

POLICY BRIEF

FEBRUARY 2015 | NO. 6



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BUILDING AN ENABLING ENVIRONMENT FOR CONTRACT FARMING SUCCESS

Contract farming, the practice of growing agricultural products under forward contract, is often touted as an effective means of rural development and the commercialization of agricultural production by smallholder farmers.¹ Contractual arrangements can facilitate smallholder access to inputs, technology, and extension services and connect smallholders to more lucrative regional and international markets. Studies have shown that smallholders engaged in contract farming schemes see their income increase as much as 44 percent.² For buyer firms, sourcing agricultural products by contract ensures a stable source of supply at a consistent quality, provides flexibility in annual procurement, and mitigates the risks of investing in production directly.

One of the biggest obstacles to the success of a contract farming scheme is that the farmers will fail to honor the contract by selling the contracted crop to a third party, a practice known as side-selling.³ When farmers fail to live up to the terms of the agreement, the contractual arrangement breaks down. At a minimum, this behavior decreases the overall efficiency of the project. In extreme cases, pervasive side-selling may drive the buyer firm to exit the market, causing a loss to both the company and the participating farmers. Avoiding side-selling requires an understanding of the incentives of the farmers who engage in it and the creation of an enabling environment that reduces the risk that farmers will resort to this behavior.

Farmers engage in side-selling for a variety of reasons. Some of these motivations are purely economic, such as an opportunistic sale to another buyer at a higher price, knowing that a weak judicial system gives the buyer firm little recourse to enforce the contract.

¹ See, for example, Melese, A.T., *Contract Farming in Ethiopia: An overview with focus on sesame*, Wageningen University (2010).

² See Roehlano, B. M., and I.M.R. Galang, *Linking small farmers to modern markets: The role of contract farming*, Philippine Institute for Development Studies, Policy Note No. 2014-09 (May 2014) (PIDS (2014)). It should be noted that contract farming arrangements, particularly those involving smallholders, often experience a high degree of turnover (see box "Contract Farming in Context"). The long-term benefits to smallholders after the contracting arrangement ends are less clear: See Minot, N., "Contract Farming in Developing Countries: Patterns, Impact, and Policy Implications," Case Study #6-3 in Andersen, P.P., and F. Cheng, *Food Policy for Developing Countries: Case Studies* (2007) (Minot (2007)). Nonetheless, engaging in contract farming has typically proven to be a successful means of increasing rural incomes and transferring skills and technology to poor farmers.

³ Side-selling is also referred to as "extra-contractual marketing" or "pole-vaulting." Farmers may also breach the contract through "input diversion," whereby farmers apply improved inputs received on credit for use on other crops.

Farmer side-selling results not just from opportunism but also issues of trust, expertise, and economic necessity.

For smallholder farmers, who frequently operate in a very risky environment with slim margins and few assets, selling agricultural produce in a spot market when liquidity is needed may make very real economic sense. However, smallholders may also lack the sophistication to adhere to contract terms. They may have little experience with formal contracts, low literacy and technical expertise, and may lack requisite knowledge of grades and standards. Side-selling may also occur due to a lack of trust between the parties, a failure to effectively communicate the terms and conditions of the contract, or due to other extraneous circumstances that prevent the farmer from living up to his or her side of the bargain. Faced with these risks, firms often prefer the sophistication and reduced monitoring costs of working with medium and large-scale farmers or employees.⁴

To encourage outside investment and the inclusion of smallholder farmers in contract farming arrangements, governments often address the risk of side-selling by granting concessions to buyer firms or by participating directly in the contract in an attempt to control and sustain the outcome. Meanwhile, important legal and regulatory reforms and/or public goods that strengthen the contracting environment are neglected.

The government, private sector, and donor partners each have different roles to play in reducing the risk of side-selling in contract farming. This policy brief specifically explores the role of government in building an enabling environment for successful and sustainable contract farming arrangements.⁵ **The central tenet is that government policies and actions in support of contract farming should promote a clear and predictable contractual environment that encourages the development of market-driven contracts between well-informed parties with an eye towards the long-term sustainability and viability of these commercial relationships.**

This paper is organized around three key means by which governments can promote and safeguard commercial transactions. First, governments should provide a strong legal, regulatory, and institutional framework that facilitates market linkages and provides clear rights and remedies to both parties. Second, governments should invest in public goods and services that lower transaction costs and increase parties' access to information. Third, government incentive programs to promote contract farming should be carefully weighed against the long-term prospects for the commercial sustainability of the contractual relationship.



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⁴ This preference for larger farmers or employees may occur notwithstanding the fact that smallholders have in some instances been found to be more efficient than hired laborers. For example, a Vietnamese pineapple company found that contract growers were two to three times more productive than employees. See *Making Markets Work Better for the Poor: 30 Cases of Contract Farming: An Analytical Overview*, Asian Development Bank (2005) (M4P 30 Cases (2005)). This is particularly true where the crop is highly labor-intensive.

⁵ The strategies employed by donors and buyer firms in preventing side-selling have been extensively covered in the literature. See, e.g., USAID, *Facilitating the Development of Outgrowing Operations: A Manual* (2009); TechnoServe, *Outgrower Schemes: Enhancing Profitability*, Technical Brief (September 2011); Wageningen UR et al., *Contract Farming Checklist* (2010).

