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Potential Impact of Country-of-Origin Labeling on Beef Industry Structure

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Nothing about COOL has been particularly simple. In fact, COOL provisions represented one of the most vigorously debated elements of the 2002 Farm Bill. Nowhere was the debate over COOL more contentious than within the beef industry.

Among beef industry participants at all levels, arguments over COOL scarcely abated (and probably intensified) after the Farm Bill was passed. Predictably, much of the debate over COOL focused on how much it would cost (and who would have to pay for it). Estimating the costs of COOL became a virtual cottage industry—with estimates varying dramatically depending on assumptions related primarily to record keeping and traceability requirements. A good deal of debate also centered on the potential benefits of COOL in terms of increased consumer demand for beef. Here, as with cost estimates, it was very difficult to arrive at a consensus. In early 2004, due at least in part to the ongoing debate related to COOL costs and benefits, Congress added an amendment to the 2004 Appropriation Act that delayed mandatory COOL for an additional two years on all covered products except for fish and shellfish (for which mandatory COOL took effect as scheduled on September 30, 2004).

The beef industry's focus on COOL costs is understandable. The industry currently is ill equipped to provide the level of traceability that the USDA has consistently indicated the labeling program will require. Sorting out how much it will cost to make compliance possible is very important. But it is also somewhat surprising that an industry which has in the past seemed almost preoccupied with structural issues (e.g., packer concentration and captive supplies) has virtually ignored the potential market structure implications of COOL legislation.

One vital element of the COOL legislation (as it is currently written) is that retailers are responsible not only for making sure covered products are labeled, but also for documenting that labels are accurate. This situation means that information on country of origin will have to be communicated clearly along the supply chain. In the beef industry, where the supply chain is rather long and complex, with ownership of cattle often changing several times along the way, this task may be a real challenge. One logical way to deal with that challenge is through contracting, or perhaps other forms of coordination.

In this article, we discuss how country-of-origin labeling is likely to affect vertical coordination/vertical integration strategies in the beef industry. In so doing, we seek not only to inform the debate over COOL, but also to place COOL within the larger context of industrial organization issues that have been the focus of much scrutiny in the beef industry over the past twenty years. Considering COOL in this larger context may lead to a different policy outcome than from a myopic focus on the costs and/or benefits of this (or any other) individual program.

Vertical Coordination in the Cattle Industry

The issue of vertical coordination in the cattle industry has been the subject of intense debate for many years. The primary focus of this debate has been on the use of market power and "captive supplies" and their effect on cash market prices. The USDA Grain Inspection, Packers and Stockyards Administration (GIPSA) defines *captive supplies* as any cattle that are under the control of the ultimate buyer fourteen days or more prior to slaughter. The three main categories of captive supply are packer-fed cattle, cattle purchased through forward contracts, and cattle purchased under marketing agreements.[1]

Figure 1 reports GIPSA captive supply data from 1999 to 2002 (the latest year reported). Over that period of time, captive supplies increased from 32.4% to 44.4% of total steer and heifer slaughter.[2] Virtually all of that increase occurred through the use of marketing agree-

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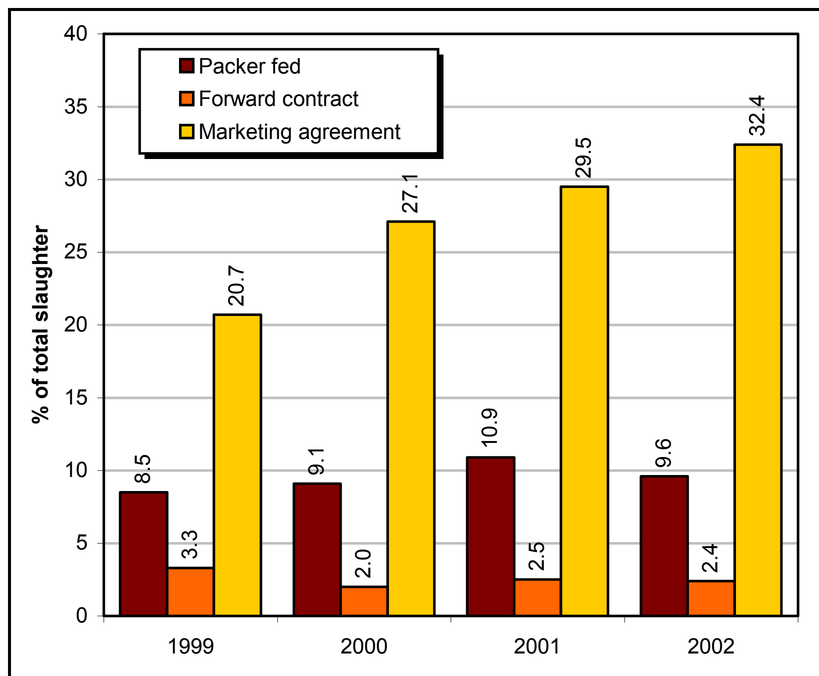

Figure 1. Packer feeding and forward purchases as a percentage of total steer and heifer slaughter-four largest packers.

