Technical Centre for Agricultural and Rural Cooperation (ACP-EU)

An introduction to Contract Farming[1]

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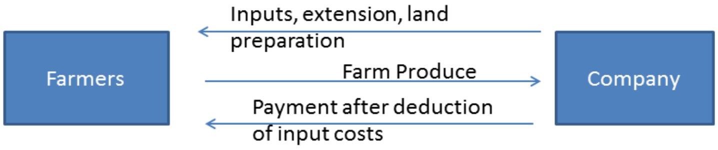
What is contract farming?

As a way of organizing agricultural production, contract farming has been in existence for decades and in recent years its use appears to have been expanding quite rapidly, including in much of Africa. But what exactly do we mean by the term? Sometimes it refers to cases where the buyer specifies the quality required and the price offered, and the farmer commits to deliver at a future date. Commonly, however, contract farming implies more than a farmer just having a contract to supply a buyer. The important feature is that the buyer has some say in how, when and where a product is produced and harvested. For example, a farmer who is growing certified seeds at an agreed price, using the foundation seed supplied by a seed company, using inputs either supplied by or recommended by the company and following all recommended production practices is doing contract farming. This leads to a simple definition, which I shall use in this paper:

"Contract farming is agricultural production carried out according to an agreement between farmers and a buyer, which places conditions on the production and marketing of the commodity"

Types of contract farming arrangement

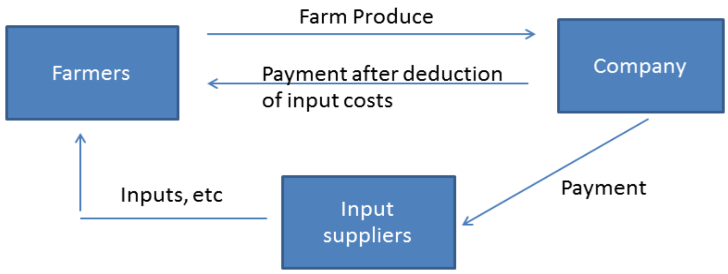
There are many ways in which companies work together with farmers. Three examples are given here but many other approaches can be found. The simplest approach is when the company supplies extension and all inputs to the farmers including, sometimes, land preparation services, and then deducts the cost of those inputs and services from the final price paid to the farmer after harvest and delivery.



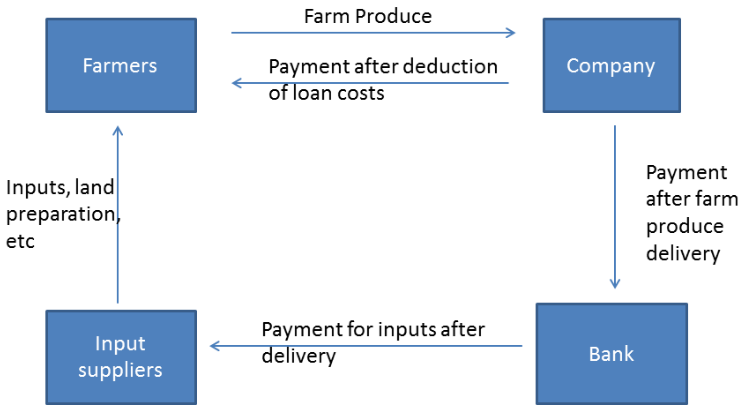
Sometimes, however, the company does not want to get involved in the physical handling of inputs or in carrying out land preparation. For example, it may not have the staff to do this work. So, where suitable local input dealers are available it may use those. The arrangement looks something like the

[1] Based on a presentation made by Mr. Shepherd at the ROPPA Business Forum, Abidjan 29th October, 2013. Comments received from Messrs Carlos da Silva, Charles Eaton and Vincent Fautrel on this paper were much appreciated.

diagram below: the company will normally still provide extension but other services are provided by private companies who are paid by the company after they have been delivered.



In other cases the company may not have enough cash to pay for the inputs and also wait several months until it can get the product from the farmer and then sell it on to other buyers, either in the same form or processed. In this situation the company needs to borrow money from a bank. The input dealers supply the inputs to the farmers, the bank pays the dealers and the company repays its loan from the bank, often not until it has been able to sell the products it makes from those delivered by the farmer. The company may even have to borrow money from a bank in order to pay its farmers, although companies with such limited resources may be risky for farmers and, possibly, best avoided.



Why are companies interested in contract farming?

So what are the advantages of contract farming for companies? There are potentially many. First, smallholders have land. Companies may indeed prefer to run large plantations and not have to deal with lots of small farmers but large areas of land are rarely available. Also it is politically sensitive and controversial to take over large chunks of African land. Even if foreign companies could succeed in obtaining suitable land they could be accused of “land grabbing”. For large international companies this would be very damaging to their reputation.

