xIlkogretim Online - Elementary Education Online,2021; Vol 20 (Issue 1): pp.1947-1952
http://ilkogretim-online.org
doi: 10.17051/ilkonline.2021.01.210

Contract Farming: Opportunities & Challenges

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Abstract- The Government of India's National Agriculture Policy[1] envisages that "Private sector participation will be promoted through contract farming and land leasing arrangements to allow accelerated technology transfer, capital inflow and assured market for crop production, especially of oilseeds, cotton and horticultural crops".

If we break down the term "contract farming" as two individual separate words it would mean a legal agreement associated with farming so naturally, it is an understanding between a producer which in this case would typically be a farmer and the buyer to whom the product is to be delivered with accordance to all the terms and conditions of the agreement. Going forward we aim to build a contrast between the different practices and ways and its effects and outcomes of two very distinct places in respect to their geographical and cultural ambience, India and USA. This will help us in grasping the advantages and disadvantages of various attributes which lead us to choose the better options at every turn.

In today's world of impersonal and open-market transaction contract farming is a much more controlled way of exchange bound by a legal agreement which is meant to protect both sides, the producer as well as the buyer. The problem, however, arises in the implementation since more than often farmers are put in a weak position and have to agree for various reasons such as the constant change in market structure or due to financial conditions. Contract farming has many agro-based advantages and it is a fast-growing practice which could be interpreted as rural development but it also has a dark side which allows buyers to exploit farmers or results in more catastrophic consequences for the farmers if they aren't able to comply with the terms of the agreement.

India is a country of enormous diversity – geographic, economic and ethnic – that has made remarkable economic and social progress since the start of liberalization reforms in the early 1990s. It is the seventh largest country by land area (2.97 million km^2) and the second most populous after China with over 1.3 billion people, accounting for 18% of the world's population. However, at just 0.15 ha per capita, agricultural land is very scarce. While the level of urbanization increased from 27.8% to 31.1% over the past decade, two thirds of the population still live-in rural areas (World Bank WDI, 2018).[2]

Farming is an age-old means of livelihood for millions of Indians. However, there have been few systems/models in which farmers are assured of a market for their produce, leave alone a remunerative price. Farmers have on occasion had to throw their produce away for want of buyers. This is one side of the coin. On the other is the agri-based and food industry, which requires timely and adequate inputs of good quality agricultural produce. This underlying paradox of the Indian agricultural scenario has given birth to the concept of Contract Farming, which promises to provide a proper linkage between the 'farm and market.'

Economic growth of around 7% over the last 5 years makes India one of the fastest-growing emerging economies (Box 1.1). The acceleration of structural reforms and low commodity prices since 2014 have boosted economic activity in India and improved the external current account position. In addition, continued fiscal consolidation, by reducing government deficits and debt accumulation, and an anti-inflationary monetary policy stance have helped consolidate macroeconomic stability (OECD, 2017a).[3]

Important steps have also been taken to make India a less fragmented domestic market. In July 2017, the Goods and Services Tax (GST) reform – in the making for over a decade – came into force. The GST replaced various taxes on goods and services levied previously by the central government and states by a single tax on value added, with the potential to enhance the efficiency of production and movement of goods and services between Indian states. Nonetheless, implementation challenges remain, stemming from the different tax rates applied across product categories, exclusion of certain products, and other administrative complexities related to registration and payment.[4]

Recognizing the need for and merits of such a linkage with the farming/producing community, several corporate involved in agro- commodity trading, processing, exports, etc. have attempted to establish convenient systems/models that ensure timely and consistent supply of raw material of the desired quality and low cost. This article discusses a few successful cases of contract farming and a brief note on the bottlenecks and criticisms leveled against this emerging alternative farm business model.

Keywords: contract farming, Private sector participation, Goods and Services Tax (GST)

I. Introduction

Contract farming can be defined as an agreement between farmers and processing and/or marketing firms for the production and supply of agricultural products under forward agreements, frequently at predetermined prices. The arrangement also invariably involves the purchaser in providing a degree of production support through, for example, the supply of inputs and the provision of technical advice. The basis of such arrangements is a commitment on the part of the farmer to provide a specific commodity in quantities and at quality standards determined by the purchaser and a commitment on the part of the company to support the farmer's production and to purchase the commodity.[5]

The intensity of the contractual arrangement varies according to the depth and complexity of the provisions in each of the following three areas:

1. Market provision: The grower and buyer agree to terms and conditions for the future sale and purchase of a crop or livestock product;
2. Resource provision: In conjunction with the marketing arrangements the buyer agrees to supply selected inputs, including on occasions land preparation and technical advice;
3. Management specifications: The grower agrees to follow recommended production methods, inputs regimes, and cultivation and harvesting specifications.

