CONTRACT FARMING: FAQs

What is Contract Farming?

Agricultural production carried out according to a prior agreement in which the farmer commits to producing a given product in a given manner and the buyer commits to purchasing it.

Different Types of Contract Farming?

In real world, we see a lot of variations being practiced, for example:

- ❖ Formal (written) vs informal (oral) contracts
- ❖ Some provide inputs on credit, others don't
- ❖ Some provide technical assistance & monitoring, others don't
- ❖ Price may be fixed, set by formula, or unspecified

Why is there a need for Contract Farming?

In an ideal circumstance, if there were no transaction costs (e.g. finding a buyer, inspection), farmers would know what and when to produce and credit would be available for inputs. However, in practical terms, processor/buyer is left with two main choices for supply to match demand:

- ❖ Buyer makes agreement with farmer so that buyer provides inputs and technical assistance on credit, while farmer agrees to sell to buyer and repay at harvest;
- ❖ Buyer purchases or leases farmland and grows on large-scale farm ("estate" or "plantation")

How does Contract Farming address the Challenge of Vertical Coordination?

In a spot market, sale transactions occur without relationship or prior agreement; price is the only "signal" for coordination. Contract farming provides for tighter co-ordination as sale transaction is based on prior agreement which may include technical assistance, inputs on credit, and/or guaranteed price. Yet another option is "vertical integration" where two stages of market channel are merged into one company, e.g. sugar mill & cane plantation.

Which Crops or Sub-sectors are Suitable for Contract Farming?

- Horticulture for processing or export
- Tea
- Tobacco
- Cotton
- Others: seed, dairy, poultry, rubber, and oil palm

In all the above cases, the relatively high-value of the crop makes it easier to justify costs of coordination. There may also be a large quality variation – need to match quality to demand. In some cases, the commodity is perishable and there is a need to coordinate timing of delivery for processing or the infrastructure requires staged deliveries (e.g. sugarcane). High initial cost or input costs increases potential for buyer to assist as crop may be difficult to grow or new to farmers.

Characteristics of buyers in contract farming are such that they tend to be much larger than farmers (e.g. processor, exporter, or retail chain) and are able to cover fixed cost of establishing and enforcing contracts. At the end of the day, the destination market must be willing to pay premium for higher quality, high income.

When does Contract Farming not make Economic Sense or present a Weaker Case?

- Staple grains
    - Exceptions: seed, for brewery, state-run irrigation schemes
- Staple roots and tubers
- Pulses
    - Exceptions: for export or for processing
- Horticulture for local consumption

What are the Global Lessons from Contract Farming?

Contract farming usually raises farm income for small farmers since there is higher productivity due to access to inputs and technical assistance coupled with higher prices due to quality and access to new markets. Nevertheless, certain well-documented challenges persist including side-selling by farmers, cheating on quality standards by buyers and high cost of dealing with small farmers.

What is the Role of Government in Promoting Contract Farming?

- To improve investment climate
- To promote development of grades and standards
- To promote inclusion of small commercial farmers
- To strengthen farmer organizations and other intermediaries
- To promote PPP in extension services
- To promote competition
- To enforce contracts

Note: A special thanks to Nicholas Minot (IFPRI) "Contract Farming in Africa: Opportunities & Challenges". Further reference may be made to "Margaret Will, Contract Farming Handbook: A Practical Guide for Linking Small Scale Producers and Buyers through Business Model Innovation" (published by GIZ).