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Contracts for Poverty Reduction and Agricultural Growth

The majority of the world's poor are smallholder farmers in developing countries. These smallholders face several obstacles that limit their productivity and profits, such that their incomes remain low. Institutional changes in the agricultural value chains are required to reduce poverty rates among smallholder farmers, and to stimulate agricultural growth. Contract farming is an institutional arrangement that can address these obstacles, generate benefits for farmers and companies, and hence contribute to poverty reduction and agricultural growth.

Why are smallholder farmers poor?

In developing countries, farmers face a number of obstacles that limit their productivity and profits:

- **Market risk:** Prices, costs and market access are uncertain. Farmers do not know whether they will be able to sell their crops, when, and at what price. They are also uncertain about market quality requirements. Uncertainty and risk often prevent farmers from investing and upgrading their production. They continue to produce traditional crops instead of more profitable high-value crops, and rarely apply modern inputs and technologies.
- **Lack of credits and inputs:** Farmers have limited access to formal credits. Thus, they have limited financial resources to invest in more profitable crops, new production inputs and technologies.

These problems are most severe if the planting and cultivation of more profitable crops is costly. Their sale is too risky for farmers and their production is too expensive. Thus, farmers continue to produce traditional crops at low productivity, and they remain poor.

Contract farming can address these obstacles and hence lead to poverty reduction and agricultural growth in small farm sectors.

How can contracts help?

Contracts can specify all transactions between the farmers (seller) and the company (buyer) in advance.

The ideal contract specifies:

- [1] **A secure market**
  Contracts between agribusiness companies and farmers state the conditions of the sale (timing, quality, quantity, and price) in advance. This reduces the market risk that the farmers face and encourages them to invest in more profitable crops, inputs and technologies.

- [2] **In-kind credits**
  Agribusiness companies can provide planting materials, other production inputs and technologies on credit at planting season. These credits can be paid back by the farmer at the time of the harvest. This allows the farmer to invest in more profitable crops, inputs, and technologies.

Our research finds that contracts that provide [1] a secure market and [2] in-kind credits lead to higher productivity and higher household incomes.

What needs to be done?

Governments and development agencies need to

- [1] Support the establishment of buying centers and processing plants that launch contract schemes with local farmers. This includes the assistance in overcoming logistical and financial constraints for the establishment of the required facilities and infrastructure.

- [2] Enable the cooperation and knowledge exchange between agribusinesses, agricultural ministries, and researchers, for a context specific contract design and the transfer of appropriate production inputs, technologies, and knowledge.

- [3] Enable and support the development of farmer groups and associations, to strengthen the farmers' bargaining power in contract negotiations.

What is contract farming?

Contract farming is an agreement between a buying agribusiness company and a producing farmer that specifies the timing, quality, quantity, and price prior to the actual sale. In addition, the contract can specify the transfer of production inputs and technologies on credit.

Why are agribusinesses most suited to provide credit?

In rural areas, banks limit and ration credit due to high information costs and unavailability of collateral. The capacity of local lenders is limited, as agricultural credit demand is highly seasonal and the risk of default is correlated among all borrowers. Agroindustrial companies are better suited to act as lenders in the rural context. They have a superior ability to monitor and enforce credits than formal banks, as they can extract the debt directly from the farmers' revenues.

Manual palm oil processing in Ghana

The study

The underlying study compares different types of contracts to understand, which characteristics a successful contract should include. For this purpose, we analysed and compared farm productivity and household welfare of three groups of oil palm producers in Ghana:

Group 1

No contract:

The first group of farmers produces without a contract. These farmers face varying prices and are often not able to sell their entire harvest before it spoils.

Group 2

Secure market:

The second group of farmers has a contract with a palm oil processing plant that specifies a fixed price, and regular pick-ups of their harvest.

Findings: These farmers have a 57% higher per capita household income, because of the stable price and the ability to sell the entire harvest.

Group 3

Secure market and in-kind credit provision:

The third group of farmers has a contract with a palm oil processing plant that specifies a fixed price, and regular pick-ups of their harvest. In addition, they receive production inputs, such as planting material and pesticides, on credit. They pay back this credit with a share of their harvest

Findings: These farmers use more modern and improved production inputs, and have twice the productivity of the other farmers. They expand their plantations and farms, and have a 85% higher per capita household income.

POLICY BRIEF

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Further readings:

- **GlobalFood Discussion Paper No.130:**
  Effects of marketing contracts and resource-providing contracts in the African small farm sector: Insights from oil palm production in Ghana (May 2019). Anette Ruml, Matin Qaim.
- **GlobalFood Discussion Paper No.135:**
  New evidence regarding the effects of contract farming on agricultural labor use (December 2019). Anette Ruml, Matin Qaim.
- **GlobalFood Discussion Paper No.138:**
  Heterogeneous effects of marketing contracts and resource-providing contracts on household income (January 2020). Anette Ruml, Catherine Ragasa, Matin Qaim.
- **GlobalFood Discussion Paper No.139:**
  Smallholder farmers' dissatisfaction with contract schemes in spite of economic benefits: Issues of mistrust and lack of transparency (January 2020). Anette Ruml, Matin Qaim.

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