Contract farming is defined as a system for the production and supply of agricultural/horticultural produce under forward contracts between producers/suppliers and buyers. The essence of such an arrangement is the commitment of the producer/ seller to provide an agricultural commodity of a certain type, at a time and a price, and in the quantity required by a known and committed buyer.

Contract farming is the contractual arrangement between farmer and a contractor, it can be oral or written specifying one or more conditions of production and/or marketing of an agricultural product. Contract farming demands a crop agreement made in advance. The contractor shares the decision-making power with the farmer. The farmer lends to the production process, labor and land in his possession. On the other hand, contractor provides some of the production, knowledge inputs, marketing facility and participates in production decision and supervision. The objectives of contract farming are supplying planting material, guiding production of crops, facilitate bank loan and assured buy back agreement.

Types of Contract Farming

Several types of contracts are distinguished according to the sharing of risks and specification of contract terms. From the management view point, two types of contracts are determined.

1. **Limited Management Contract** where a farmer gets production input and sells the produce to the contractor. There is no real guarantee for the price for the produce.
2. **Full Management Contract** where the farmer and the contractor have entered into contract for certain amount of production. In this kind of contract, the price is announced before the season thus the price risk is minimized. The contractor provides market for the produce provided the quality specifications are met.

Numerous studies have been conducted on contract farming and many are listed in the Food and Agriculture Organization's (FAO) Contract Farming Resource Centre. The research has shown various results in numerous places around the world. In Lao PDR, the research suggested that contracted farmers earned significantly higher profits than non-contracted farmers.

Contract farming usually involves the following basic elements - pre-agreed price, quality, quantity or acreage (minimum/maximum) and time.

According to the contract, the farmer is required to plant the contractor's crop on his land, and to harvest and deliver to the contractor a quantum of produce, based upon anticipated yield and contracted acreage. This could be at a pre-agreed price. Towards these ends, the contractor supplies the farmer with selected inputs, including the required technical advice.

Thus, the contractor supplies all the inputs required for cultivation, while the farmer supplies land and labour. However, the terms and nature of the contract differ according to variations in the nature of crops to be grown, agencies, farmers, and technologies and the context in which they are practiced.

Agricultural policies in India are designed and implemented by a complex system of institutions. States have constitutional responsibility for many aspects of agriculture, but the central government plays an important role by developing national approaches to policy and providing the necessary funds for implementation at the state level. Nevertheless, no sufficiently strong mechanism exists to bring state and central level policy-makers together to discuss problems, design solutions, and monitor performance. At the central level, while the Ministry of Agriculture and Farmers' Welfare has responsibility for agricultural policy, many other ministries and agencies have important roles. There is, therefore, significant risk of fragmentation, overlapping and unclear attribution of responsibilities.

For example, contract farming in wheat is being practiced in Madhya Pradesh by Hindustan Lever Ltd (HLL), Rallis and ICICI. Under the system, Rallis supplies agri-inputs and know-how, and ICICI finances (farm credit) the farmers. HLL, the processing company, which requires the farm produce as raw material for its food processing industry, provides the buyback arrangement for the farm output. In this arrangement, farmers benefit through the assured market for their produce in addition to timely, adequate and quality input supply including free technical know-how; HLL benefits through supply-chain efficiency; while Rallis and ICICI benefit through assured clientele for their products and services. The consortium is also planning to rope in other specialist partners including insurance, equipment and storage companies.[6]

The Centre's ordinance of June 5, 2020 attempts to provide a national framework for contract farming by bringing uniformity in provisions of contract farming under state regulation enacted under APMC Acts and the laws passed by some states on the lines of model Act circulated in 2018.

Three New Acts and Their Effects

The concept of contract farming is not new in India but the three new acts passed by the Indian parliament have the capacity to open new dimensions in the field of contract farming in India hence it becomes a necessity to mention about the following acts and their effect on contract farming.

1) The Essential Commodities (Amendment Act) 2020[7]

Aim To increase competition in agriculture sector and increase farmer's income with help of liberalized system keeping in mind interest of consumer

- The act amends Essential Commodities Act 1955
- The act empowers the central government to designate certain commodities as essential commodities and regulate or prohibit the production, distribution, trade and commerce of such items
- This will apply on certain food items such as onion, potato, cereals, oil seeds etc. only under extraordinary circumstances. These include (1) war (2) famine (3) extraordinary price rise (4) natural calamity of grave nature
- No stock limit cannot be applied to processor or value chain participant or value chain participant at any stage of processing, packaging, storage, transport and distribution of agriculture produce

2) The Farmers' Produce Trade and Commerce (Promotion And Facilitation) Act 2020[8] Aim To provide barrier free trade to all farmers and create trade opportunities outside APMC areas.

