Thursday, October 31, 2013

Snapshot Background Note on Contract Farming

1. Why Contract Farming is important for agriculture and agribusiness

Agri-food production and distribution systems are rapidly changing. World population is expected to reach 9 billion by 2050 and fertile farmland is increasingly becoming an attractive asset. In many countries small farmer landholdings are quickly fragmenting. On the other end of the food chain, organized retail is expanding and consolidating.

The use of production contracts has become attractive to many agricultural producers worldwide and contract farming in particular has been increasing lately because of benefits such as the assured market and access to support services. It is also a system of interest to buyers who are looking for assured supplies of produce for sale or for processing. A key feature of contract farming is that it facilitates backward and forward market linkages that are the cornerstone of market-led, commercial agriculture.

Contract farming can be defined as agricultural production carried out according to a (formal) contract between a purchaser and a farmer (agricultural production contract), which establishes conditions for the production and marketing of a farm product or products. Typically, the farmer agrees to provide agreed quantities of a specific agricultural product which should meet the quality standards of the purchaser and be supplied at the time determined by the purchaser. In turn, the purchaser commits to buy the product and, in some cases, to support production through, for example, the supply of farm inputs, the provision of credit, land preparation and the provision of technical advice.

Contract farming can be promoted with a favorable investment climate, the development of grades and standards, facilitation of farmer organizations to link farmers and firms, cooperation with private firms on provision of extension services, provision of mediation services, and exploration of innovative ways to enforce contracts.

Governments have an important role to play in shaping a clear and complete legal framework governing fair and equitable contracts and promoting cooperation between farmers and farmers' organizations linking them to agri-businesses. In addition, governments should create an enabling environment for quick, accessible and efficient dispute settlement.

2. Advantages of Contract Farming and challenges

Evidence shows that contract farming represents an effective mechanism to link smallholder farmers to agribusiness firms. Farmers benefit by having a guaranteed buyer for their goods, access to technology, credit for farming inputs, and sometimes extension advice and oversight. Agribusiness firms benefit by ensuring they will be able to meet demand for the goods they want to sell at a reasonable price.

Advantages for Farmers

Agricultural production contracts secure:
- income generating activity
- access to (new) markets, including specialized markets
- opportunity for obtaining higher prices
- reduce market insecurity
- reduce transaction costs related to the search for markets
- technical assistance
- know-how and managerial skills
- diversification of production from traditional crops

Advantages for Firms

Agricultural production contracts secure:
- lower transaction costs
- more synchronized procurement and redistribution of product
- circumvent constraints due to limited legislation or high land prices
- higher access to credit and subsidies
- consistency of supply
- increased quality control
- reduce risk of dissatisfied customers
- strengthen business image for firms' corporate social responsibility strategy

Disparity of economic power between the parties is one characteristic feature of the contract farming relationship. Typically, large processing or marketing companies with sophisticated management capacities deal with large numbers of small or medium-scale producers thus spreading risks of loss, while producers are dependent upon natural factors and financial constraints, and lack market information. Producers are generally engaged in an exclusive relationship with the firm, and may have little or no opportunity to contract with another potential party. Voluntary breaches can take place whereby parties attempt to obtain more benefits or escape liabilities. On the contractor's side this may happen by manipulating the performance of the producer, while on the producer's side, frequent practices are diverting the contractor's inputs or selling the production in violation of the contract (also known as "side-selling").

Critical issues have been pointed out regarding farmers' compliance with domestic labor legislation, adverse effects of use of inputs for human health and the environment, the risk of farmers being ever more indebted and trapped into the contractual arrangement due to the monopolistic power of the contractor and abusive practices in particular as regards price calculation. Even where protective legal rules exist, obtaining relief through public enforcement mechanisms is often impracticable.

These problems notwithstanding, the balance between advantages and disadvantages for both firms and farmers seems to be on the positive side: contractual arrangements are more and more frequently being used in agriculture worldwide.

3. Proposed focus of the indicators

Doing Business in Agriculture (DBA) indicators and Deep Dives (DD) will complement each other by providing actionable indicators and analysis of broader policy issues related to agricultural marketing.

The aim of indicators proposed below is to provide governments, policy makers and other institutions working on contract farming issues to address with a better understanding of the existing process faced by firms and producers trying to engage in agricultural production contracts. The project will also aim to showcase good practices in regulation and policy which affect the ease at which agricultural production contracts can be conducted.

4. Contract Farming Indicators: Doing Business in Agriculture (DBA) and Deep Dives (DD)

Doing Business in Agriculture regulatory indicators:

1. **Contract Farming Legal Indicators:** The aim of the Contract farming legal indicators is to assess whether a country's legal regime contains good practices which encourage fair and efficient contract farming relationships. These compounded data points, which will be scored, will constitute a legal index and could be designed as follows:

i. Measure minimum regulatory requirements:

   a. Parties to an agricultural contract
   b. Contract form and contract formation
   c. Parties' obligations
   d. Contract specifications and contractual practices
   e. Non-performance and remedies
   f. Duration and renewal of contract
   g. Applicable law

ii. Regulation of unfair practices

iii. Identification of good practices with regard to contract farming laws and regulations

iv. Role of Farmers' Organizations in contract formation and enforcement

Deep Dive topic areas and indicators:

To provide context, a DD could cite studies or publically available data on the prevalence of contracts in different types of agricultural production (% output passing through contracts) and specifically focus on:

1. Extent of use of contract farming (which crops, what % output for those crops)
2. Contractual mechanisms for setting prices paid to producers in different countries and commodity value chains
3. Role of Farmers' organizations: Aggregation capacity, ability to negotiate and establish contracts on competitive terms, input delivery capacity and ability to secure inputs in bulk at competitive prices
4. Degree of value addition: storage, processing, marketing (actual sales/distribution), branding.

2. Alternative Dispute Resolution: A government also has a role to play in strengthening the dispute resolution framework. ADR presents a flexible framework in which parties can work out difficult issues without waiting for the judicial system to render a decision. Objectives of the ADR in Agriculture Legal Indicators will be: a. Measurement of existing legal ADR framework (if feasible in all countries) b. Measurement of preferred ADR method(s) (if feasible in all countries) c. Time and motion indicators for the preferred ADR methods (case study) (if feasible in all countries) d. Identification of different ADR platforms (if feasible in all countries)	

5. Potential policy impacts of indicators on Contract Farming

Identification of weaknesses in a country's legal regime which impede the development of contract farming enabling rapid-response reform programs:

- The legal regime can be too general (contract farming is regulate by general principles found in different general laws): this could mean a continuation of inequality of contracting partners which in turns leads to lower success rates of contract farming ventures (e.g. breach of contract, side-selling, inputs diversion)
- The legal regime is outdated: global good practices can improve contract farming success rates
- Identification of possible deficiencies in the legal regime which regulates farmers organizations
- Identification to what extent farmers organizations are effective in playing a supporting role for contract farming ventures (e.g. act as a bona fide intermediary between contracting parties, development of quality standards, education of farmers with regard to contracts)

Identification of deficiencies with regard to ADR mechanisms; identification of bottlenecks which prevent farmers from accessing ADR mechanisms.