QUICK POLICY BREIF:

IMRPOVING AGRICULTURAL CONTRACTING MECHANISMS

1. Introduction

The Policy Action Research Component (PARU) of the M4P2 programme contracted research aimed at assessing the policies and implementation of regulations under Decision No.80/2002/QD- CP issued by the Prime Minister on promoting contracting between agribusinesses and agricultural producers within Vietnam. Two study teams were contracted to move towards a more sustainable and realistic approach to agricultural contracting that has the potential to be replicated in other suitable value chains. Although much was expected of Decision 80 – it is one of the few explicit government attempts anywhere in the world to improve contractual links specifically in the agricultural sector – it results have been disappointing. The Government's plans for the Decision revolved around meeting implicit or in some cases explicit targets for achieving certain proportion of each major crop being either exported or produced through a system of contracting.

As part of the studies a number of value chains were studied for the effectiveness of contracting within them. They included: Tea and tea processing in Ha Giang Province; Sugar-cane production and processing in Tuyen Quang Province; The Coffee sector in DakLak Province; Artichoke in Lam Dong Province; Dragon Fruit production and marketing in Binh Thuan Province; Seed Rice growing in Ninh Thuan Province; and Luong Bamboo in Thanh Hoa province.

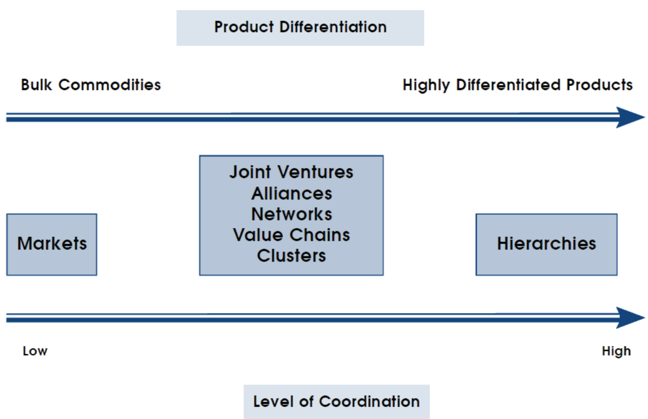
Contracts will typically specify various details regarding the terms of trade (e.g. prices, quantities, delivery dates, payment terms), and input provision and production specifications (i.e. the use of particular production practices). At the same time, not all terms will be formally specified; indeed, there are often good reasons to leave certain terms unwritten to prevent future holdups in the wake of changes in market conditions.

2. The Theory of Contracting

Contract farming is an attempt by usually large agribusiness firms to expand their operations to improve profitability or manage risk by diversifying their sources of agricultural products.

Contracts tend to work better where markets are stable and demands for quality and coordination in the value chain are greater. Where production is less specialized and relatively undifferentiated, contracts may be suboptimal compared to market forms of procurement, due to the high levels of transaction costs in coordinating small producers (Williamson, 1989). In this regard, some of the questions to ask are: How specialized is the product produced by the agribusiness? Are there specialized quality or production practices for the agricultural product that require greater coordination? As shown in Figure 1 below, as specialization of the product increases, the greater the efficiency and suitability of procurement by contract.

Figure 1: Increasing Complexity of Coordination



Transaction costs incurred by agribusiness firms engaged in contract farming fall broadly into areas: i) Costs of drafting, negotiating and enforcing contracts; ii) costs when contract specifications are not met; iii) running costs of managing contracts; and iv) bonding (mainly costs for inputs such as seeds & fertiliser) to induce farmers to engage in contracts.

When these costs are factored in, then from a theoretical point of view, agribusinesses will contract only when the costs of doing so outweigh the costs of purchasing in the open market. Thus agribusiness will only consider the additional costs of contracting when quality requirements increases sufficiently (with associated increases in prices that the firm receives) to consider entering into contracts.