Note. From USDA Grain Inspection Packers and Stockyards Administration. (2004). *Packers and Stockyards Statistical Report: 2002 Reporting Year* (GIPSA SR-04-1). Washington DC: USDA.

ments. These arrangements tend to be longer-run, standing agreements. They often give feeders considerable influence over the timing of cattle delivery. Such agreements also often involve the use of individual (or grid) pricing of cattle. In many cases, the packer provides information on the carcass merits of the cattle back to the feeder for use in future management decisions.

The inability of the price system to efficiently convey information along the supply chain often has been cited as contributing to the substantial decline in beef demand throughout the 1980s. Although marketing agreements and forward contracting clearly provide a logical means of dealing with this perceived problem, the practice has been controversial. This controversy stems from concern that packers may be able to use captive supplies strategically to depress prices. In 1996, GIPSA concluded a multiyear, congressionally mandated study of this issue. Results were somewhat mixed, showing a negative (but small) relationship between captive supply cattle as a percent of total cattle purchases and transaction price.

More recently, the controversy over captive supplies has been taken to Congress and the courts. The Senate version of the 2002 Farm Bill included an amendment offered by Tim Johnson of South Dakota that would have banned "packer control" of cattle prior to slaughter.[3] The Johnson amendment did not make it into the final version of the Farm Bill, but debate over the provision was intense.

In the courts, in early 2004, an Alabama jury issued a $1.28 billion judgment against Tyson Fresh Meats in a lawsuit brought by a group of cattle producers. The suit alleged that IBP (subsequently purchased by Tyson Foods, Inc.) had used captive supplies to depress cattle prices in the spot market. A judge later overturned the jury's decision, stating that there was no legally sufficient evidence to support the jury's verdict or the size of the award. However, the issue has not been put to rest, as the producers have filed an appeal that will likely be heard in early 2005.

Although many producers vocally opposed the Johnson amendment to the 2002 Farm Bill and the position

1. *Marketing agreements establish an ongoing relationship between the buyer and seller of cattle, in contrast to forward contracts, which generally apply only to a single transaction. Marketing agreements typically specify the number of cattle to be delivered per time period and the means by which cattle will be priced (often through a pricing formula).*

2. *GIPSA data on packer feeding go back as far as 1954. GIPSA began collecting data on forward contract and market agreement purchases in 1988; however, prior to 1999, GIPSA reported unaudited data as reported by packers. Since 1999, GIPSA has audited the data it reports. For this reason, it is difficult to compare current data on captive supplies to that reported prior to 1999.*

3. *During debate over this provision, proponents of the ban held that the rather ambiguous term "packer control" referred strictly to packer ownership of cattle, not to forward contracting or marketing agreements.*

of the plaintiffs in the *Pickett vs. Tyson Fresh Meats* case, grassroots support for both of these causes has been significant—has been, in fact, a driving force. For example, an amicus brief was recently filed in support of the *Pickett* appeal. This brief was joined by more than 50 individuals and grassroots organizations, including many with a national presence such as the Ranchers-Cattlemen's Action Legal Fund, United Stockgrowers of America (R-CALF USA), the Organization for Competitive Markets (OCM), and the National Farmer's Organization. These, along with many other producer groups on record as being strongly opposed to the practice of packer feeding and contracting, are also among the most ardent supporters of mandatory COOL.

Changing the Rules Requires Changing the Structure

Given the current structural state of the industry and the visceral obsession with market structure issues, it seems ironic that the implications of COOL on the structure of the beef industry have not been a large issue in the COOL debate. Because COOL requires retailers to be able to guarantee the accuracy of their labeling, a fundamental shift in the transactions cost for retailers would be expected. In a world where "anything goes," an open market procurement system where retailers seek out the lowest cost source of supply is sufficient to coordinate production and consumption. When one factors in supply risk and food-safety concerns, the incentives for retailers to vertically coordinate with packers and wholesalers becomes more important, leading the industry beyond its current structure.

The mandatory COOL program adds the requirement that the retailer be able to guarantee information on the source of the beef being presented to consumers. The question is: "How might one achieve this high level of information availability and integrity?" In the absence of some intervening force, the costs of researching, certifying, and *trusting* source information in an open procurement market are surely higher than if the system were vertically coordinated. If that hypothesis were true, then the impact of COOL on transactions costs would suggest that the policy creates *more* pressure for contracting in beef, not less. Grassroots organization within the beef industry that, on the one hand, argue vociferously for COOL, but, on the other, display considerable antipathy toward contracting, demonstrate that the potential linkage between COOL and contracting has not been adequately explored in this debate.

