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CONTRACT FARMING: WHY? WHAT? HOW?

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1. INTRODUCTION

Following the dismantling of international commodity agreements and the liberalisation of agricultural and agri-food markets, agricultural markets have been restructured, becoming increasingly consumer-driven and vertically integrated (Swinnen, 2007). In addition to this, smallholder farmers do not have the economies of size and the access to technology that is required in order to be competitive, particularly in times and economies characterised by State withdrawal and a decline in public support to agriculture. Both these trends have the potential to exclude small-scale farmers from mainstream agro-food markets (Louw *et al.*, 2008).

It is against this background that contract farming has now been recognised as a policy and planning priority, in order to facilitate access to markets for small-scale farmers. As such, the 2008 World Development Report on agriculture argues that contract farming is one of the ways for smallholders in developing countries to escape from poverty. It is seen as a tool for fostering smallholder participation in restructured markets and value chains, increasing and stabilising smallholder incomes (The Work Bank, 2007). Smallholders are often considered to be very efficient producers in terms of labour intensity and labour-related transaction costs, but they also often suffer from capital and liquidity difficulties, and lack of access and/or capacity to adopt technological innovations. There is a need to provide guidance to the key economic players in agriculture who can exploit the potential of contract famring.

2. WHAT IS CONTRACT FARMING? - DEFINITIONS AND CHARACTERISATION OF THE CONTRACTS

Contracts are means by which people seek, identify and negotiate opportunities from exchange. Contract farming can be defined as an agreement between farmers and processing and/or marketing firms for the production and supply of agricultural products with conditions arranged in advance (Baumann, 2000; Eaton and Shepherd, 2001 among others). A contract is a legally binding or informal agreement concerning a bargain, which is essentially commercial in its nature and involves sale or hire of a commodity. Da Silva (2005) defines contract farming as an intermediate mode of coordination whereby the conditions of exchange are specifically set among transacting partners by some form of legally enforceable binding agreement. Specifications can include production technology, price discovery, risk sharing and other product and transaction attributes. Contractual agreements are shaped by a number of factors, which includes property rights relations, labour process and organisational form (Bellemare, 2009).

2.1 Diversity of types of contracts

Contracts are generally heterogeneous in nature as they are designed to fit unique trading situations (Just and Wu, 2009). Contractual agreements vary depending on a number of variables, which include asset fixity, frequency of trade, switching on and off cost, the legal environment and the inherent characteristics of the product (Kirsten and Sartorius, 2007). Literature on contract farming differentiates between three classic types of contracts according to their main objectives, the transfer of decision-rights and the shift of risk from the farmer to the buyer (Key and Runsten, 1999).

- *Market-specification contracts* refer to pre-harvest agreements that engage a buyer in providing a market outlet to a farmer under pre-established conditions often related to price, quantity, quality and timing. Thus, the farmer delegates a part of the risk to the buyer, while keeping control over production.
- *Management-providing (production-management) contracts* are similar to market contracts, however, such arrangements delegate some of the farmer's control over the production process to the buyer. In terms of these contracts the adoption of specific farming practices (land preparation, planting dates, seedlings, fertilisers application rates and dates etc.) or the choice of post-harvest management practices will come under the technical supervision of the buyer to attain higher quality and to control the timing of output. The buyer recoups the costs of extension from the proceeds of marketing a higher-quality product according to the timing of demand.
- Finally, *resource-providing contracts* are the closest arrangement to full vertical integration and require not only that the buyer provide a market outlet to the farmer, but also that he delivers input packages on credit and corresponding technical assistance in its use. It results in the buyer having major control over production with the contract shifting most decision-rights and risks to the buyer.

2.2 Formality of the contract

Contract farming is diverse in nature and ranges from informal handshake arrangements to formal written arrangements. Contracts in this expanded sense are found everywhere in agriculture. Most contractual agreements are verbal and are transitory in nature. Usually informal contracts are seasonal and are mainly found in fresh vegetables and tropical fruits, as it is suitable for those agricultural produce that requires minimal processing. In particular supermarkets frequently use this model to procure fresh vegetables from the farmers (Eaton and Shepherd, 2001). Financial investment is low and risk of non-compliance for both contracting partners is very high since switching costs are very low. Furthermore this model largely depends on the availability of basic market and physical infrastructure.

A written contract can specify quantity and quality of the produce, price and price determination, condition of payment, price of output adjustability, contract duration, cultivation practices, and risk associated with the contract. Price and price determination is one of the crucial elements a written contract contains. High level of illiteracy among smallholder farmers has been pointed out as an argument a strong and influential leadership to speak for them in the drafting of contracts (Eaton and Shepherd, 2001).

