Food and Agriculture Organization
of the United Nations

CONTRACT FARMING

Contract farming

SESSION REPORT

International conference
Making the connection: Value chains for transforming smallholder agriculture
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The moderator of the session was Mr Andrew Shepherd of Technical Centre for Agricultural and Rural Cooperation (CTA). The panel consisted of Ms Elizabeth Isu Rava from Papua New Guinea's oil palm industry, Ms Sudha Narayanan, a researcher from India, Ms Sithembile Maunze who works for SNV Netherlands Development Organisation in Zimbabwe, Mr Charles Eaton, a manager and researcher of contract farming programmes, based in Fiji, Mr Kit Chan, a Malaysian exporter of carambola produced under contract and Mr Andy Keck who directs a United States Agency for International Development (USAID)-funded project in Senegal under USAID's "Feed the Future" strategy to develop cereals value chains.

Under contract farming farmers benefit from reliable market outlets, reduced price uncertainty, extension advice, inputs on credit, etc. Companies get a reliable supply of products and are able to dictate quantity, quality and timing. Despite its apparent advantages, however, contract farming is often criticised for the perceived unequal nature of the relationship between the parties. Although companies dictate policies it is their responsibility, and in their interest, to ensure that farmers receive efficient extension services, appropriate inputs and guaranteed incomes that they would not usually obtain from the open market situation.

The discussion started by considering the factors that determined which farmers were chosen by companies for contract farming. Ms Narayanan considered that in India the fundamental concern of firms was to be able to procure required volumes at the lowest cost while minimizing the risks that the required volumes might not be met. They needed to balance transactions costs and reliability: farmers who could produce at low cost may be more likely to side sell. This implied a sequencing of farmer choice decisions with location, logistics, and agro-climatic requirements dominating initial selection and individual farmers then chosen from within those areas. Ms Narayanan considered that farmer selection was ongoing and in her experience there was a lot of "churning", resulting in farmer addition and attrition. While there is similar evidence of a trial and error approach in other contract programmes around the world, Mr Eaton stressed that companies cannot afford such a random approach. Farmers' capacity to achieve quotas was essential.He added that to reduce the risk of trial and error, farmer selection should be based on a clear interest on the part of the farmer; a survey to determine if the farmer meets the criteria of farm size, soil suitability, farm equipment and human resources; an assessment of farmer's historical yields and performance; and the support of the community's leaders. Mr. Keck added that in Senegal the cereals aggregators and millers working with the project selected farmer groups based on at least one of three factors: (i) presence in a zone where commercial surplus was a clear possibility; (ii) pre-existing commercial operations in that zone and knowledge of the farmer groups; and/or (iii) family-based linkage to an area and to farmer groups.

The Moderator then raised the question of the gender impact of contract farming and ways of resolving problems. Ms Rava reported on a scheme in Papua New Guinea, known as the Lus Fruit Mamas scheme, which gave women the opportunity to sell oil palm to the companies. Social problems had been experienced as a result of the men, who held accounts with the

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companies, failing to allocate enough of their earnings to their families. The Lus Fruit Mamas scheme was initially designed so that women could pick up the "loose fruit" and sell it to the companies but, in time, women came to do some of the harvesting. Ms Maunze also identified gender problems in Zimbabwe. In most cases these were due to cultural practices. Registration is in the name of the husbands and the husbands attend most of the training courses even though the women are the ones participating in the projects. She added that whilst companies were aware of this, there was not much that they could do. All payments are made to the husbands. Some companies were now encouraging spouses to register jointly and to also attend training programmes together. This is not enough: more needs to be done to ensure equitable sharing of labour as well as decision making on use of the money.