Contract Farming in Context

Despite the numerous articles and research extolling the benefits of contract farming, contract farming makes up only a small percentage of all farming worldwide. Even in developed countries, where many of the enabling environment challenges discussed in this paper do not exist, contract farming accounts for only 15 percent of agricultural output.⁶ In addition, only a small percentage of all contract farming arrangements involve smallholder farmers. For example, in a 2012 study of contract farming in South Africa, while 80 percent of processed horticultural products and 70-100 percent of all supermarket products were grown under contract, only 5 percent were sourced from smallholders.⁷

Whether contract farming is an appropriate business model depends on the structure of the market, the capabilities of the farmers, and the practical logistics of the setting. In general, contract farming makes sense where the product has a limited and specific output market, requires a substantial upfront investment, or where the buyer seeks a particular quantity or quality that the market would otherwise not provide.⁸ For these reasons, contracting is most common for industrial crops such as rubber, cotton, and sugarcane, as well as high-value horticulture and tree crops such as coffee and cocoa. Nonperishable crops for which quality is easily observed, such as most staple crops, can be efficiently traded through spot markets.⁹

Contract farming is not without its critics. Contract farming arrangements experience natural expansion and contraction as market prices and consumer demand fluctuate. When coupled with farmer side-selling and other enabling environment challenges, smallholder-based contracting schemes have a high turnover and failure rate. In Ghana, poor relations between buyers and sellers resulted in more than 50 percent of all pineapple contract growers leaving the arrangement within 12 years.¹⁰ Studies in Kenya and Senegal have also shown a decline in the use of smallholders in favor of larger farms and production estates over time.¹¹ These statistics have led critics to question whether the short-term welfare gains from participation in contract farming schemes translate into long-term benefits for the smallholders involved, especially if the farmer must take on debt to invest in new technology in order to join the scheme.

Critics also argue that contract farming exploits the free family labor employed by smallholders in these schemes, particularly the unpaid labor of women and children.¹² Others have raised concerns that contract farming encourages (or indeed requires) monocropping, thus increasing vulnerability and reducing food security for poor rural households.¹³ Environmentalists have voiced worry that the heavy reliance on chemicals in contract farming production methods contributes to environmental degradation.¹⁴

Despite its benefits, contract farming is not the only or even the best solution to rural poverty and food insecurity in all contexts. Donors and policymakers should be careful to recognize the risks and limitations and to avoid promoting contract farming arrangements where they are not sustainable or where the risks to producers or the environment outweigh the potential benefits.

⁶ Prowse, M., *Contract Farming in Developing Countries: A Review*, Institute of Development Policy and Management, University of Antwerp (2012). The average share of U.S. farm production is much higher – roughly 40 percent as of 2008. Nagler, A. M. et al., "Managing Marketing and Pricing Risks in Evolving Agricultural Markets," *Choices*, 30(1) (1st Quarter 2015)(*Choices* (2015)).

⁷ Freguin-Gresh, S., and W. Anseeuw, *Integrating Smallholders into the Global Economy: Agribusinesses, Contracts, and Public Policy in South Africa*, International Farming Systems Association, Aarhus (2012).

⁸ See TechnoServe (2011) and Minot (2007).

⁹ Cf. Minot, Nicholas, *Contract Farming in Sub-Saharan Africa: Opportunities and Challenges*, prepared for policy seminar "Smallholder-led Agricultural Commercialization and Poverty Reduction: How to Achieve It?," Kigali, Rwanda (April 18-22, 2011) (finding some success had been achieved using contract farming for organic grains, grain seed, and grain for specialty market such as breweries).

¹⁰ See Barrett, C. B., et al., *Smallholder Participation in Agricultural Value Chains: Comparative Evidence from Three Continents*, MPRA Paper No. 27829 (December 2010).

¹¹ See Minot (2007) and Oya, C., "Contract Farming in Sub-Saharan Africa: A Survey of Approaches, Debates, and Issues," *Journal of Agrarian Change*, Vol. 12, No. 1 (January 2012)(finding that "the rise of agri-food grades and standards (G&S), and the fact that often only medium-large-sized more capital-intensive farmers manage to meet the standards, have raised the barriers to entry for smallholder farmers.").

¹² Singh, S., *Contract Farming in India: Impact on Women and Child Workers*, International Institute for Environment and Development, Gatekeeper Series No. 111 (2003).

¹³ Setboonsarng, S., *Global Partnership in Poverty Reduction: Contract Farming and Regional Cooperation*, ADB Institute Discussion Paper No. 89 (2008).

¹⁴ Melese (2010).

Whether contract farming is an appropriate business model depends on the structure of the market, the capabilities of the farmers, and the practical logistics of the setting.



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A SAMPLE OF CONTRACT FARMING ACTS AROUND THE WORLD

Contract farming laws can be used to correct market imbalances, improve the bargaining power of smallholders, and improve the ability of the parties to come to a common understanding of the terms of the agreement.

France: The *Code rural* provides that contract farming agreements must be in writing and contain certain provisions to ensure the farmer is aware of the risks and requirements of the agreement.

United States: The *Competitive and Fair Agricultural Markets Act (2006)* disallows confidentiality provisions, requires a period during which the agreement can be cancelled without penalty, provides standard damages for farmers if the firm breaches, and requires the agreement to specify a dispute resolution mechanism and incorporate clear, honest, and accurate terms.

India: The *Agricultural Produce Marketing (Development and Regulation) Act (2003)* specifies certain mandatory provisions (such as those relating to duration of the agreement, product quality, transport, pricing, credit, registration, and dispute resolution procedures) and optional provisions.

Thailand and Vietnam: Both countries have contract farming regulations that cover *force majeure*, compensatory damages, registration of contract farming arrangements, and specific dispute resolution mechanisms.

While these acts can provide uniformity, improve understanding between contracting parties, and protect farmers from abusive contracting practices, governments should be careful not to go so far as to unnecessarily abridge the freedom of contract. In **Kenya**, the *Dairy Industry Act (1967)* grants the Minister of Agriculture price-setting authority and makes the dairy oversight board a third party to any contract.

SOURCES: Prowse (2012); Iannarelli, A., "Contractual Relationships and Inter-firm Cooperation in the Agri-food Sector," *Rivista di Diritto Alimentare*, Anno V, numero 4 (Oct-Dec 2011); Pultrone, C., "An Overview of Contract Farming: Legal Issues and Challenges," *Uniform Law Review*, UNIDROIT, Vol. XVII (2012).

