Contract farming: some lessons for Ethiopia

The Ethiopian agribusiness (mostly consisting of exporters) faces difficulty in procuring produce from spot markets at required quality and quantity at the right time to satisfy the demand of the foreign markets. As a result, exporters have expressed an interest to engaged in trade relationship with producers in a way to address those problems and minimize transaction costs.

Various types of arrangements
Contract farming can take various forms.

In the Centralized model, an agribusiness (processor and/or exporter) buys from a large number of smallholders under strict quality control and predetermined quantity.

In the Nucleus estate model is a variation of the centralized model where an agribusiness owns the plantation besides contracting with independent farmers.

The multipartite model involves various actors like government, NGOs and service providers. It usually also involves dealing with farmers' organizations like cooperatives as well as joint ventures between government and the private sector.

The Informal model is usually characterized by individual entrepreneurs and/or small companies with informal contracts, usually on a seasonal basis.

The Intermediary model involves intermediaries between producers and buyers who subcontract buyers. In this model, because of the absence of strong linkages with farmers, buyers run the risk of losing control over quality, quantity and price.

Various types of contracts
There are also various types of contracts.

Market specification contracts usually specify quality, price and timing with minimal or non-provision of inputs.

Resource specification contracts usually specify that buyers will provide inputs and extension services at various stages of production to producers on credit. The inputs and extension services will have to be paid for when the crops are sold.

Production-management contracts involve higher levels of coordination than the other two types of contracts and the buyer makes decision over production and harvest. In this contract, the buyer provides technological guidelines on the production process.

Enforcement mechanisms
There are various ways to enforce a contract. Lending via groups has the potential of reducing default as well as transaction cost. In this case, the group takes joint responsibility for the default of a single member. As a result the group serves as a guarantee for the agribusiness as the members check on each other to avoid default.

Good communication with and close monitoring of farmers avoids many potential problems. Good communication and monitoring leads to trustful long-term relationships and avoids 'strategic' defaults.

The range and quality of service offered may affect the long-term trust relationship between farmer and agribusiness. If the agribusiness is committed to deliver broad range and good quality of services at a right time and quantity, the farmer will put his/her in the long-term contract farming relationship and choose less to default for short-term gains.

Incentives for performance and strict treatment of defaulters help to minimize default. Penalties for default may include exclusion from a contract or publishing names of defaulters in the locality.

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For quality of life

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Cooperation between buyers can be achieved through agreement among buyers not to buy from farmers who are producing under another contract.

Pricing

There are different kinds of pricing formulas that can be used in contracts. These can either be based on the type of the product or the market conditions.

Fixed prices. This mechanism offers farmers a fixed price at the beginning of each season and these usually relate to grade specification. The fixed price structure is widely used by tobacco corporations and companies processing crops for canning.

Flexible prices. In this case prices are calculated based on the mechanism that considers the possible changes in local and international markets. Farmers are paid based on a formula that considers agreed processing and other costs of the agribusiness as well as the international market prices over a particular period. International market information on price and grades should be available to farmers.

Price calculated on spot-market values. This is a very complex process because it may be difficult to agree on what constitutes a spot-market price. Prices in spot markets typically tend to fluctuate daily.

Price on consignment basis. Prices calculated after the produce has been marketed and sold may be considered another form of spot-market pricing, but this form of payment is normally termed 'on consignment'.

Split pricing In this mechanism an agreed floor price is paid at the time of purchase or at the end of the harvest season. The final price is calculated after the agribusiness sold the produce. It may involve a premium if this price was higher than the floor price.

Recommendations for Ethiopia

In general, there has been little experience with contract farming in Ethiopia, despite interest from the commercial sector.

The Ethiopian government can be much more instrumental in facilitating contract farming (see VC4PPD brief # 6). Technical advice and other services also can be provided jointly by governmental institutions and NGOs. Contracting with groups of smallholders or cooperatives can be more efficient than working with individual farmers. Cooperatives can serve as a communication channel as well as input distribution centres.

Cooperative management can play an important role in follow-up and monitoring of performance and preventing side selling. Working in an cooperative can also benefit smallholders as it enhances their bargaining power and helps to organize joint actions. However, it is very important to ensure the autonomy of cooperatives to make their own decision without influence of the government.

A successful contract requires commitment and trust between contracting parties that can be built in the long term. This can be achieved by designing together clear and easily understandable contracts; through frequent communication; by providing good quality of inputs and services; and by creating access to market information.

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