Mr Eaton noted that companies did recognise gender imbalances but progress to rectify the issue was relatively slow. While making some efforts, companies were reluctant to go against prevailing social norms in the areas where they operated. Wherever possible contracts should be issued to the lead worker of the contract, irrespective of gender. Ms Narayanan had identified few gender problems in her research in southern India although she considered that this could be a problem in other parts of the country. Mr Keck indicated that his project had worked successfully with both male and female farmer groups although the success with women's farmer groups was driven more by the existing context than a specific gender strategy. The Senegal experience indicates that women's direct involvement often depends on the roles for men and women in a given society and a given crop.

Based on his experiences in Malaysia and elsewhere, Mr Chan then listed reasons why small farmers could benefit from contract farming. Many farmers were illiterate, used traditional cultivation practices and were confused about modern technology. They had limited financial resources but spent heavily on purchase of crop-protection chemicals. They found it difficult to meet the increasing demand for reliable supply, quality, food safety assurance and traceability and were unable to comply with third- party certification. Finally, they sold through chains with multiple market intermediaries. As a consultant in Pakistan, Mr Chan had developed a 4+1 cluster model, where one leading farmer would work together with four smaller producers, in order to address some of these problems.

The discussion then turned to the problems that could be caused when the market failed. Ms Maunze said that after the fast-track land redistribution programme in Zimbabwe, many agro- processors who had relied on commercial farmers for their supplies had to look for alternatives. This presented an opportunity for many smallholder farmers to grow crops that were traditionally grown by commercial farmers, including seed crops. One company had successfully contracted smallholder farmers to grow seeds for NGOs who were distributing free seed packs to the smallholders during the decade-long economic and humanitarian crisis. In time, however, the non-government organisation moved away from an "emergency" approach to helping those farmers, to more of a commercial one. They stopped distributing free seed packs. This led to a a decline in the company's seed market. The company honoured its contractual obligation to the farmers and purchased all the seed at the agreed prices although it had no market. Although the company eventually managed to find an alternative market for the seed, it eventually stopped contracting the farmers to produce seed.

Mr Chan stressed that matching supply and demand was essential for companies buying on contract. They needed to confirm their clients' requirements, plan forward so that harvest corresponded with the time supply was required and the logistics would be in place, monitor all operations and cover themselves against risk (e.g. through hedging currency rates). Mr Eaton indicated that market risk was greatest with smaller informal operations. There is an argument that contracts should be underwritten; particularly against the risk that the buyer reneges on purchasing farmers' crops. Few companies would agree to insure against market failure on behalf of their farmers unless there were reciprocal arrangements that addressed poor performance and extra contractual sales. Such insurance would be very difficult to administer. The best insurance for the maintenance of successful contracts is that they are based on goodwill, and the development of positive "relationships" as had previously stressed by other panellists. Uncomplicated registration agreements that outlined quotas, basic agronomic practices, grading standards and pricing structures were recommended. Mr Eaton noted that a Kenyan vegetable exporter had confirmed that the legal enforcement of contracts was virtually impossible and such contracts were "a waste of paper". When long-term tree crops, land tenure and bank loans for infrastucture were involved, Mr Eaton considered that contracts had to be legally binding under common law.

Mr Keck added that, in Senegal, the ability to penetrate the urban/industrial cereals markets was constrained by financing of the necessary inputs. This offered the right context for contract-based arrangements to be introduced, to shift production practices and varieties to meet the quality expectations of such markets. He also indicated that contracts

were essential but that the contract pricing and payment terms required considerable facilitation between farmer groups, buyers and banks. Despite such interventions, conflicts arose the first time the country had a poor rainy season that led to production shortfalls.

Mr Eaton also emphasised that projects could collapse, not just because of market risks but also because of the physical environment, farmer effort, the technology used, climatic factors and management skills of the company. Mr Keck added that in Senegal financing of the input supply was a major problem. He also indicated that contracts were essential but that farmers had trouble understanding pricing arrangements. Ms Narayanan indicated that farmers often experienced labour constraints and that the companies were well aware of this, choosing to contract in areas when average family size was greater, for example. In others, where particularly skilled labour was required, companies might employ their own skilled labourers to assist farmers with certain operations. Mr Eaton stressed that a common error was for companies to arbitrarily increase farmers' quotas beyond their capacity.