PRINCIPLE I: Governments should provide a strong legal, regulatory, and institutional framework that facilitates market linkages and provides clear rights and remedies in commercial transactions.

In developing countries, the legal, regulatory, and institutional environment in which contract farming arrangements operate is often murky. The contract laws may be antiquated or overlapping, and there may be legal restrictions on commercial relations, a lack of coordination and common measures to guide market transactions, and a lack of predictability in public policies on politicized topics such as land tenure or trade. In addition, a weak judiciary system may afford little opportunity for fair and impartial dispute resolution.

With little fear of contract enforcement, farmers can sell to the highest bidder without concern for the pre-existing contract. Alternatively, farmers may not have a clear understanding of their rights and obligations under the contract, leading to a lack of trust in the buyer and a sense of exploitation when disputes arise. Consequently, the contract itself, whether written or oral, holds little weight, and farmers have few incentives to refrain from side-selling.¹⁵ Governments can reduce the incidence of side-selling by establishing market policies and regulations that provide stable and clear parameters for commercial transactions and a credible threat of contract enforcement.

ENSURE CONTRACT LAWS PROVIDE CLEAR RIGHTS AND REMEDIES.

Effective commercial relationships provide an acceptable balance of risk, reward, and recourse for both parties. While contract law generally does not protect either party from making a bad deal, the arrangement should come about through a "meeting of the minds" – i.e., a clear, mutually understood communication of contractual terms to which both parties voluntarily agree to be bound. Where one party does not understand the terms of the agreement or is forced into it under duress, the likelihood of breach – whether deliberate or inadvertent – increases.

Contract laws govern who has the right to enter into a contract and the terms to which they can be bound. Contract laws can take a number of forms – from general contract or commercial laws to very specific contract farming acts. The fundamental tenets of good contract law include the establishment of freedom of contract (including for women and minorities), the parameters of permissible damages in the event of breach of contract, and protection against contracts formed under duress, fraud, or coercion. Contract laws generally recognize a range of contract forms, including not just written contracts but also verbal agreements and more flexible memoranda of understanding (MOUs). Where contracts must be written and signed or sealed by a notary, the costs of making the contract legal can be a deterrent to formal contracting.¹⁶

In the contract farming setting, there is often an imbalance of power in favor of the buyer firm, which typically has greater resources and access to market information. In some jurisdictions, governments have enacted specific contract farming legislation in an attempt to mitigate this dynamic. While not essential, a contract farming act can allow for the establishment of required minimum terms and default interpretations of common contractual provisions, which can provide a shared vocabulary to reduce the risk of future contract disputes. For example, contract farming acts may require good faith dealing and a balanced treatment of the risk of *force majeure*, or they may explicitly prohibit provisions known to be exploitative. The United States' *Competitive and Fair Agricultural Markets Act (2006)* disallows the use of confidentiality provisions and requires that farmers be given a right to rescind the contract for a fixed amount of time after signing.

While governments should ensure that contract laws provide suitable protections from abuse, they should not interfere with the market terms of the agreement. For example, dictating pricing formulas or controlling the purchase price through a marketing board may unduly interfere with the market relationship.

¹⁵ For example, in Honduras, contracts have been described as merely "guidelines" to clarify expectations between commercial partners, not concrete contractual obligations.

¹⁶ In the Democratic Republic of Congo, there is only one notary for the entire province of Kinshasa. USAID, *AgCLIR Democratic Republic of Congo* (2010).

In partnership with the United Nations Food and Agriculture Organization (FAO) and the International Fund for Agricultural Development (IFAD), UNIDROIT has recently released a draft Legal Guide on Contract Farming, which is expected to be finalized in 2015.¹⁷ The guide will be the culmination of a series of consultations among legal experts, farmers, and buyer firms across the globe. The stated goal of the project is to provide guidance – primarily to producers and contracting companies and secondarily to policymakers – “to promote more stable and balanced relationships, to assist parties in designing and implementing sound contracts and to develop good practices, thereby generally contributing to building a sound and conducive environment for contract farming.”¹⁸ While the draft guide is full of a tremendous amount of research on contract farming in different legal contexts and will no doubt be an excellent resource, the density of the material (over 200 pages) raises questions as to how accessible it will be for farmers and their associations.

STRENGTHEN THE JUDICIAL AND ALTERNATIVE DISPUTE RESOLUTION SYSTEMS AT ALL LEVELS OF GOVERNMENT.

Throughout the world, judicial enforcement is seldom the preferred mechanism for the resolution of commercial contract disputes. Even in developed countries, where the court system is generally more reliable, business partners prefer to sort out disputes among themselves, to save time and money, protect confidentiality, and preserve the collaborative nature of the relationship. Similarly, in developing countries, there is frequently a cultural aversion for litigation. In Ghana and Tanzania, for example, studies have shown that individuals and businesses prefer not to use the courts to resolve their disputes.¹⁸ In China, private enforcement mechanisms, such as floor prices and bonuses, are considered more effective than costly litigation.¹⁹

Nonetheless, the threat of litigation is a powerful tool for discouraging contractual breach. The availability of a credible means of enforcement gives both parties greater incentives to comply with the terms of the agreement as written. In developed countries, this threat of being sued contributes to a healthy “culture of contracts” where, by and large, parties treat their contractual obligations seriously.

Having a credible threat of enforcement requires a forum for adjudication that is accessible, timely, impartial, and affordable to both parties. While the traditional court system may be slow and expensive, many countries have established commercial courts or small claims courts that can provide expertise and expedited dispute resolution. Alternative fora such as mediation and arbitration can also expedite a ruling.²⁰ Expedited mechanisms are particularly important for the agricultural sector. For example, in Bangladesh in 2014, it takes an average of 1,442 days (or nearly four years) to enforce a claim in court.²¹ If the suit pertained to the ownership of perishable goods, the goods would spoil long before the suit could be settled.

