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CONTRACT FARMING RATIONALE FOR SMALL-SCALE FARMERS AND AGRI-BUSINESSES

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1. INTRODUCTION

Contract farming allows the sharing of production and marketing risks between farmers and agribusinesses. It therefore has the potential to benefit both stakeholders in several ways. However, contract farming can have several disadvantages for farmers and business too, especially in developing country contexts where weak government, policy and governance frameworks lead to contractual enforcement issues. This policy brief presents the advantages and disadvantages for the different actors engaged.

	Advantages	Disadvantages
Farmers	-Securing markets -Access to new markets -Access to inputs, credit and production services -Access to extension services and technical advice -Opportunities to learn new skills and technology -Reduction of price risk -Enhancing farm production and management skills -Increased and more stable income flows	-Non-compliance by agri-businesses -Complexity of contracts, price setting mechanisms -Lack of exit options -Reduced flexibility -Increased requirements and standards -Increased asset compliance -Farm land degradation -Loss of farmer independence -Lack of public frameworks and effective contract enforcement - Increased social tensions
Agri-businesses	-Transaction costs reduction -Quantity control and timely procurement -Quality control -Favourable prices -Access to primary resources -Access to financial instruments -Access to public support mechanisms -Agribusiness corporate image	-Side-selling by farmers - Transaction/logistic costs increase through farmers isolation and non-compliance -Internalisation of farmer support costs -Diversion of supplied inputs -Flexibility constraints for agribusinesses

2. BENEFITS FOR FARMERS

Contract farming can positively affect farmers, both by improving farmers' capacity to take advantage of opportunities (pull factors) and by contributing to farmers' capacity to overcome constraints (push factors) (Glover, 1984). Engaging into a contractual arrangement in some cases acts as a type of insurance for farmers as it may lower production and marketing risks through:

- *Securing market outlet, reducing market uncertainty and transaction costs related to the search for markets.* Small-scale farmers in particular benefit from the reduction of marketing risks, as they often have more limited market access (da Silva, 2005).
- *Opening up new markets:* The opening up of new markets out of reach of farmers and securing access to distant and more rewarding markets. This

is particularly the case related to the increasing importance of both public and private standards in agricultural market transactions.

- *Reducing price risk:* The reduction of the uncertainty about sales price, since contracts typically specify the price (to be paid at delivery) at the beginning of the growing cycle. As such it provides capacity to strive against price volatility and instability by acting as a risk management tool (Eaton and Shepherd, 2001).

> CHIMOIO COMMERCIAL FARMERS' ASSOCIATION (MOZAMBIQUE):
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> As an association, CMFA is negotiating contracts which should allow them:
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> - to open up remote markets (Maputo)
> - to lower logistical costs to access these markets
>
> Farmers have to group in an association, in order to be able to provide the requested quantity, at one specific time. This would also lead to the reduction of production costs through economies of scale.
>
> *(Chimoio Commercial Farmers' Association interview, 19/6/2012)*

- *Providing production services,* such as mechanisation and transportation, by agribusiness firms. This significantly lowers the farmers' costs related to mechanised land preparation, sowing and harvest, but also transport of produce, etc. – making these feasible to individual (small) farmers.

- *Providing technical advice and technological assistance,* offered by the contracting firm. This presents an opportunity to learn new skills and technology (among which improved seed varieties, specialised skills), favouring the production of higher valued, often riskier crops and livestock. Again, this is particularly important for (small) farmers' capacity to adapt to new and increasing quality demands and standards (Maertens and Swinnen, 2009). Contract farming may thus help decreasing small-scale farmers' barriers to entry.

- *Enhancing farm production and management skills* by the agribusinesses (with possibility of spill-over effects for other non-contracted productions) (da Silva, 2005).

Through these different elements, contract farming can contribute to more stable income flows and thus to improved planning capacity for the farmer over the year. Contract farming has been seen as a way to favour diversification of farmers out of traditional crops into high value crops and thus provide farmers with higher potential for income generation.

3. DISADVANTAGES FOR FARMERS

Although contract farming can have notable advantages to both farmers and contracting firms, a significant number of drawbacks have also been pointed out. These are mainly related to unequal relationships.

- *Non-compliance by agribusinesses.* Tactics sometimes used are: company's refusal to buy products at the agreed prices, or the downgrading of produce quality by the buyer, changing pre-agreed standards, downgrading crops on delivery so offering lower prices, or over-pricing for inputs and transport provided.

- *The complexity of contracts*, leaving farmers (avoiding excessive legal costs) under the command of the agribusiness. This relates to the complexity of price setting mechanisms that farmers do not understand and are thus forced to accept.

- *The lack of exit options for producers,* contributing to this dissymmetry, can lead to farmers not being to discontinue the contractual relationship, but also to a dependency to the latter.