The Moderator then introduced the topic of side selling. An opposite problem is the sale of produce into the buying chain that has been produced outside of the contract. This can happen to take advantage of higher prices offered by companies. Such a practice may result over-production and the introduction of produce grown using dubious chemicals. Mr Eaton stressed that there was a need for company-farmer representative forums that met regularly and functioned as "sounding boards" for potential problems. Experienced extension officers were found to be beneficial but they should have a genuine understanding of the culture they worked in. Mr Keck indicated that although his project was working with rice and maize, which are generally considered more likely to be side sold, side selling was reduced through two actions. First, the contracting approach was only pursued for higher quality products that met the needs of specific domestic market niches, namely urban rice consumers and animal feed businesses, both of whom prefered imported products.

Second, the parties assumed that only one third of total farm production would be sold under contract, even though the inputs provided corresponded to 100% of planned production. This gave farmers secured financing and inputs, and an initial output market, but also assurance that they would have enough to eat and enough left over to sell on the spot market. In addition, most of the buyers were prepared to sign contracts using the previous year's highest prices, instead of the typical low prices that prevail just after harvest.

Ms Maunze indicated that some seed farmers in Zimbabwe side-sold even though they were offered premium prices for the seed crop compared to the commercial crop. This was because farmers would be trying to avoid loan repayments. This was because the price they could obtain for seeds sold as food crops was still higher than the price for seeds with the cost of inputs supplied deducted by the company. In addition to side-selling, farmers would sometimes deliver to companies through other farmers who had already paid off their loans. A similar problem of loan repayment avoidance was indicated by Ms Rava. Farmers would try to avoid loan repayment by delivering fresh fruit bunches in the name of their wives or of other farmers.

Ms Maunze indicated that SNV had facilitated training of farmers in basic business management skills. This had helped build relationships between farmers and companies and reduce the frequency of several bad practices including side selling and input diversion. If farmers understand basic business concepts, they start appreciating why a company requires a certain quality and quantity of a product at a specific time. Famers also get to understand the value of the services that are offered by the contracting company and they get to calculate their profits realistically and compare them with what they would get if they had to source their own transport, storage facilities etc. Therefore business training is very useful in eliminating the many sources of tension that exist between small holder farmers and contracting companies. Mr Eaton stressed that practical training through field days was a great boost to cement linkages. However, Ms Narayanan indicated that farmers still saw risks from entering contracts. The presence of some "fly-by-night" operators had contributed to this but reliable companies tended to honour commitments to farmers, even if this meant destroying produce that was purchased but not required. She noted that some contracts had led to significant declines in soil fertility and farmers were therefore wary of growing new crops.

Questions from the floor initially concentrated on the idea that under contract farming farmers were no better than "labourers on their own land". The panel agreed that there was a slight possibility of this but considered that most available studies had found that contracted farmers had higher incomes than non-contracted ones. Farmers faced heavier risks when making long-term investments, which is why some third-party involvement (e.g. government or trade association) in the monitoring of prices to farmers for crops such as oil palm was essential.

One question from the floor raised the subject of farm extension services for the contracted farmers. Mr Chan believed that extension provision was the essential foundation to sustain the relationship of the contract, because the dissemination of technical knowledge to the smallholder farmers ensured that they were able to produce and upgrade their farm quality to compete in the market place. Others noted that in many countries the provision of both agricultural extension services and rural finance was poor and one advantage of contract farming was that it helped overcome these weaknesses. Mr. Keck pointed out that the cereals experience had led to development of private farmer outreach and training. He also noted that the initial years of pre-season contracting in rice and maize helped establish a positive credit status for farmer groups with the local banks. As a result, after only a few years, these farmer groups had been able to mobilize financing and inputs without pre- season contracts and, instead, were shifting towards in-season contracts, closer to the time of harvest.

TO KNOW MORE

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