In some jurisdictions, local officials or customary tribunals have served as a more rapid and accessible resource. In Bangladesh, village-level courts are the primary forum for the resolution of local disputes valuing less than \$300.²² However, these traditional forms of dispute resolution often have limited jurisdiction that may not extend to commercial matters and lack training in contract law. The local customs on which decisions are based may not be codified, and decision makers may lack impartiality towards minority groups or outsiders and are often prone to perpetuating cultural biases, such as discrimination against women.

¹⁷ UNIDROIT Working Group for the preparation of a Legal Guide on Contract Farming, *Consolidated Zero Draft of the Guide*, Study 80 A, Doc. 19 (September 2014). More information on this project is available at <http://www.unidroit.org/work-in-progress-studies/current-studies/contract-farming>.

¹⁸ Kahkonen, S., and P Meagher, *Opportunism Knocks?: Legal Institutions, Contracting, and Economic Performance in Africa*, Center for Institutional Reform and the Informal Sector, Working Paper No. 204 (1997).

¹⁹ Prowse (2012).

²⁰ USAID EAT project, *AGRI Index Final Report* (2015) (finding that while most of the 10 countries studied had expedited mechanisms, in practice usage was low due to understaffing, low awareness, and/or limited access).

²¹ World Bank, *Doing Business 2014*, available at <http://www.doingbusiness.org/>. Similarly, Nepal lacks a legal mechanism for the expedited resolution of disputes involving agricultural goods, and the lack of recourse may reduce buyers' incentives to provide credit to producers. See USAID EAT project, *AGRI Index Final Report* (2015).

²² Id.

A credible threat of enforcement, including rapid adjudication mechanisms for small claims and perishable goods, gives both parties greater incentives to comply with the agreement.

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GENDER DIMENSIONS OF CONTRACT FARMING

Women face many disadvantages that limit their ability to benefit from contract farming arrangements to the same degree as men.

Control over income and resources. Women are less likely to own or otherwise control the use of agricultural land yet are more likely to be the source of unpaid family labor on small farms. Thus women whose husbands enter contract farming agreements may find their labor burden increase while not directly benefitting from the increased income. In a study of contract farming households in Indonesia, only three of 300 households were headed by women. Where land is allocated by tribal leaders, women are often allocated less productive land that is further from the main road.

Contract formation. In some countries, women are not permitted to freely enter into contracts, and higher rates of illiteracy among women put them at higher risk of exploitation in the contracting process. Where a producer organization acts as an intermediary with the buyer firm, women may be excluded from leadership or unable to attend meetings due to household obligations.

Dispute resolution. When disputes arise, women may lack access to a neutral adjudication forum. Time, cost, and physical access to the formal legal system often make it ineffectively unavailable to women, and local customary dispute resolution mechanisms may be biased against women's equal economic participation.

In encouraging contract farming arrangements, donors and policymakers should pay attention to the gender dimensions of contract farming and ensure that these agreements do not perpetuate gender disparities but rather provide opportunities for women's economic empowerment.

SOURCES: Simmons et al. (2003); Singh, S., *Contract Farming in India: Impacts on Women and Child Workers*, IIED Gatekeeper Series No. 111 (2003); Smalley, R., *Plantations, Contract Farming and Commercial Farming Areas in Africa: a Comparative Review*, LACA Working Paper 055 (April 2013).

While the court system may not be the preferred means of dispute resolution for parties to the contracting agreement, governments should nonetheless work towards the long-term goal of a legal system that provides a credible threat of fair enforcement of contractual rights, including the implementation of rapid adjudication mechanisms for small claims and disputes over perishable goods.

REMOVE RESTRICTIONS ON MARKET RELATIONSHIPS.

In many countries, marketing restrictions limit direct farmer-buyer relationships. These restrictions are often enacted for the purpose of protecting the farmer, but in practice these rules may merely entrench a middleman and introduce unnecessary costs and inefficiencies in the value chain. For example, in Benin, regulations have institutionalized the role of the *acheteurs*, a powerful private intermediary in the shea and cashew value chains, which inhibits direct communication between farmers and exporters and the development of contract farming.²³ Similarly, in India some states require the channeling of agricultural products through wholesale markets, which makes it difficult for buyers to prescribe clear quality specifications.²⁴ Governments should remove restrictions on direct relationships between buyers and producers to improve communication, trust, and efficiency in the value chain. In Uganda, where regulations were amended to remove the requirement of working through an agricultural cooperative, tobacco production via smallholders tripled in six years while also seeing increases in quality and the timeliness of payments to farmers.²⁵

FACILITATE THE USE OF INTERMEDIARIES TO ENCOURAGE CONTRACT COMPLIANCE.

Despite the risks of restricting direct farmer-buyer relationships as described above, the voluntary use of an intermediary between farmer and buyer can improve communication and encourage contract compliance. Contract farming schemes involving many small farmers often work more smoothly where those farmers are organized into groups, with a leadership structure or common intermediary who can ensure quality compliance and on-time delivery and can engender trust between farmers and buyers. The intermediary entity can be a farmers' organization or cooperative, a respected community leader, or it may be a trader or miller one step up in the value chain.²⁶ These local brokers may receive pre-financing to distribute to farmers in exchange for delivering a guaranteed quality and quantity of product at harvest. For buyers, pursuing legal remedies against the broker can be far easier than against individual farmers. The most appropriate intermediary depends on the social and cultural context and what leadership structure is most conducive to effective coordination. For example, studies in Indonesia and Kenya found that groups founded along traditional networks and social ties were able to better influence the decisions made by group members.²⁷ Market-oriented organizations have been found to be more effective than community-based organizations devoted to broader community needs.²⁸ Governments can facilitate these relationships by ensuring that intermediary organizations are exempt from taxation and have the legal standing to negotiate and enter into contracts on behalf of their members and with the contracting firm.²⁹

²³ USAID EAT project, *AgCLIR Benin* (2013).