To illustrate the argument in a context that is free from the emotional baggage of COOL, consider the case of a retailer that wanted to market a product based on its location of origin because it perceived that consumers valued that information. Now, one could simply go into the market and purchase the product with little concern about the "truth" of the claims by the wholesaler. But, one could imagine the *Dateline TV* exposé on your company when they find out that you are making claims you cannot guarantee and the requisite class-action lawsuits that follow. So, what do you do? One logical solution is to bind the wholesaler in a contract which shifts the legal liability for certifying that your product does, in fact, come from where you claim it does from yourself to the wholesaler. The wholesaler, of course, wishes to shift legal liability back to the processor, and, so on. The central point of this simple illustration is that a choice by the retailer to provide information on a product attribute as a marketing tool led to this shift in market structure. In COOL, the provision of this information is mandated.

One should recognize that there are many simultaneous forces exerting themselves on the beef market—foreign animal diseases, product branding, international sourcing and trade restrictions, to name a few—each with potentially different effects on market structure and performance. The structural impacts of COOL are just a part of the myriad of issues facing the beef industry. However, it seems clear that without some intervening force, COOL is likely to increase pressure for contracting in beef.

The Potential Intervening Force—Animal Identification

The potential impact of COOL on the use of forward contracts and marketing agreements in the cattle industry has been complicated somewhat by the related issue of animal identification. In the wake of the December 2003 discovery of a dairy cow in Washington state infected with Bovine Spongiform Encephalopathy (BSE), the USDA announced its intention to implement a comprehensive animal identification program. Although the ID program would be geared toward providing rapid animal tracking capabilities in the event of a disease outbreak, such a system could perhaps be useful in meeting the requirements of a food-labeling program like mandatory COOL.

The National Animal Identification System (NAIS), as currently proposed, would include a uniform

individual-animal numbering system. Production information would not be required; however, information on animal movement (both intra- and interstate) as well as changes in ownership would be tracked in the system. The result will ideally be a concise, easily accessible record of where an animal originated and where it has been throughout its life.

If the NAIS can feasibly be implemented as planned, the information it could provide ought to facilitate the development of a COOL program. Each animal would have a record of its origin and movement. That record would, by design, follow the animal through the supply chain. This tracking capability is consistent with the needs of the COOL (or any other labeling) program.

The NAIS will not necessarily address all of the concerns related to COOL (e.g., additional costs required for segregating product by location of origin at the wholesale and retail level); however, it does potentially represent one reasonable means of collecting and transferring the information required for the COOL program. Consequently, an effective identification system potentially reduces the incentive for contracting created by COOL. If the provenance of every steer and heifer coming out of the feedlot is readily available through the identification system, there is less reason for retailers to rely on contracting as a means of reliably and efficiently securing this information.

Although the NAIS would provide tracking capability from birth to slaughter, one should keep in mind the difficulty of maintaining identification from slaughtering through fabricating a carcass into many hundreds of products. Animal tracking is one part, but keeping identification through processing is more difficult and potentially costly. Exactly how beef trimmings are to be identified is not clear. Plants or days could be identified as US only, but these structural issues certainly will affect transaction costs. Although they may satisfy COOL requirements, they may not be a traceback system.

Although a national animal identification system may reduce the cost of country-of-origin labeling, this is not to say that it will reduce total costs to the system. The higher transaction costs associated with the requirements of labeling will, in effect, become costs associated with the identification program—a program that provides additional benefits besides simply facilitating origin labeling. These costs will be the same whether animals are contracted or traded on the open market, because the requirement of the identification program will have to be met on all animals.

Summary and Conclusions

Well over two years have elapsed since passage of the COOL provisions in the 2002 Farm Bill. In that time, few if any of the more controversial aspects of the policy have been resolved, at least within the beef industry. Debate still swirls around questions such as how much the program will cost and what its potential benefits might be. At the same time, controversy continues to surround the issue of vertical integration and coordination in the beef industry. Pending court cases and the potential for additional legislation related to captive supplies will keep this issue front-and-center for the foreseeable future.

The relationship between mandatory COOL, captive supplies, and other structural changes in the beef industry (e.g., closer vertical coordination between processors and retailers) has unfortunately been virtually ignored in the lengthy debate over labeling policy. It is long past time for industry participants and policy makers to take up this discussion. Some important issues should be addressed now in order to avoid (or at least minimize) further controversy in the future.

If mandatory COOL does lead to greater vertical coordination through nonprice means (such as forward contracting and use of marketing agreements) what are the implications for the beef industry? For example, will price discovery problems associated with thin markets (already a topic of discussion in the industry) become a significant problem? More generally, will industry participants view an increase in captive supplies as an acceptable side effect of COOL, or will this simply exacerbate the current conflict, leading to additional litigation and political maneuvering? Historic precedent in the industry clearly favors the latter outcome. That being the case, industry leaders and policy makers would do well to consider what might be done now to reduce the potential for future conflicts—perhaps, for example, making changes to the provisions of mandatory COOL and/or working to more explicitly align the goals of COOL and the nascent NAIS.

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