3. CONTRACT FARMING AS A COORDINATION AND RISK MANAGEMENT INSTRUMENT, BETWEEN SPOT AND VERTICALLY INTEGRATED MARKETS

Contract farming is an institutional arrangement that operates as an intermediary between spot and vertical integration (Key and Rusten, 1999). It is generally considered that contract farming ensures consistent procurement and therefore helps processing companies optimising their processing capacity and their fixed assets investment with regard to spot markets risks of discontinuities while avoiding integrated production risks (Eaton et Shepherd, 2001). Companies have more control over production than on spot markets while not incurring directly risks associated with land and labour.

3.1 Risk management dimensions

Agricultural decision-making is done in an environment of risk and uncertainty. Contracting is fundamentally a way of allocating risk between producer and contractor and it can consist of very different risk allocations depending on the contract specification: agreement on the level of production exchanged or price specification (Baumann, 2000; Eaton and Shepherd, 2001). In order to mitigate risk and uncertainty in developed economies, farmers insure their crop or livestock. However in developing countries both insurance and credit markets are either thin or missing and in some cases collapsed because of high risks. This can leave contracting as the only institutional form that can mitigate market risks and uncertainties (Saenz Segura, 2006). Supportive actions to promote contract farming with smallholders may appear decisive to reduce marketing risks. Contract farming also serves to mitigate transaction costs (market research costs, screening costs.

On the other hand, contractual arrangements entail their own risks, which are the risks of opportunistic behaviour from the two contracting parties (Ton and van der Mheen, 2009). Indeed, all contracts whether written or oral are incomplete because of the bounded rationality of contracting parties and the non-verifiability of relevant variables necessary to make them complete (Kirsten et al., 2009).

4. CONTRACT AS A TYPE OF COORDINATION MECHANISMS

The types of market arrangement that will be favoured depend on the production and market risks faced by producers and buyers.

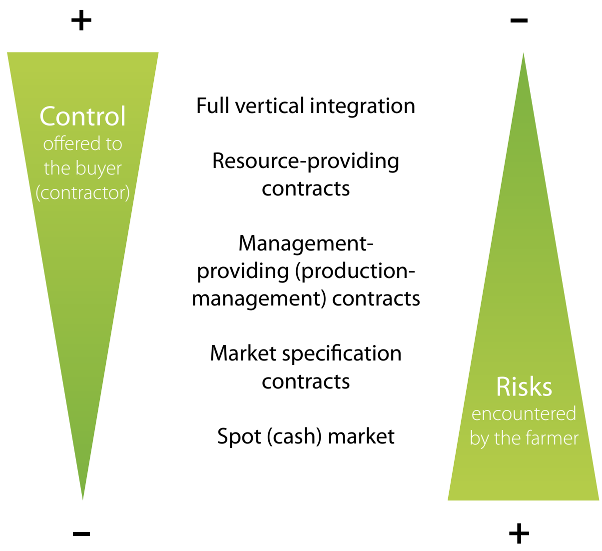
Table 1: Type of arrangements according to production and market risks

		Production risks		
		High	Medium	Low
Markets risks	High	Vertical integration	Vertical integration	Long-term contract
	Medium	Vertical integration	Long-term contract	Long-term contract/ spot market
	Low	Vertical integration	Long-term contract	Spot market

Source: Van Lieshout et al., 1995

The more the coordination goes toward integrated forms, the more the risk decreases, the resources access is secured and the bargaining power is strengthened (Jaffee, 1994). Nevertheless, vertical integration does not allow specific know-how and may face time constraints since functions are accumulated (Moustier, 1998). Thus, a highly centralised organisation (vertical organisation) or very rigid (very precise terms and restrictive contracts) may lead to prohibitive costs. Thus, flexible forms of coordination (implicit contract or contract on the products) may be more efficient, except in the case of high risk level or high asymmetric bargaining power conditions. Moreover, vertical organisation may reinforce situations of dependence between actors (Moustier, 1998) (see Figure 1).

Figure 1: Vertical integration, risks and control



Source: Adapted by author from Mighell and Jones (1963) and Minot (1986)

5. CONCLUSION – CONTRACT FARMING AS A POTENTIAL INSTRUMENT TO FACILITATE MARKET ACCESS FOR SMALL-SCALE FARMERS

In a framework of the restructuring of agricultural markets and the withdrawal of state support for small-scale farmers that do not have the economies of scale and the access to technology that is required in order to be competitive, contract farming can be a potential instrument to facilitate market access for small-scale farmers. It can as such be seen as a tool for increasing and stabilising smallholder incomes.

Besides the positive effects of contractual arrangements, several authors have, however, drawn the attention on certain negative aspects of this instrument (biased relations between contractors and farmers, negative conditions for small-scale farmers, etc.) (Minor, 1986; Baumann, 2000; Anseeuw et al., 2011). There is thus a need to further analyse the contracts and contractual arrangements and their implications for small-scale farmers.

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