²⁴ Prowse (2012). PepsiCo, however, has successfully worked around this system by partnering with the wholesale commission agents and a rice processor, who in turn provide services to contract farmers. See da Silva, C.A. and M. Rankin, *Contract Farming for Inclusive Market Access*, FAO (2013).

²⁵ Minot (2011).

²⁶ Nongovernmental organization (NGOs) and local officials have also played this role, but this structure creates risks in terms of market interference and sustainability (see below in Principle III).

²⁷ Simmons, P et al., *Evaluation of a Hybrid Seed Contract Between Smallholders and an MNC in East Java, Indonesia*, Graduate School of Agricultural and Resource Economics, University of New England (2003). Fischer, E., and M. Qaim, *Smallholder Farmers and Collective Action: What Determines the Intensity of Participation?*, EAAE 2011 Congress: Change and Uncertainty, Zurich, Switzerland (August 30 – September 2, 2011). However, attention should be paid to the potential restrictions on the rights of minority groups by these networks, particularly the membership rights and decision-making power of women (see box on "Gender Dimensions of Contract Farming").

²⁸ UK Department for International Development, *Agriculture and private sector*, Agriculture and growth evidence paper series (June 2014).

²⁹ Prowse (2012).

PROVIDE STABLE TRADE POLICIES FOR INPUT AND OUTPUT MARKETS.

In export schemes, companies form contracts with producers on the basis of anticipated input prices, output prices, and the costs and terms of contracts with overseas buyers. Where input or output markets are regularly disrupted, the fundamental economics of the deal could be threatened. For example, a sharp increase in the cost of inputs, including electricity, fertilizer, and water, caused the average monthly income for a Nestle milk farmer in Vietnam to drop to only 5 percent of the previous level. As a result, many contracts failed as farmers switched production from milk to rice or chickens.³⁰

Government policies aimed at protecting food security, such as short-term trade bans and price controls, are often enacted on an *ad hoc* basis and may alter market dynamics and price signals without warning. In employing these policies, policymakers can inadvertently threaten the income of smallholder farmers in contract farming schemes by inducing companies to renege on the agreement. When faced with unexpected costs or trade restrictions, the company may breach or resort to more stringent quality determinations to limit losses. This behavior harms farmers in the short run and reduces trust between buyer and seller, thus encouraging the farmer to side-sell in future seasons if the opportunity arises. Governments should provide clear, stable trade policies and a transparent policymaking process to avoid disrupting the market and threatening the viability of contract farming arrangements.

ESTABLISH PUBLIC GRADES AND STANDARDS FOR CONTRACTED CROPS.

The basic premise of farming on contract is that the buyer firm will specify a certain level of quality which the farmer must meet. In general, the farmer is paid a premium for higher quality produce. This arrangement depends on the existence of a common understanding of quality standards recognized by farmers and consumers and the willingness of consumers to pay a price premium for higher quality. Where farmers do not understand or cannot meet established standards, they may resort to side-selling in anticipation of the rejection of the product by the buyer firm.

Governments can facilitate contract farming by establishing and enforcing minimum public grades and standards for contracted crops.³¹ The use of uniform grades and standards throughout the industry serves two purposes. First, it eases the relationship between farmer and contracting firm by providing a common language and clearer expectations regarding contractual obligations. Second, public grades and standards can help to develop a differentiated consumer market willing to pay a premium for the product. In Vietnam, a contract farming arrangement targeting “safe vegetables” failed because the government did not adequately protect against fraudulent use of the quality certification. Without consumer trust in the label, the contracting firm did not have a sufficiently strong output market segment to support the added costs of complying with the certified quality standards.³²

SUPPORT DIVERSE LENDING STRUCTURES.

Where legal and regulatory pressures may not sufficiently motivate farmers to respect contractual obligations to contracting firms, there may be other pressures within the community that would compel compliance.³³ For example, there may be a reputational risk to defaulting on a loan from a bank or the community. Firms have successfully used group lending and tripartite arrangements with financial institutions to leverage social sanctions as a means of combatting side-selling. For example, in Senegal, banks have used tripartite production agreements as a basis for secured lending to agricultural producers

³⁰ M4P 30 Cases (2005).

³¹ Public grades and standards are distinct from private standards, such as FairTrade and GLOBALGAP, which are established and enforced by the private sector. Public standards should be kept to a minimum level that balances consumer safety and demand for better quality with the cost of adherence to the standards and the risk of pricing out of the market those producers who are unable to meet the minimum.

³² M4P 30 Cases (2005).

³³ Ardnt, C., K. Cormier, and E. Ryzanov, *Value Chain Management and Poverty Alleviation in Rural Areas: Project Experience of Kyrgyzstan*, Helvetas and ICCO (2005).

Food security measures, such as short-term trade bans and price controls, are often enacted on an *ad hoc* basis that disrupts contract arrangements.



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Governments can facilitate a “meeting of the minds” in contract negotiations by providing information on agricultural markets, contracts, and potential partners.

where land tenure laws do not permit mortgaging land.³⁴ In India, the State Bank of India and the Union Bank of India have successfully funded loans for irrigation systems whereby the buyer firm is liable on the loan but deducts the payment from the farmer.³⁵ Group lending uses social or cultural pressures within the community to encouraging borrower groups to self-police. For example, Cottco in Zimbabwe has introduced loans to producer groups whereby producers are “jointly and severally liable,” i.e., default by one of the borrowers must be compensated by the rest of the group. This structure encourages group members to monitor and support one another.³⁶

To make these types of arrangements viable, governments should ensure that borrowers have adequate remedies in the event that the other party does not follow through with its obligations. In Honduras, regulations require that all coffee producers pay a small fee per bag to the Honduran Institute of Coffee (*Instituto Hondureño del Café*), a private non-profit institution that promotes and regulates the industry.³⁷ These fees are held in an interest-bearing account until financial institutions verify that farmers have repaid their loans, at which point the funds are used to pay off any loans in default, and the remainder is reimbursed to the farmers. This system functions as an insurance mechanism for the banks and, by lowering the risk of lending to farmers, reduces the cost of capital for the sector.