Spreading production over a large number of smallholders also spreads the risks from disease, pests or drought. The entire crop on a plantation could be wiped out but this is unlikely to be the case for the entire production of all smallholders. Moreover, some crops, such as many horticultural crops and tobacco, are generally considered to be more suitable for smallholder production. Indeed, in some cases companies may lease plots to farmers who are short of land, providing they use it for contract farming. The company prefers the crop to be grown by smallholders. In addition, when companies operate estates they have to pay the workers from Day 1. With contract farming they can make advances to farmers for inputs and may sometimes also give cash advances but they only pay the full cost to smallholders when the produce is delivered.

But you may still ask why companies go to all the trouble of working with so many farmers and providing them with extension and inputs. Why don't they just announce that they are buying products at their factory and wait for farmers to deliver? In the first place, of course, farmers are not going to make an investment in crops with a long growing period unless they can be sure of a market. For a farmer to invest in crops that need to be processed soon after harvest, such as oil palm or rubber, a guarantee is required that someone will buy the product once the trees are mature. So if companies want to obtain supply of this sort of product contract farming is almost essential.

But contract farming can be important even for companies handling crops that can grow in a few months. They are not dependent on farmers deciding to sell to them rather than to a different company. This enables them to be fairly sure that they can meet contractual and delivery obligations to their buyers and, where they do processing, guarantees factory throughput. No company wants to be buying 20t a day when its factory can handle 100t. Further, by providing planting material and extension advice and scheduling planting and harvesting by farmers, the company can ensure that supplies are available at the right time, in the right quantity, and of the right variety. Again, a company with a daily capacity of 100t. wants 100t. a day to be delivered, not 50t. one day and 200t. the next.

But perhaps the most important reason for contracting with farmers is to ensure that the product complies with the certification requirements of the eventual buyers. A company that is marketing produce as "organic" or "Fairtrade" cannot just go down to the local market to get its supplies. The products must be produced in accordance with the requirements of those labels and the farmers must be certified. Demand from overseas markets for products to be certified has been spreading rapidly and exporters now have to comply with a whole range of standards, increasing the need for contractual arrangements with their farmers. In time, local companies, such as supermarkets, are also likely to insist that the products they buy are similarly certified.

But there are problems

Offsetting the many advantages to companies of using contract farming are a number of potential problems. Companies have the right to expect that if they supply inputs, advice, etc. to farmers then those farmers will honour their side of the bargain. But farmers sometimes sell the inputs or use them on other crops. Or they may use all the inputs correctly, but then sell the products to an entirely different company or to a small trader who visits their farm. Alternatively, they may supply too much to the company, buying produce from neighbouring farmers. Consider the implications for a company and all of its farmers if it is selling fresh vegetables in Europe as "free of pesticides" and some of its farmers buy from their neighbours vegetables grown with pesticides.

It can be extremely expensive for companies if contract farming arrangements break down. If they don't get any products from their farmers they will not be able to meet the contracts they have with their buyers, such as supermarkets in Europe. Alternatively, they may have spent a fortune on a processing facility, only to see it lying idle. They will not get back the money they have spent on inputs and other services supplied to the farmers. For these reasons it is certainly not in the interests of reputable companies to upset their farmers.

The advantages for farmers

Contract farming should provide farmers with a reliable outlet for their production, at a predetermined price. The alternative is to grow or rear a product and then hope that someone will buy it, a very risky venture. By growing to the quantity specifications of the company, farmers minimise unnecessary time and resources spent on producing something they can't sell or have to sell at a give-away price.

For contract farming to work it has to be a "win-win" for both companies and farmers. So, what are the potential advantages for farmers? First, it is generally easier for them to obtain productivity-enhancing inputs. In many rural areas there are no companies supplying seeds, fertilizers, chemicals, etc. or, if there are, they often have little stock. Life is made easier for farmers when companies take over responsibility for organizing input supply. Second, it can also be very difficult for farmers to obtain credit for their agricultural activities. The fact that companies are prepared to provide inputs without payment until the crop is delivered removes farmers' need for credit. Sometimes companies are also prepared to advance inputs for family food crops. Something else in short supply in much of Africa these days is good-quality agricultural extension. Working under contract can provide farmers with extension advice that may otherwise be unavailable, although in a few cases extension support offered by companies also proves ineffective. Farmers may also have access to land preparation services which, again, are often not available to farmers without a contract.

... and potential disadvantages

There is obviously a risk for farmers that companies may fail to honour their contracts. This could occur if the company finds that the venture is not profitable enough or if it loses the market for the products it is selling. Products such as tree crops, for which there is nearly always a market, are less risky than fruits and vegetables, where supplying European supermarkets is very cut-throat. For example, a supermarket chain that has bad experiences with suppliers from Kenya may switch almost overnight to buying from Senegal, or vice-versa. On the other hand, vegetables that grow in just a few months are less of a long-term risk than tree crops. If a vegetable contract collapses the farmer loses the time and money spent on growing just one harvest. If an oil palm factory goes broke the farmer may have no other outlet for the fruit and may be stuck with hectares of palms that suddenly have no value.

