Making contract farming work with co-operatives

Prowse, Martin

2007

Making contract farming work with co-operatives

Prowse, Martin Philip

Published in:
Overseas Development Institute Opinion

Publication date:
2007

Citation for published version (APA):
Prowse, M. (2007). Making contract farming work with co-operatives. Overseas Development Institute Opinion, (87).

Overseas Development Institute

Opinion 87

October 2007

Making contract farming work with co-operatives

Martin Prowse

'A greater focus on strengthening market-orientated producer organisations and dispute-resolution mechanisms between farmers and firms may increase the chances of win-win outcomes from this form of institutional innovation'

The World Development Report (WDR) 2008 strikes an optimistic note on the potential for reducing poverty through contract farming – where a firm lends inputs such as credit, fertiliser, seed and extension to a farmer, in exchange for exclusive purchase rights over the contracted crop. In the WDR, contract farming is seen as a tool for fostering smallholder participation in new high-value product markets, and improving quality standards, thus increasing and stabilising smallholder incomes. As the vast majority of farms in developing countries are, and will continue to be, under two hectares in size,[1] this focus on integrating smallholders into global value chains is an important channel for poverty reduction. That said, there are risks to contract farming. The WDR emphasis on mitigating risks by linking contract farming with producer organisations is a welcome one. However, a greater focus on strengthening market-orientated producer organisations and dispute-resolution mechanisms between farmers and firms may increase the chances of win-win outcomes from this form of institutional innovation.

What are the opportunities and risks for farms and firms?

There are good reasons for the expansion of contract farming, and it offers great potential for poverty reduction.

Following the collapse of international commodity agreements and the liberalisation of national markets, agricultural value chains have become increasingly buyer-driven and vertically integrated. In this environment, contract farming offers the best of both small- and large-farm production systems. Smallholders are frequently the most efficient agricultural producers, and have advantages over large farms in terms of labour-related transaction costs, in particular supervision and motivation. However, small-farm production often suffers from capital constraints, and a lack of capacity to adopt technological innovations. Contract farming can overcome this and deliver the scale benefits typically associated with large-farm production systems. Economies of scale decrease the cost of inputs and transport, and firms have a comparative advantage in market and technical knowledge, and product traceability and quality. From a poverty-reduction perspective, contracting smallholders can reap large dividends: small farms are generally owned and operated by the poor, often use locally-hired labour, and often spend income within nearby locales, creating multipliers (Hazell et al, 2006).

Contract farming clearly offers numerous opportunities for smallholders. It gives access to a reliable market, provides guaranteed and fixed pricing structures, and most importantly provides access to credit, inputs and production services (seed, fertiliser, training, extension). On a wider note, it can stimulate technology and skill transfer, and can support farmers in meeting vital sanitary and phytosanitary standards.

The opportunities for firms are also clear and convincing. Contract farming can provide increased reliability of supply quantity and quality, and off-loads production risk onto farmers. In this respect, contract farming can increase profits from, and improve governance of, the value chain. On a broader note, and especially where access to land is highly politicised, it overcomes land constraints. For example, firms may find it hard to obtain land, or may run the risk of expropriation if they own it.

Whilst the upside arguments are convincing, contract farming also contains substantial risks. Five risks are particularly important for smallholders:

1. Contract farmingt can contribute to a loss of autonomy and control over farm enterprises.
2. Substantial production risk are faced if the technology or the company's forecast is inappropriate.
3. The firm's exclusive purchase rights can depress producer prices, or lead to late and partial payments. Increased indebtedness is not uncommon.
4. Contracts can be verbal and if written are not always in the vernacular. This can result in manipulation of conditions.
5. The strong gender dimension means that the

Overseas Development Institute

ODI is the UK's leading independent think tank on international development and humanitarian issues.

intra-household distribution of labour/income is often altered to the detriment of women's interests.