PRINCIPLE II: Governments should invest in public goods and services that lower transaction costs and increase parties’ access to information.

Contract farming is a complex logistical operation requiring aggregation, quality determinations, and transportation. Farmers often require training to enable them to meet quality standards, as well as monetary or in-kind advances to cover the costs of improved inputs. The threat of natural disaster makes harvests uncertain, and this challenging environment must be negotiated by partners who may come from vastly different cultures with different business norms. Side-selling occurs when the market conditions shift well beyond the expectations of the farmer and make selling to a third party a more favorable option.

No contract can perfectly account for every eventuality. Even if it could, the time and cost of researching and negotiating those terms would be cost-prohibitive. Contracts instead reflect a careful consideration by the parties of the risks and a balancing of the likely eventualities they believe can be managed between themselves (through private enforcement mechanisms) and those for which explicit written terms are deemed necessary.³⁸ Parties make a better deal (and one that is more likely to be respected) when they have a better understanding of the range of possible outcomes. Governments can reduce the costs and risks inherent in agricultural contracting through public investment in extension and infrastructure and by facilitating access to information on potential contract partners and market conditions.

FACILITATE ACCESS TO INFORMATION ON CONTRACTING PARTNERS AND MARKET CONDITIONS.

When parties are well-informed regarding the terms of the agreement, the contract partner, and relevant market conditions, the clarity of intentions creates the basis for a productive relationship and reduces the likelihood of a future dispute. By contrast, side-selling may occur for the simple reason that the farmers involved failed to understand the terms of the agreement. For example, the Tien Gieng Food Company in Vietnam failed to adequately communicate quality standards to its contracted rice farmers. When it turned out that the farmers did not understand and could not meet the quality standards set forth in the contract, the scheme collapsed.³⁹

³⁴ USAID EAT project, *AGRI Index Final Report* (2015).

³⁵ Prowse (2012).

³⁶ Id. The firm also pays a salary to each of the chairs of the farming clubs, turning them into “pseudo employees” and encouraging them to monitor their group members.

³⁷ The *Instituto Hondureño del Café* is a formerly state-owned enterprise that was privatized in 2000.

³⁸ Klein, Benjamin, “Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships,” *Economic Inquiry*, Vol. 34 (July 1996).

³⁹ Melese (2010).



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Governments can provide a number of public goods and services that help ensure that the parties have a “meeting of the minds” in negotiating contractual terms. In China, the local government provides a catalogue of investment opportunities to facilitate networking.⁴⁰ The government can also assist in contract negotiations through the development of model contracts and the provision of contract support services to assist farmers in understanding and evaluating potential contracts. Market information systems and public information campaigns teach farmers about contract farming arrangements and help them to feel comfortable with the terms of the deal, setting the stage for a more productive working relationship. For example, in Brazil, a government-sponsored television program teaches farmers what to expect in contract farming arrangements.⁴¹ In Kenya, the Horticultural Crops Development Authority promulgated a professional Code of Conduct for the horticulture industry that details fair production, management, and contracting practices.⁴²

Registering contracts and maintaining a database of parties’ past performance under similar contracts can help farmers and buyers to evaluate the risks of entering into a contract with a potential partner. Such a “naming and shaming” database also serves as a strong deterrent to contractual breach. For example, the Government of Benin maintains a clearinghouse on cotton farmers to inform potential contracting firms of individual records with respect to receiving inputs on credit.⁴³

PROVIDE EXTENSION SERVICES TO CONTRACT FARMERS.

Governments have a strong interest in developing the skills of local farmers to meet the demands of markets at home and abroad. Public extension services can be customized to acclimate farmers to the expectations of contract farming agreements, such as educating farmers on contract terminology and law, quality standards, and new production methods tailored to the specifications of the output market. However, providing extension services to a large number of small farmers can require significant time, cost, and human resources, and many governments lack the resources to provide these services as a public good. In the absence of public extension, contracting firms must provide technical assistance directly, the cost of which may be a strong deterrent to working with smallholder farmers. Public-private partnerships that deliver these services can help to fill this gap. In Vietnam, government extension centers have provided technical advice to farmers in contract farming schemes, thus reducing the cost of such services for the contracting firms.⁴⁴ These service centers can also offer certification services for private grades and standards, such as Fair Trade or GLOBALGAP.

INVEST IN TRANSPORTATION INFRASTRUCTURE.

Transportation of agricultural goods from farmgate to a processing center or point of export can be risky and expensive. Rough terrain, poor roads, and informal taxation by public officials can add significant costs to transportation. Smallholders often lack the means for such transportation, yet farm-by-farm collection is very expensive for the contracting firm. Transportation is frequently a cause for the failure of contract farming arrangements. Where the buyer is responsible for pick-up and does not arrive, or where the farmer is responsible but either unaware of this requirement or unable to meet it, the rate of side-selling to traders at farmgate can be as high as 100 percent of participating farmers.⁴⁵ Governments can reduce this risk by lowering the cost of transportation through investments in infrastructure and combatting corruption on trade routes.

Extension services can be customized to acclimate farmers to contract terminology, quality standards, and production methods.

⁴⁰ Prowse (2012).

⁴¹ Prowse (2012). The overall goal of facilitating access to information is to increase the agency of producers – i.e., their capacity to evaluate the risks inherent in choosing to enter into a contract farming arrangement – rather than using a top-down approach to protect the farmer from wrongdoing.

⁴² Pultrone (2012).

⁴³ Minot (2011) and Prowse (2012).

⁴⁴ Melese (2010) (noting that the extension centers also initially served as a distribution point for inputs, a function that was ultimately successfully transitioned to the cooperative).