So it is important that farmers and their organizations do some research about the company offering the contract. The higher the level of risk, the more that farmers need to be reassured about the reliability of the company. They also need to make sure that legal protection for farmers is built into the contract.

Other possible disadvantages include the fact that farmers tied to a contract are unable to benefit from high prices on the open market. Offsetting that, of course, is that in some years the open market prices may be much lower than the contract prices, and in that case farmers benefit. However, companies do recognize that farmers will be very tempted to ignore their contracts when local market prices are higher than agreed with the company and there are different pricing mechanisms that can be used in contracts to take this into account.

Farmers investing in crops with a long growing period receive no income until the crops bear fruit. For most small farmers such investments are impossible without funding from a company, the government or a development bank. Even if such funding is available it is unlikely to come as a gift and thus farmers become more indebted than they would if following traditional farming practices, even though in the long run they may be much better off.

Not all farmers are suitable for contract farming

Contract farming has to be commercially viable for companies. They are private organizations, not development institutions, NGOs or charities. In the same way that someone running a business in a city would aim to choose the best possible employees, so companies want to choose the best available farmers. In deciding on areas to work with farmers, companies consider factors such as agronomic suitability of the land, climate, pests and diseases, the location of the farm, availability of input supplies and services and infrastructure such as roads, electricity and communications. Having identified a suitable location they may then choose which farmers to work with based on a whole range of other factors. Farmers should have some assets and access to finance other than from the company. They often need to employ labourers and these want to be paid daily whereas the farmers only get paid when they deliver the crops. Companies may also want to assess whether individual farmers have the capacity to meet market requirements, for example in terms of fully following cultivation instructions. To do this, they may consider the farmer's level of education or visual evidence from inspecting the farmer's fields. Reliable companies will also look at how much land is available to the farmer. Sometimes too much land is used for contracted crops, making it difficult for families to meet all their food needs from the farm.

Gender relationships

Problems can obviously arise when the contract breaks down, for whatever reason. But apparently successful contracts can also have other difficulties when looked at closely. Gender relationships can present particular problems. Much of the work is often done by women but companies tend to put contracts in the name of the man and, as a result, payment is also to the man. In some countries it may be socially unacceptable for the contract to be in a woman's name. Sometimes, land used by women for food crops is taken by their husbands for contract production, with the result that the family has to buy food rather than grow it. This may not always be a problem were it not for the many examples that show that men often spend the money unwisely and don't give their wives enough to buy food. Because contracts are put in the name of the man, it is the man who is invited to meetings and training courses. Even if women do most of the work they often get no training.

What can go wrong?

While some farmers may not be suitable for contract farming, the same can be said of some companies or, at least, some management teams. Managers who lack the skills to develop good relationships with farmers can cause major problems. When a company goes into contract farming for the first time its staff may have no previous experience of smallholders and no knowledge of their problems. A common difficulty is that companies have unrealistic expectations of the yields that can be achieved. Estimates are often based on yields achieved on research farms, sometimes not even in the same country, rather than on yields achieved by smallholders. As a result farmers are promised high yields and high incomes, which are never achieved. Companies operating "nucleus estates", where they run a small plantation and are surrounded by smallholder outgrowers, are best able to avoid such problems because they have a better understanding of the production environment.

Contract farming is much more likely to succeed where the so-called “enabling environment” is most suitable. This means that political, legal, and financial factors must be supportive of both the private sector and of the contract farming concept. To start with there must be a strong national and local political understanding of the purpose and requirements of contract farming but, unfortunately, there are too many examples of both national and local politicians seeking political advantage by encouraging farmers to break their contracts.

While written contracts are legal documents it is unlikely that small farmers, other than through their organizations, will take companies to court, or vice versa. Nevertheless, it is still important that a country has in place laws of contract on which contracts can be based. Many African countries have inadequate land tenure laws and this can cause difficulties: farmers will not invest in long-term tree crops if they don’t have tenure. If farmer organizations or associations are to be involved with contract farming then rules governing associations are necessary. A strong banking environment is essential if companies, service providers and farmers are to be able to finance their activities, and if companies are to trade and export with the minimum of risk.

In addition to providing an appropriate enabling environment, governments can also undertake proactive measures to support contract farming growth. For example, they could assist companies to identify suitable farmers, something that is already being done by NGOs. Public-Private Partnerships (PPPs) are being talked about a lot these days. Examples of such PPPs for contract farming could include government financial support to farmers planting long-term crops, government research station assistance to companies, or government construction of roads to connect farmers with processing facilities.