The risks for firms are also significant. There is a large risk of smallholders side-marketing inputs and produce: fertiliser can be sold to increase liquidity; and post harvest, produce can be side-marketed to facilitate faster access to capital, to seek higher producer prices, or just to avoid repayment. The limited literacy and education of some small farmers may increase risks for the firm, and a widely-dispersed smallholder population certainly increases transaction costs.

What role for producer organisations (POs)?

The WDR places great emphasis on the role of POs in ensuring the stability and longevity of contract farming arrangements, and delivering an equitable distribution of benefits. It argues that institutional innovation, in the form of new-style POs, is essential for augmenting win-win outcomes from contract farming. From a farmer's perspective, POs can help to rebalance the power relations between firms and farms: collective bargaining, and the creation of relationships with rural credit and transport providers, can help reduce the risks farmers face. Moreover, POs provide a forum for farmer dissatisfaction (on prices, timing and extension), and it is more likely that a firm will recognise social and environmental responsibilities. From a firm's perspective, POs reduce transaction costs per unit and address information and communication blockages. They are also an important channel to foster trust and good farmer-company relations, and provide peer-embedded incentives for members to repay loans.

However, POs are not necessarily a panacea for successful contract farming. There is ample evidence that many POs collapse.[2] Moreover, if problems with contract farming arise, firms easily switch to engaging estates.

Whilst the WDR notes the limitations of many POs – that they frequently lack managerial capacity, sometimes struggle to achieve coherence among a diverse membership, and are subject to elite capture – there is a danger of placing too many expectations on these often incipient rural institutions. For example, the WDR argues that the role of POs should extend beyond improving the terms of engagement with contracting companies (or wider input, output and transport markets): they can become stakeholders in agricultural policy forums; support technological adoption; manage communal natural resources; and can play a role in determining who provides devolved agricultural extension services and the direction of agronomic research.

The WDR's policy response is for government and development partners to foster a political climate where the right to organise is supported, to provide training, and to attempt to empower weaker members within POs, perhaps through harnessing the particular competences of specialist NGOs. Such policy goals are certainly laudable. However, in promoting successful marriages between contract farming and POs, it is also important to focus on two key issues:

1. Considering the risks farms and firms face, it is essential that state or non-state actors offer accessible, transparent and legally-binding mechanisms for dispute resolution between firms and POs.
2. Whilst the WDR distinguishes between types of POs by their function – commodity-specific organisations, advocacy organisations, and multi-purpose organisations – this distinction may not be the best way to offer bespoke support to engage with contracting firms. For example, focusing on market-orientated POs that provide benefits to members only is more likely to foster successful contract farming arrangements than community-orientated participatory POs, who mainly focus on providing public goods to an entire community.[3] In this respect, support to POs needs to be very clear about the priority outcome it is working towards: increasing and stabilising smallholder incomes, or providing a sphere for participatory governance and empowerment.[2]

Conjoining contract farming and POs clearly offers substantial potential for poverty reduction. For the optimism of the WDR to have the greatest chance of being realised will require a selectivity about the types of POs that are supported, and the provision of spaces for disagreements and conflicts to be resolved.

Endnotes

1. Hazell,P., Poulton,C. Wiggins,S. and Dorwood, A. (2006) '*The Future of Small Farms: Synthesis Paper*' Based on Research Workshop organised by IFPRI, ODI and Imperial College, Wye.
2. Penrose-Buckley, C. (2007) '*Background Public Policy Brief on Producer Organisations*' Oxfam Policy Brief, Oxfam UK.
3. Bernard,T. Birhanu,A. and Gabre-Madhin (2007) '*Linking Ethiopian Smallholders to Markets: Promises and Pitfalls of Collective Action*' Ethiopia Strategy Support Program Policy Research Conference, June 6-8, 2006, Addis Ababa, Ethiopia.

Written by ODI Research Officer Martin Prowse (m.prowse@odi.org.uk)

For more ODI resources on agriculture, visit: www.odi.org.uk/agriculture

odi

Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email: publications@odi.org.uk

ODI Opinion Papers

are signed pieces by ODI researchers on current development and humanitarian topics

This and other ODI Opinions are available from www.odi.org.uk