⁴⁵ M4P 30 Cases (2005) (citing case study in which 100 percent of farmers engaged in side-selling due to transportation issues). See also Barrett et al. (2010) (discussing similar challenges, e.g., failure of the buyer to show up for harvest, in Ghana, India, and Nicaragua).



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Policymakers should be sure that investment incentives do not promote contract farming schemes that lack long-term commercial viability and leave the government with few options for an exit strategy.

PRINCIPLE III: Government incentive programs to promote contract farming should be carefully weighed against the long-term prospects for the commercial sustainability of the contractual relationship.

The enabling environment solutions presented in Principles I and II are essential to the long-term development of a healthy contractual environment, but they are not quick fixes. Establishing a strong legal, regulatory, and institutional environment and funding effective public services takes time, money, and sustained political will. In the interim, many contract farming arrangements will fail. In the face of pressure to support smallholder farmers and the potential of millions of dollars in foreign investment, policymakers grow impatient with long-term solutions and may resort to more heavy-handed approaches to preventing contract failure. These approaches can take the form of dictating contract terms, controlling prices, and providing heavy subsidies or territorial concessions.

Incentive programs are typically designed to address specific market failures or weaknesses within the enabling environment that prevent market forces from effectively regulating commercial behavior. When properly tailored and including a clear exit strategy, government incentive programs can be an effective means of incubating a nascent industry. However, all too often these programs are plagued by corruption and waste and prove too difficult to remove without undermining the sustainability of the contract farming arrangements they were intended to nurture. In tight budget situations, these programs may also divert money away from the needed long-term legal, regulatory, and institutional reforms that could make such programs unnecessary.⁴⁶

This section explores some of the most common government incentives and direct interventions in contract farming arrangements and carefully considers the circumstances and conditions under which a more heavy-handed role of government may be justified. In short, policymakers should carefully weigh government capacity and the expected timeframe and cost of the intervention against the long-term prospects for the commercial sustainability of the contractual relationship.

ENSURE SUBSIDIES AND INVESTMENT INCENTIVES HAVE A CLEAR SHORT-TERM GOAL AND EXIT STRATEGY.

Government policies aimed at smoothing risk and lowering transaction costs for farmers and firms can be helpful in promoting contract farming investment. For example, in Zimbabwe, the government introduced special export processing zones that provide preferential trade policies for firms engaged in contract farming for export.⁴⁷ In addition, government subsidies for inputs and technology can encourage the use of smallholder farmers in contract farming arrangements by reducing the cost and risk to the contracting firm.

Nonetheless, there is a risk that investment incentives may encourage the establishment of contract farming schemes that lack long-term commercial viability and leave the government with few options for an exit strategy. For example, government incentives in Vietnam under the Decision 80 initiative encouraged the spread of contract farming arrangements by providing preferential access to land, finance, and infrastructure, but many of these contracts failed.⁴⁸ In Brazil, the wind-down of favorable government policies with respect to bioethanol could not be accomplished without causing great harm to the sector.⁴⁹ If poorly designed, investment incentives can undermine the development of private sector service providers that could make the incentive no longer necessary. Government financing programs for agriculture have often had a negative effect on the availability of private finance, either by undercutting the interest rates that private banks can afford to



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⁴⁶ In essence, many of these incentive programs reflect the executive branch of government stepping in to correct the outcome where the judicial branch has failed. These programs should be viewed as a stop gap measure, not as a substitute for sustained judicial reform efforts.

⁴⁷ Prowse (2012).

⁴⁸ M4P 30 Cases (2005).

⁴⁹ Da Silva (2013).

offer or by implementing loan programs with lax enforcement of repayment terms, leading farmers to develop a culture of non-repayment where they do not feel obligated to meet the terms of a loan.⁵⁰

Policymakers should be sure that investment incentives do not promote contract farming beyond what is economically sustainable in the absence of the subsidy and that there is a very clear exit strategy that prevents the government from being tied to the program indefinitely.

LIMIT THE USE OF MONOPSONY POWER AS A MEANS OF CONTROLLING SIDE-SELLING.

In general, increasing competition among buyer firms reduces the incidence of side-selling by incentivizing firms to offer better prices and benefits to inspire loyalty in their producers. Rather than resulting in contract failure, this competition can actually increase the strength and long-term sustainability of the arrangement. For example, in Thailand, increased competition between contract buyers and intermediaries in the wood industry resulted in improved terms for contract growers.⁵¹ In Argentina, breweries seeking specific varieties of barley had to offer contract farmers better terms and services to account for the opportunity cost lost in forgoing the production of competitive substitution crops.⁵² Open competition ensures that there exists a market-based incentive for both parties, that the terms offered by the company are competitive, and that farmers have freedom to farm crops of their choice.

Nonetheless, not all markets are naturally conducive to such robust competition, particularly in the early stages of a new industry or in rural areas where parties have lopsided or imperfect access to market information. In such situations, granting a territorial concession to a buyer firm is the surest way to control farmer side-selling and is commonly advocated by policymakers and donors alike. Where farmers have no alternative buyers for their product, particularly where that product is not a food crop, the risk of side-selling or deliberately diverting the crop for other uses is substantially reduced.⁵³ This arrangement encourages foreign investment and, if the terms are fair and offer a premium over the income from substitute crops, benefits farmers while helping to establish a new industry.

Yet granting monopsony power that eliminates the possibility of competition from other buyers also gives the buyer firm substantial opportunity to abuse its dominant market position. In practice, where power is so skewed in favor of one party, governments often must ultimately insert themselves into the relationship to ensure farmers are treated fairly. For example, a contract farming arrangement between PepsiCo and basmati rice farmers in the Punjab region of India reportedly became so contentious that the government agency responsible for arranging the program was forced to make the farmers whole after the company refused to purchase the production on the grounds of inferior quality.⁵⁴ Governments frequently must intervene to mandate minimum prices for producers, and studies have shown that farmers under monopsony control receive lower prices than those in more competitive markets.⁵⁵

While granting monopsony power on a short-term basis may succeed in some cases, governments and donors should be wary of this approach absent strong market opportunity, a short-term market incubation goal, and a clear exit strategy.