3. Pilot Research Activities

The research teams undertook two pilot activities – in the sugar and coffee sectors. The pilots were chosen because they highlight two typical reasons why companies and farmers engage in contract farming in Vietnam at present, namely either for the purposes of coordinating with a high number of smallholder producers (such as the case for the sugar sector in Tuyen Quang) or for the development of highly differentiated commodity (for the coffee sector in DakLak).

The pilot activities built on the various issues and lessons learnt during the course of implementation to test contracting processes under differing circumstances and across a number of divergent agro-ecological zones. Furthermore, the activities were envisaged to test whether the widely held view that contracting tends to work better where markets are stable and demands for quality and coordination in the value chain are greater hold or whether there may be exceptions to this rule in Vietnam.

4. Conclusions from the Pilot Activities

Establishment of Farmer Groups

Through the operation of the coffee pilot, commune level authorities, farmers and collectors where able to have a deeper appreciation of the role that collective action can play in supporting market development. The ability of small farming households to organize themselves through collective action, especially if there are very large numbers of smallholders operating through fragmented geographic locations, can address one of the most typical market failures in Vietnam's rural sector - coordination failures. *Caution should be made in ensuring that farmers groups are allowed to form organically rather than imposed by Government policies and in a form which is suitable to the particular farmers in question rather than prescriptive types of intervention such as cooperatives.*

Although there was enthusiasm on the part of sugarcane producers to form groups, less work has been done on improving their constitution and having a genuinely democratic way in which decisions are made. The dual system of incentives means that farmers' leaders can be seen as being agents of the company rather than focusing on the interests of the group. Over time this is likely to lead to problems in terms of group cohesion and further development unless more clear and transparent process are not developed within the group.

Implementation of Contract between Agro-Processing Enterprises and Farmers

Contract enforcement and penalties for breaking the contract by farmers within both pilots were non-existent. Although it is understandable to provide relatively generous terms at the beginning of the contract to instigate farmers to join certification programmes in coffee (such as UTZ), or in the case of the sugar sector getting new farmers to engage with the company, it does store a significant level of problems and issues to the company should the scheme be expanded.

In both pilots, given the lax terms, slow adjustments to buying prices (in the case of coffee) and the rigidly identified prices (in the case of sugarcane) and the fact that both pilots experienced difficulties in accessing transportation to pick up the product from farmers' fields, which other collectors are willing to do, it is unsurprising that the contracted quantities received by the contract has been disappointing.

5. Lessons Learnt

Contract farming is not a "silver bullet" and cannot be adopted in a "one size fits all" approach. Rather the models that emerge need to be framed in relation to the historical development of the particular sector, its relative competitiveness and the incentives that are provided to farmers, collectors, agribusinesses and exporters to engage in contracts. The following provides the lessons learnt during the study:

Necessary conditions for successful implementation of contract farming: Where products are relatively undifferentiated, the costs of organizing the value chain to utilize contracts are high relative to engaging in market-based transactions. As products become more specialized and issues of quality and process more important, greater coordination is required and contracts are potentially more useful. Determining the "crossing point" for specific products, in terms of the level of quality or ***product specificity*** required, is driven by the private sector which if adopted widely can verify whether such contracts are a more useful form of value chain governance than reliance on the market.

Incentives: For a contracting relationship to survive and to strengthen in the medium to long-term there must be incentives on both sides (between firm and farmers). This means that both parties to a contract should derive benefits from the contractual relationship. Payment levels and negotiations must be attractive to both suppliers and purchasers and risk must be shared between the parties.

Incentives must be based on market forces. When the formation and operation of a cooperative / farmer group or the participation in contracting systems is undertaken on the basis of subsidies, genuine long-term incentives for the relationship do not exist.

Partnerships: The contracting relationship should be seen as a partnership between the participants, rather than as a competitive relationship, or a relationship where one party exploits the other. It is only by building a high level of trust and interaction between the parties to a contract will the relationship be successful. This type of partnership arrangement can frequently extend beyond a purely business relationship to include social interactions and social relationships.