How can potential problems be avoided?

The most important word in contract farming is “trust”. The whole process will not work if farmers don’t trust the company and the company doesn’t trust the farmers. Contracts will only work when both parties believe they are better off by engaging in them and for this to happen there must be an understanding of each others’ needs and problems. This requires a willingness to collaborate and share information.

Maximising communication is essential. Companies have to visit farmers to understand their difficulties. Ideally they should have extension workers “on-the-ground” and also organize regular meetings. Farmers have to visit the premises of the companies in order to understand what the companies require in terms of product quality, delivery arrangements, etc. Disagreements over product grading are particularly common. The contract should give clear specifications. Simplicity is key and the fewer the different standards the better. Having the farmer or a representative of farmers present when the crop is received and graded can avoid many problems. Late payment can also cause major difficulties. Companies should aim to pay within a week, if not at the time of delivery or collection. Contracts must be clearly understood by all the farmers and, as noted earlier, should have some flexibility to allow for extreme events such as high prices on the local market or bad weather. Finally, however hard you try there will always be disagreements, so contracts should allow for arbitration by an organization or individual acceptable to both the company and the farmers.

What could be the role of farmer organizations?

Farmer organizations can act as intermediaries between companies and farmers. This could be both to organize production and harvest and to negotiate contracts.

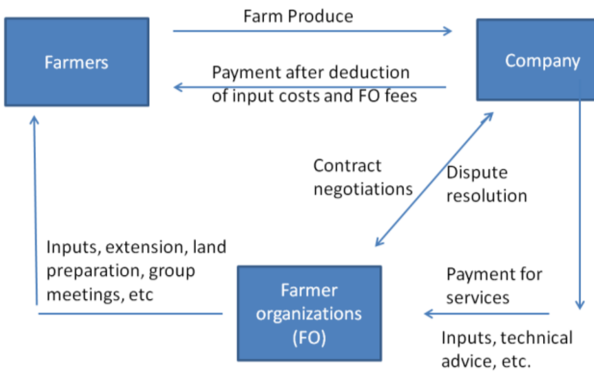
Companies rarely want to work directly with thousands of farmers. It is costly and complicated for them to organize farmer meetings, arrange input supply and land preparation and schedule harvests, product collection and deliveries. In most cases they would prefer to work with a few organizations who can do this for them. Working with farmer organizations could also give them a certain political respectability in countries that are still often hostile to the private sector. Finally, companies often hope that organizations can discourage farmers from side selling and can put pressure on farmers to repay their loans.

That said, companies often continue to work directly with farmers because the skills of many farmer organizations remain inadequate for the task. The necessary managerial capacity can be in short supply and financial accountability can be poor. Farmer representatives may not always understand how the private sector works. Also, it can't be denied that many farmer organizations have collapsed in the past and this is a risk that companies don't want to take. They are also slightly concerned that messages to farmers may get watered down when a farmer organization acts as an intermediary. Being a member of an association or cooperative and being involved with contract farming can also be time-consuming for farmers: not only do they need to attend meetings to discuss the contract but they also need to attend meetings called by the association. Finally, there is some evidence that farmers are not happy when they see officers of their organizations being paid by the company, even if those officers are working in the farmers' best interests.

Little research has been done on the role played in contract farming by farmer organizations. What information there is suggests that things work best when the organization exists mainly to service the contract farming operation. General purpose cooperatives or farmer associations have too many other things to worry about to devote enough attention to making sure the contract is a success. Further, where there is more than one association supporting a contract, the terms and conditions of the contract should be exactly the same, and the farmer bodies should not be competing for farmers.

Given the lack of research on the role of farmer organizations in contracts, the best method of operation is far from clear. Should the organization sign a contract with the company and then work with its farmers to ensure the company gets the supply it requires? Or should the company sign a contract with each individual farmer, with the organization playing more of a support role? If the organization had a contract with a company and then its farmers failed to deliver, what would be the legal position of the organization? In general, companies will probably want to have contracts directly with the farmers. They prefer to pay the farmers themselves so there can be no questions raised about financial malpractice. Also, a company likes to be able to monitor the performance of individual farmers. It doesn't want to be supplying farmers with inputs if those farmers are not making good use of them: in many cases it will not renew a farmer's contract when the farmer fails to produce satisfactory yields. It also wants to be sure that the farmer is not delivering too much, i.e. also delivering products grown by neighbours.

So, the best model for farmer organization support to contracts appears to be something like this:



This article has touched on just a few of the many issues related to contract farming. Further sources of information are given below.

For further info see: Eaton C. and A.W. Shepherd, "Contract Farming: Partnerships for Growth" FAO, Rome, 2001. http://www.fao.org/docrep/014/y0937e/y0937e00.pdf

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