- *Reduced flexibility:* Contracting may leave farmers with very little flexibility in enterprise choice and participation in other alternative markets especially when specific assets are involved in the contract specification. In cases of perennial crops such as coffee, citrus and tea, land is locked away from other profitable enterprise and switching off costs are particularly high for both trading partners.

- *Increased technological pressure:* Although farmers may gain from technological innovations, technical control can also be used by firms as a conduit to shift market pressures to producers who lack expertise to understand what some technologies entail and to comprehend their consequences.

> FREPEGA- EXPORT VEGETABLE GROWERS ASSOCIATION (ZAMBIA)
>
> Before the existence of the Frepega's growers and exporters association, the vegetable farmers under contract with several off-takers were confronted to many issues related to the companies bargaining power. Issues were:
>
> - Company's refusal to buy products at the agreed price, downgrading of produce quality by the buyer, default by failing to make timely payment
> - Overpricing of inputs – leading to poor financial results for the farmers. Frepega is presently not offering certain of the required services, it also re-balances the power-relations between the different entities
>
> *(Frepega interview – 24/8/2012)*

- *Increased requirements and standards:* The sophistication in the standards together with the prevalent lack of quality information creates a significant impediment for farmers in meeting the required safety and quality standards. Also, this provides significant ground for disguised form of contractual hold up through the rejection of product delivered by the farmer under the pretext of non-conformity of quality regulations (da Silva 2005).
- *Increased asset compliance: I*n order to reduce the risk of non-compliance most farmers may be forced to invest in certain level of assets sometimes under credit or loan arrangements.
- *Farm land degradation:* Risk of farm land degradation as a consequence of monoculture that can be a consequence of contractual arrangements and farmers' investment and is likely not to be accounted for in the arrangement (da Silva, 2005).
- *Loss of independence:* Contract farming has been analysed in some cases as an institutional arrangement in which companies acquire temporal rights over produce and labour, that is an arrangement that leaves the farmer with little control over land and labour. As such, contract farming has been considered in some cases as a disguised salaried relationship, leaving the farmer with imaginary control.
- *Lack of public framework and effective contract enforcement:* The lack of public framework leads to weak tools for addressing issues of contract enforcement, information asymmetry and to the lack of capacity from farmers' side – resulting in an even more dominant position of companies. The lack of public framework on contracting, especially in developing countries, exposes farmers to higher risk of losing assets when contract fails.
- *Increased social tensions:* At territorial level, significant differences between contracted and non-contracted farmers can create social tensions. Even in cases where contracted farmers benefit from it, actors that are not participating from contract farming may face problems arising from increase in land value or increased prices locally for inputs or food in particular (Bienabe and Sautier, 2005).

4. BENEFITS FOR AGRI-BUSINESS FIRMS

- *Transaction cost reduction:* The benefits that accrue to agribusinesses from contract farming schemes hinges on transaction cost reduction, asset specificity, quality control and reduced uncertainty with regard to the supply consistency.
- *Quantity control and synchronised procurement:* Contractual arrangements allow more synchronised procurement and redistribution of agricultural produce and products. This helps firms circumvent costs associated with spot markets.
- *Quality control:* Contracting firms can influence production by providing resources and technical expertise in order to ensure quality produce. The consistent use of quality inputs by contracted farmers reduces the risk of dissatisfied consumers.
- *Favourable prices:* Since contracting firms often have relatively stronger bargaining positions in contractual arrangements, they can influence favourable farmer commodity prices (Delgado, 1999). Lower producer prices will serve to increase the gains of firms.
- *Access to primary resources:* In countries where access to productive land is limited by legislation or high

land prices, agribusinesses can use contract farming with local farmers to circumvent this constraint and secure constant supplies of commodities for their processing and export ventures (Key & Runsten, 1999; da Silva, 2005).

- *Access to financial instruments:* Efficient supply chains and economies of scale realised by agribusinesses through contracting make them less risky borrowers; access to credit finance and subsidies is improved since financial institutions' willingness to lend money is increased (ibid).
- *Access to support mechanisms:* Contracting with farmers can be advantageous to agribusiness firms in developing countries where incorporation of farmers (in particular small farmers) into agricultural markets is a government developmental goal (Watts, 1994). Such activities can lead to public support.
- *Agribusiness corporate image:* Engaging with independent farmers, particularly small farmers, might be used to strengthen the business image, in the framework of its corporate social responsibility strategy (Anseeuw et al., 2011).

COMPHANHIA DO VANDUZI, MOZFOODS (MOZAMBIQUE)

The company's major challenges were:

- consistency of supply
- provision of quality exports

Through contractual arrangements with 400-600 farmers (including) smallholder), it provided:

- Assistance with the procurement of inputs
- Logistical support
- technical assistance
- Controls and governance processes

Being presently certified under Fairtrade practices, it results in higher prices which the company gives through to farmers. The governance of the process in expensive and audits of the process takes time

(Vanduzi interview, 21/6/2012)

This policy brief can be downloaded on the NBF website www.nepadbusinessfoundation.org

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