works to ensure that per-unit production costs of the lowest-cost producer keep getting lower. And lower costs mean greater supplies. Unless demand grows faster than supply, prices drop. This largely explains why commodity prices throughout the 1990s were depressed. The world’s ability to produce commodities grew faster than the world’s appetite for them. This situation reversed itself in 2000, in the energy sector at least, where robust growth in demand outstripped supplies.

But over time, higher prices for commodities inevitably spurs supply,

as new companies enter the business and as existing companies adopt new technologies. The result of this new supply is that upward price spikes prove temporary. One of the first lessons that economics students learn is that, over time, profits in excess of those needed to keep a commodity producer in business will eventually fall to zero. That is, commodity producers should expect that the “normal” situation for their industry is one of zero profits.

Producers can only expect continual positive profits if there are restrictions that prevent new companies from entering the market. Such restrictions could be high technological or capital requirements for startup firms, or they could be government restrictions on entry, such as those for tobacco and peanuts. Another restriction is that a producer could offer a unique product that others would have difficulty replicating. In other words, the product is no longer a commodity; rather, it is differentiated in some respect.

Advocates of value-added agriculture hope that moving a farmer up the supply chain closer to the consumer will transform agriculture from a situation of zero-profit commodity production into one of positive-profit production of food. But if many producers join in to supply these food products, one would expect that the long-run profits of these new enterprises would also dwindle to zero.

Is the outlook for all but the lowest-cost commodity producers really this grim? The answer can be found by looking at the long-run return on agricultural assets. Indeed, the answer is this grim. Is there an alternative? Perhaps the only alternative is to move away from commodity production toward something new, something unique.

ECONOMICS OF DE-COMMODITIZATION

Suppose a group of farmers banded together to produce something unique, for which there is a high demand. For example, Niman Ranch

sells free-range pork. The source for the pork is a unique Iowa pork aggregator who has few competitors. This producer can expect a higher price than is paid for commodity pork. This higher price rewards the aggregator for being unique and compensates him for any additional costs incurred. If there were no reward for being unique, then there would be no incentive for a new entrant into this particular line of work. However, if the reward for being unique is high enough, then a new entrant likely will be attracted. If the market did not grow fast enough to accommodate the increased supply from this new entrant, then it is likely that the uniqueness reward for free-range pork would soon be bid to zero, as both suppliers would bid for business.

The main point here is that the early firm that identifies and develops a market should expect to earn profits. But as these profits become publicized, they serve as an incentive for other firms to capture some of them. Without significant market expansion, the price premium received will decrease. Does this mean that it is not in the interest of agriculture to move away from commodity production? After all, in the long run the returns to being unique from the new market will be zero. But just as the early adopters of a new cost-reducing technology receive additional profits, so too do the early movers into a new market. So, clearly, early movers have an incentive to supply to and/or develop products in segmented markets.

How likely is it that enough new markets will develop to support a significant movement of farmers away from commodity production? In part, the answer depends on two factors. The first factor is whether the drivers of change of consumer preferences discussed in the first part of this article are successful in forcing companies to change their procurement requirements, and in convincing consumers to care more about how their food is produced. If they are successful, then these extreme demands will

offer important marketing opportunities. The second factor is whether the cost of meeting these extreme demands falls enough to make the market feasible.

FEASIBILITY OF MEETING

EXTREME DEMANDS

Given a choice, I would prefer to purchase a tender New York strip steak that came from a painlessly killed steer that was raised in a grass pasture by a farmer who had adopted waste management practices that did not contribute to water pollution. Furthermore, given a choice, I would prefer that the steer had been fed antibiotic-free, animal-product-free feed, and had not been given supplemental growth promoters.

If this extraordinary steak were presented to me in my local grocery store at a price within \$1.00 per pound of a commodity steak, then I would buy it. A brief market survey of my colleagues indicated that more than half would buy it also. How likely is it that, first, I will ever be offered this choice, and, second, that the cost will be within \$1.00 per pound of a commodity steak? The answer to the first question is that products with many of these attributes are available now through the Internet (for example, www.lasatergrasslandsbeef.com). But the cost is more than \$1.00/lb greater than commodity steaks, and I cannot access the steaks at my local grocery. So I will not purchase the steak—yet.

But this story illustrates that the time is not too far off when consumers will be given much more choice in the kinds of food they purchase. Our ability to set up identity-preserved supply chains that deliver full information about the products being delivered at a reasonable cost is growing rapidly. Information technology is being used to implement management systems to preserve the identity of products and product ingredients. The Internet is facilitating direct contacts between buyers and producers of products as varied as

coffee and crafts made by artisans and artists from around the world.

IDENTITY PRESERVATION AND THE FUTURE OF AGRICULTURE

Growing consumer demand for products that complement and reinforce individual morals and ethics, combined with an increased ability to deliver products laden with attribute information, increases the likelihood of a proliferation of viable markets. An increasing share of agricultural production will be devoted to meeting these new market demands. Some of the new products will require that suppliers change their production practices. Individual or coordinated groups of growers working alone or with downstream processors and retailers will deliver a wide variety of meat and grains that are source identified and tailored to meet specific consumer demands.

Of course, for the foreseeable future, a large share of agricultural production will continue to be devoted to commodity production. After all, markets for new products can grow only so fast. As always, the successful commodity producers will be those with the lowest cost of production.

How fast we move from commodity production to customized production depends upon the willingness of consumers to pay for new products and the willingness of companies to invest in developing supply chains to deliver customized production. As these investments take place, farmers who would like to start de-emphasizing commodity production in their operations should be on the outlook for new opportunities from both start-up food companies and from well-established companies that are looking to expand their product offerings. ♦

If you are interested in learning more about this topic, plan to attend the 2001 Agricultural Forum, "Extreme Demands—Extraordinary Products," on March 2 in Ames. Details are available at www.agforum.com or by calling 515-294-6257.