Contract Farming: Linking Farmers to Markets

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Accepted on July 16th 2006, Approved on September 8th 2006

Abstract: Contract farming in Indonesia is a growing phenomenon. This paper examines the evolution of contract farming, and explores the incentives to engage in contract farming, preferred contract forms and contract performance from the perspective of both Indonesian farmers and contracting firms. Contract farming is characterized by a contract between a farmer and a firm that will process and/or market the farmer’s crop. It has been a component of some of the most successful income generating programs for smallholder farmers; it has been a component of various schemes involving agribusiness firms. Smallholders may enter contracts to reduce transaction costs of accessing new markets, borrowing, managing risk, acquiring information or increasing employment opportunities. The success of contracts reflects both the contracting environment and management practices. Benefits from contracting accrue to smallholders from improved access to markets, improved technology, better management of risk and opportunities for employment of family members.

Keywords: Contract farming, agribusiness firms, Indonesia, smallholder, sponsor company (nucleus), partnerships for growth

INTRODUCTION

Agricultural sector (including livestock, fishery, and forestry) is the sector mostly absorbing the national manpower. According to the data from Department of Manpower and Transmigration, in 2005, this sector provided employment for 41.8 million people or 44.04% of the total national manpower. However, the farmers working in the sector were dominated by very weak households in numerous fields, like limitations in controlling productive asset, working capital, bargaining position, and economic political power, so it could not be developed independently and dynamically.

The number of poor people in Indonesia is dominated by rural community whose means of livelihoods are in majority as farmer. While on the other side, new opportunities to improve agricultural sector are mostly focusing on large scale production and marketing process. The condition causes more complicated production and marketing system faced by small-scale farmers.

For the last two decades, globalization has caused a rapid increase of agroindustry activities in developing countries. The benefits of agroindustry activities are still mostly enjoyed by large scale farmers or companies. Various problems are still faced by small scale farmers, for example low capital possession, simple and limited tools, lack of processing industry, and difficulties in marketing aspect, which make the farmers unable to produce high-value and competitive products. Therefore, the farmers need assistance and protection from many parties, both government and private sector in solving the problem. To empower the farmers and to increase the bargaining position of farmers, the institutional in form of collaborative organization and partnership can be formed. One of strategic steps to assist the farmers particularly in production and marketing process is by implementing contract farming system.

METHODS

Meaning and Type of Contract Farming.
The term ‘contract farming’ in Indonesia is more widely known as partnership. It is said that the New Order regime at that time was quite dislike the term ‘contract’ since it reminded people about ‘koeli kontrak’ (contract worker) during the colonial era which life during that time was very apprehensive. Until now, the term ‘partnership’ is more popular in Indonesia.

Contract farming system is one institutional mechanism (contract) which strengthens the bargaining position of farmers by linking them directly or indirectly to the corporation having relatively stron-
ger economic level. Through contract, the small scale farmers can transfer from traditional/subsistent venture to high-value and export oriented production. This is not only potential to increase the income of small scale farmers joining the contract, but also has multiple effects toward rural economy and broader scale economy (Patrick et. al. (2004)).

Contract farming can also mean the middle scale production and marketing system, where there is a division of risk responsibility for production and marketing between agribusiness actors and small scale farmers; all these are conducted with the purpose to reduce the transaction cost. In the agricultural context, according to Eaton and Shepherd (2001) contract farming can be divided into five models. First, centralized model, i.e. the model that is vertically coordinated, where the sponsor buys the product from the farmers and then processes or packs and markets the product. Second, nucleus estate model, i.e. the variation of centralized model, where in this model the sponsor of the project also owns and administers the estate land which is usually near the processing factory. Third, multipartite model, i.e. usually involving corporate body and private company who collectively participate with farmers. Fourth, informal model, i.e. the model that is usually applied to individual entrepreneur or small scale company which usually makes seasonal-based informal production contract that is easy for farmers. Fifth, intermediary model. Intermediary contracts are made between buyers and traders rather than directly between buyers and producers.

In Indonesia, commonly, we know four types of contract/partnership, i.e.: First, plasma nucleus partnership type, i.e. the partnership relation between partner group and partner company where the partner group acts as the nucleus plasma. The partner company builds the partner group in a) land provision and preparation, b) providing rice production means, c) giving technical guidance on business management and production, d) gaining, mastery, and improvement of technology, e) financing, f) other assistances like business efficiency and productivity. Second, sub contract type, i.e. the partnership relation between partner group and partner company where the partner group produces components needed by the partner company as part of its production. Third, common trading type, i.e. the partnership relation between partner group and partner company where the partner group supplies the needs of the partner company in accord with the requirements set. Fourth, operational collaborative system, i.e. the partner group provides capital and or means for venturing/cultivating.

Benefits of Contract Farming. From several types of contract farming explained above, it implies that the collaboration between farmer and second party can be well entangled if there is a mutual interdependence. In other words, contract farming in agricultural sector can be profitable for both parties, i.e. farmer and company (sponsor). Contract farming enables broader support and can handle problems related to lack of information. Besides that, contract farming also reduces the risk for farmers. The farmers get assurance that their products will be bought at the harvest time. In the long run, they also gain benefits, i.e. the partnership opportunity in the future and the access to the government programs. According to Key and Runsten (1999), the benefits of participating in the contract are market access development, credit and technology, better risk management, better employment opportunities for family members and indirectly, women empowerment as well as development of successful trading culture.