When working with small farmers, the ***contract format*** should be kept as simple as possible. The success of contract farming shows that farmers prefer monitorable and measurable indicators for technical standards for contracted produce. Thus the setting up of complex standard systems based on highly differentiated pricing structures should be avoided as this has the potential to lead to confusion and the potential for significant conflict. It is preferable to have a limited number of clearly defined grades highlighted in the contract which is clearly explained to the farmers.

By using a ***clearly identified and agreed system of grading and standardization***, the threat of agribusiness firms, particularly those with monopsony power, using technical standards as a mechanism to reduce prices paid for farmers is reduced.

Organization: As our case studies have shown successful contracts usually have some form of farmer organization in place - often these are not formal institutions but those that have evolved through the farmers themselves. The organization (either formal or informal) acts as a 'peak body' for the numerous farm households, effectively representing their interests, coordinating logistics, and often entering into contracts on behalf of the group members.

In the Vietnamese context, the form of organization with the highest level of legal recognition and the ability to sign contracts is the cooperative. However, numerous other formal and informal groups exist in the sector, including farmer groups, farmer 'clubs', and community groups based around a representative farmer. Irrespective of the form the organization takes the key ingredients for success of such organizations, or forms of cooperative action, is the ability of the organization's leadership. If the leader of the organization is dynamic and well-connected to markets and information, then the organization has a higher chance of success.

Local Government institutions often need to buy-in to the contracting process and understand the objectives and limits under which the contract is framed if the contract is likely to be successful, especially in more remote areas. This requires a relatively good level of capacity, with commune level authorities seen to be impartial actors in supporting contracting - enterprises are more willing to initiate contract farming in the areas where local governments provide active support in terms of contract information dissemination and extension services.

The selection of intermediaries needs to be carefully managed and needs an understanding of the dynamics and motivations of stakeholders at the village level. Thus many firms have initially attempted to introduce intermediary contracts through village heads, as they are normally considered reliable and influential within the village, and are able to connect all farmers in the village. However, the downsides include the fact that: i) Village heads are elected every year which creates instability for the execution of the contract; ii) they are from the same village so in many cases farmers are tempted to break rules because of their long-term relationships with these individuals and to ensure social cohesion within the village setting; iii) many village heads lack capacity in terms of financial and business management, and often fail to purchase the crop on behalf of companies efficiently – the case of sugar case study illuminates this point; and iv) payments made via village heads are sometimes slow and disbursed in a non-transparent manner.

Informal contracting models despite their limitations have developed successfully and delivered long term benefits to both farmers and businesses. This is primarily due to the long-term trust, flexibility in marketing channels and price setting that they engender. Thus for products which are actively traded in a competitive market such as Dragon Fruit but where the asset specificity criteria is weaker (in terms of limited or no processing), the use of informal contracts is both rational and cost effective for all sides of the transaction.

Non-traditional crops have higher production costs hence more income is at risk in the event of crop failure. In addition, prices of non-traditional crops are more volatile due to thinly traded markets, yield is more uncertain than with traditional crops and such crops are often more perishable. Hence, adoption of these crops can be unattractive from a risk standpoint without some form of risk protection. Such protection can occur in contracts in different ways. Subsidies may be provided when farmers first enter contracts to reduce risks in setup of the new enterprise, cash assistance with operating costs and extension and management input from the firm may reduce yield risk.

Impact on Spot Markets: From a government policy perspective, the shift away from spot markets toward contracting facilitates the traceability of food and food ingredients in the agri-food chain. The increased vertical coordination in the production and marketing of agricultural commodities is typically associated with ensuring food safety and delivering quality assurances to consumers, especially when commodity attributes are not easily observable.

The shift from spot markets to contracting also raises concerns about whether spot markets will be a viable option in the future. As more quantities are marketed with contracts, the lower traded volume on the spot markets may induce a tipping point where the thinness and uncertainty of spot markets may force independent producers to accept contracts.

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