Open competition ensures a market-based incentive for both parties, that the terms offered by the company are competitive, and that farmers have freedom to farm crops of their choice.

PHOTO BY FINTRAC INC.



⁵⁰ Minot (2011).

⁵¹ Da Silva (2013).

⁵² Id. Similarly, in the United States, a Department of Justice study of competition policy highlighted the importance of antitrust enforcement to ensuring fairness and competition in the agricultural sector. See Choices (2015).

⁵³ This model has been employed in Mozambique for the tobacco industry. FAO, *Analysis of Incentives and Disincentives for Tobacco in Mozambique*, Monitoring African Food and Agriculture Policies (February 2013).

⁵⁴ Ghosh, J., "Is Contract Farming Really the Solution for Indian Agriculture," *OneWorld South Asia* (May 17, 2007). In another case in the Kyrgyz Republic, farmers who felt powerless to fight back against the terms and practices imposed on them by the processing company refused to deliver their fruits and vegetables as a means of asserting some control in the relationship. Cormier, K., "Grievance Practices in Post-Soviet Kyrgyz Agriculture," *Law and Social Inquiry*, Vol. 32, Issue 2 (2007).

⁵⁵ FAO (2013).

Kelley Cormier
USAID
+1.202.712.4492
kcormier@usaid.gov

Nate Kline, Chief of Party
EAT/Fintrac Inc.
+1.202.621.7349
nkline@fintrac.com

www.eatproject.org

This policy brief was produced by USAID's Enabling Agricultural Trade (EAT) project, implemented by Fintrac Inc., and was written by Amy Chambers, Technical Lead, EAT project (achambers@fintrac.com).

This policy brief is made possible by the support of the American People through the United States Agency for International Development (USAID). The contents of this policy brief are the sole responsibility of Fintrac Inc. and do not necessarily reflect the views of the USAID or of the United States government.

AVOID UNDUE GOVERNMENT OR DONOR INTERFERENCE IN SETTING THE TERMS OF THE AGREEMENT.

As discussed above in Principle I, an intermediary can play a valuable role in facilitating clear communication and encouraging compliance. However, there is a risk with any intermediary that the leadership will not adequately represent the wishes of the members. Contract farming arrangements have failed where the purported "leader" of a cooperative or farmers' organization did not actually speak for the group.⁵⁶ Similarly, the use of an intermediary can actually reduce efficiency where incentives are poorly aligned or the intermediary role is poorly executed.

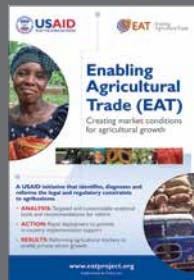
In some contract farming arrangements, governments or donors have played an active intermediary role in negotiating the contract between the buyer and producers. For example, in China, village leaders serve as a go-between for the farmer and buyer from initial recruitment through final delivery.⁵⁷ Where a government intermediary is involved, there is an elevated risk that the intermediary may be out of touch with the needs of producers or be motivated by political instead of economic considerations. For example, where government officials in Vietnam helped to negotiate the contracts, farmers displayed very low understanding of the terms and in some cases did not even know the name of the company.⁵⁸ Government intermediaries may also be tempted to go beyond the role of neutral facilitator and begin setting prices or otherwise interfering in the commercial arrangement.⁵⁹

Third-party intermediaries such as NGOs have a stronger track record of success as intermediaries. While effective in facilitating relationships, these organizations can have a long-term negative effect on the viability of the arrangement if funding expires. A study in Mozambique found that more than half of contracted farmers left the scheme after the NGO funding the farmers' organization wound down its support. With the departure of the NGO, the farmers' organization was no longer able to provide the same level of service to its members.⁶⁰

Enacting legal protections for farmers and buyers that address common contract farming disputes (as described in Principle I) and encouraging the development of representative, inclusive, and voluntary private-sector intermediaries has a greater chance of long-term success than *ad hoc* government or donor interference in specific agreements.

CONCLUSION

In sum, contract farming can be an effective means of rural development, increasing smallholder incomes, and facilitating the transfer of knowledge and technology to smallholder farmers. To be successful, the prevalence of side-selling – one of the leading causes of contract failure – must be addressed. Governments can build an enabling environment for contract farming success by establishing a strong legal, regulatory, and institutional framework for agricultural contracting, providing public goods and services that lower transaction costs for farms and buyers, and employing targeted incentives with an eye towards the long-term sustainability and commercial viability of these arrangements.



ABOUT THE EAT PROJECT

The Enabling Agricultural Trade (EAT) project, funded by the United States Agency for International

Development (USAID), supports the U.S. government's global efforts to create conditions for agricultural growth. USAID established EAT based on substantial academic and field experience suggesting that a sound legal, regulatory, and institutional environment is a prerequisite to economic growth in the agricultural sector. EAT offers a suite of targeted and customizable analytical tools and implementation support to identify, diagnose, and reform agribusiness enabling environment (AgBEE) constraints that hinder start up and growth across the agricultural sector.

⁵⁶ Wageningen (2010).

⁵⁷ Minot (2011).

⁵⁸ M4P 30 Cases (2005).

⁵⁹ These challenges have led some firms to stick to negotiating with farmers directly. In Zimbabwe, Cottco continues to sign individual written contracts with all 60,000 of its farmers. USAID, *Contract Farming and Policy Options in Ethiopia* (2012).

⁶⁰ Barrett et al. (2010). In other contexts, NGOs have been used to provide extension and/or quality determination services. See also Melese (2010) (citing a contract farming scheme in Guatemala that relied on a Swiss NGO for these services); RAVInvest, *Facilitating Market Access*, LLL Briefing Note No. 32 (July 2009) (highlighting a common pitfall of public programs is assuming the private sector will step in when public funding ends).