



December 1991

What is in a Price?

by

Bruce L. Anderson

Department of Agricultural Economics

New York State College of Agriculture and Life Sciences, Cornell University

As US agricultural industries become more market oriented, it is appropriate to step back and examine the role of price. Price serves several functions and it is difficult, if not impossible, to separate them. More importantly, the new role of price has major implications for how farmers and growers manage their operations.

The Four Functions of Price

First, price provides income. Price times the quantity sold results in the total income from a commodity. When trying to get a higher price, either through better marketing or government programs, it is this aspect of price that concerns most farmers.

Second, price determines the quantity supplied and consumed. As prices increase more will be supplied and less consumed. The opposite is true as prices decrease. In this way, price regulates the quantity available and consumed. As agricultural industries become more market oriented, increased emphasis is placed on this function of price. Less emphasis is placed on price as a provider of income as minimizing surpluses takes priority.

Third, price serves as a signal. Through price incentives (premiums) and disincentives (discounts) it communicates the need to provide more or less of a product or qualitative feature. For example, a higher price for a certain variety of sweet corn, higher protein in milk, or a specific level of sugar in grapes is designed to signal producers that these features are what

processors want and consumers are willing to pay for. Farmers and growers can expect more of these types of incentives and disincentives as agricultural industries become more market oriented. Why? Because it is an efficient way to communicate to producers what consumers and processors want and need.

Finally, price transfers ownership. Once you pay the price, you are the new owner of the product, tractor, or plot of land.

Costs of Production

One issue farmers and growers are always interested in is the relationship between prices and the costs of production. Costs of production can be an ambiguous concept. There is no such thing as a single cost of production. For example, costs of production for any given commodity probably vary by 30 percent or more from farm to farm. In other words, there are always some producers with costs of production higher than the price, no matter what that price is. The key is to make every attempt to be a low-cost producer.

At any given point in time, the role of price has little to do with the costs of production in a market-oriented environment. Sometimes prices will significantly exceed the costs of production and at other time prices will be lower than costs. Does this make sense? Yes, it does when price is used to communicate market information about consumer and processor wants instead of providing producers a stable income with little concern about surpluses. Over time, price will be sufficient to cover the costs of production of the survivors.

Strategies for Farmers

The changing role of prices means farmers and growers must also change their strategies. What are some of the changes required?

First, be prepared for greater price swings. This implies one must use more equity financing and less debt financing. Equity is an essential cushion to weather fluctuations in price.

Second, strive to be a low-cost producer. Know your costs and those of other producers of your commodity. Cornell Cooperative Extension and commercial firms can help you in this effort. Also, continue to identify new ways to maintain a competitive cost advantage.

Third, be cautious in reacting to short-term price changes, both on the upside and the downside. For example, one should be skeptical of the reaction to expand operations based on

an extremely attractive short-term price. When analyzing such alternatives, make sure you also budget for average and worst-case price scenarios. Those are the prices you may experience when added production eventually comes on line.

Fourth, seek market outlets that are providing price incentives for specific product features. However, this usually means there are also disincentives for delivering undesirable product features. In addition, work with processors and other buyers to identify qualitative characteristics customers are willing to pay for. That is the simplest way to find and create your own market niche. But remember, it almost always costs more to produce and deliver those product features. However if done correctly, the added revenues should more than cover the added cost.

Summary

There is a tendency for some farmers and growers to long for a return to the good ol' days and to resist the new role of price. There is little indication that those days will return anytime soon, however. The alternative is to acknowledge the new role of price and adjust one's operations according. Producers who accept the changes and adopt appropriate strategies are those who are most likely to survive and benefit from this new environment.