Seen from the company aspect, there are some benefits from the contract farming system with small scale farmers. The most important benefit is that they gain access to get cheaper labor and land to grow high-value product. The company can participate in the market where they do usually not participate and minimize the cost by not buying the land or directly hiring labor. Raw material supply can be maintained with rational limitation and the company has control toward production base and post-harvest treatment. Besides that, the company has also control toward product quality and has opportunities to gain and introduce new varieties as well as increase the possibility to fulfill the needs of consumers specifically.

An example of contract farming in the estate sector is the introduction of People Nucleus Company-Estate system in 1976. The People Nucleus Company-Estate program is an attempt to combine vertical planting and integrating system of small scale farmers with large capital entrepreneur to get profits in certain economic scale, particularly in upstream and downstream activities relation and to assure the stability of high productivity. The example of contract farming in the livestock sector is the one conducted by PT Charoen Pokphand started from 1998 in Lombok. The collaboration is conducted with the cattle breeders venturing broiler. The selection of broiler becomes very profitable for the cattle breeders with the income reaching five times compared to that of non-contract cattle breeders (Patrick, et al., 2004). The cost for chicken meat production is very high and the cattle breeder gets advance payment from the company to buy fodder and other needs to handle credit limitation. Risk, low production, and low
price are shouldered by the company. PT Indomilk also implements the collaboration with plasma nucleus type where the cattle breeders and the milk processor industry try to maintain the balance of bargaining position, so the need of fresh milk can be fulfilled continuously. In the fishery sector, some shrimp ponds are developed in several areas in Indonesia, and they also implement contract system in form of plasma nucleus, e.g. in Banggai, East Aceh, and eastern coast of Sumatra (Lampung and South Sumatra Provinces), with the area of some thousand hectares. Some examples of contract are successful in empowering the farmers in increasing their income.

RESULTS AND DISCUSSION

Contract farming implemented in several areas in general shows positive result; nevertheless, some problems often occur, both in the farmer side and the company side. There are a lot of farmers who cannot produce the products requested by the company. The farmers cannot repay the input and credit loan because of production failure, financial deduction or no price assurance from the processing industry, and often breach the contract by selling their product to the competitor of sponsor company (nucleus).

Besides that, there are concerns that the contract farming is more interested in large scale farmers, so the small scale farmers are not involved in the further development process. Other concerns are the possibility that the small scale farmers will be "trapped" in a contract and the negative behavior of multinational companies in developing countries.

For the company position, seeking suitable small scale farmers and selecting better small scale farmers need quite high transaction cost. This limits the company to be linked to small scale farmers. The company finds it difficult to maintain and monitor the quality of farmers because the number of small scale farmers is so plenty. The presence of additional institutions, like small scale farmer organizations, is very important as the mediation between farmers and company.

CONCLUSION

The above explanation shows that the contract farming can provide benefits for both actors (farmer and company) and economy broadly. However, it is necessary to have special policies to handle the problems occurred in the contract farming. The policies to take are: First, it is necessary to form an established and integrated partnership system and all parties concerned should be able to work together harmoniously, which is interdependence and mutual. In building the partnership, it is necessary to have an integrity from various elements, both farmer/farm group, government, and private/entrepreneur (Figure 1).

![Figure 1. Integrated Partnership Development (Supardi, 2004)](image)

The farmer (fisher/cattle breeder) is the main actor which should be empowered. To empower the farmer, the initial phase to be conducted is to form an institutional in form of farm group which is a collaborative organization. To venture regularly and well-directed, the farm group institutional should build collaboration and partnership with external/private sectors. The interrelatedness and collaboration with private sectors can be well entangled if there are symmetric and mutual interdependence and collaboration. The role of government, through various policies and programs, is expected to promote and create conducive business climate and stimulate farmers and private sectors, so the business can develop. In this case, the government acts as a facilitator, regulator, and motivator who should harmonize the relation among those actors, so the actors could proportionally interact and there will be no contradictory exploitation.

Second, i.e. to optimize the role of financial in-
stitution (bank) as the institution assisting in financing (credit) for farmers and company implementing the contract farming system. Bank can assist farmers and company in obtaining credit with easy procedures and requirements.

Third, the farm group is very potential to motivate and empower the farmer’s economy. For the reason, the contract farming system in its realization to the future should optimize the role of farm group as well as encourage and assist the farm group, both from the aspects of financing and institutional management.

Fourth, the government should support the contract farming by releasing the policies, which among them are: (a) The enforcement of law and regulation will not hamper the development of the livestock and fishery business and the contract farming; (b) The contract farming should be supported and protected by legal and efficient law system; (c) The development and repairment of infrastructure; (d) Cattle breeder and fisher should be protected from exploitation in the collaborative activities with the industrial sector by checking the financial feasibility and the managerial capacity of industry (company), so it will generate profitable business for all parties; (e) The increase of farmer’s negotiation capacity.

If the problems relating to contract farming can be anticipated adequately, and the policies aforementioned can be held effectively, with the application of contract farming, such a huge potential of agricultural sector, gradually can be realized. The contract farming can function to increase the farmer’s welfare since this model can link the farmer directly to the market of his products.

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