- The act will prevail over Agriculture Produce Market Committee Act 2003(APMC)of all states which provided for market board regulated by state government to protect the interest of farmers

- It allows intra-state and inter-state trade of farmers' produce outside: (1) the physical premises of market yards run by market committees formed under the state APMC Acts and (2) other markets notified under the state APMC acts such as private market yards and market sub-yards, direct marketing collection centers, and private farmer-consumer market yards. Such trade can be conducted in any place of production, collection, and aggregation of farmers' produce including: (1) farm gates, (2) factory premises, (3) warehouses, (4) silos, and (5) cold storages.

- The allows farmers, farm producer organizations as well as anyone who buys farmers' produce for: (1) wholesale trade, (2) retail, (3) end-use, (4) value addition, (5) processing, (5) manufacturing, (6) export, or (7) consumption, to engage in such intra-state or inter-state trade

- The Ordinance permits the electronic trading of farmers' produce in the specified trade area. An electronic trading and transaction platform may be set up to facilitate the direct and online buying and selling of farmers' produce. The central government may define rules and norms for such platform

- A person transacting with a farmer will be required to make payments to the farmer on the same day, or within three working days in certain conditions, for any transaction of scheduled farmers' produce.
- The act prohibits state governments from levying any market fee, cess or levy on farmers, traders, and electronic trading platforms for any trade under the Ordinance.

The parties involved in a trade-related dispute may apply to the Sub-Divisional Magistrate for relief through conciliation. The Magistrate will appoint a Conciliation Board and refer the dispute to the Board. If the dispute remains unresolved after 30 days, the parties may approach the Magistrate for settlement of the dispute. The parties will have a right to appeal against the decisions of the Magistrate before an Appellate Authority (Collector or Additional Collector nominated by the Collector)

Basically, the Ordinance has three main features:

➢ A farmer may enter into a written agreement which can specify terms and conditions of quality, grade, time of supply price and the extension services etc.

➢ The agreement could be for a period of 1 to 5 years.

➢ The price or any variation of the same has to be part of the agreement. For any additional amount over the agreed price, the prevailing price in APMC/electronic portal etc. will be the benchmark.

3) The Farmers (Empowerment and Protection) Agreement on Price Assurance and Farm Services Act, 2020[9]. Aim To provide national level framework for contract farming and protection of farmer during sale and purchase of farm products
Key Points

- The act provides agreement prior to the production or rearing of any farm produce, aimed at facilitating farmers in selling farm produces to sponsors
- A sponsor includes individuals, partnership firms, companies, limited liability groups and societies
- Such agreement may be between: (i) a farmer and a sponsor, or (ii) a farmer, a sponsor, and a third party.
- The agreement may provide for mutually agreed terms and conditions for supply, quality, standards and price of farming produce as well as terms related

All contracts are to be registered with a state level authority to be set up by state governments. In addition, there are several other safeguards for farmers.

At present, informal contracts between industry and farmers are also quite common. In West Bengal, many small and marginal farmers grow chip grade potatoes under contractual arrangements, mostly without written contracts. Under this system, the company inspects the farms on a periodic basis and provides extension services.

There are apprehensions on the part of farmers to enter into contracts as they are not organized and are ill equipped for any legal battle with corporate. Only last year, a few Gujarat farmers were sued for more than Rs 1 crore for illegally growing and selling a potato variety registered by PepsiCo. On the intervention of the state government, PepsiCo withdrew the cases but the incidence left a question mark over the future of contract farming in which resource-poor farmers were pitted against a powerful multinational.

The Ordinance provides for setting up of a registration authority in every state to electronically register the contracts. The states will do well to quickly notify the regulations governing the registration of contracts.

So far, modern retail has been largely purchasing perishable produce from mandis. Since the volumes of fresh produce are still low for modern retail and it has to compete with roadside vendors, it has been reluctant to invest in backend infrastructure.

This ordinance has the potential to change the contours of modern retail as it can expand its reach to better off consumers, willing to pay higher prices for fresh produce of higher grade which meets the standards of pesticide residue and food safety. Other sectors provide a better example of what the future should look like. The most successful example of contract farming in India comes from the sugarcane and poultry sectors.

Contract farming can be viewed as a partnership between farmers and processing companies or cooperatives, where the farmer is obligated to supply the agreed quantity and quality of crops, in a specific time period. In return, the processing company agrees to buy off the crops from the farmers, at a prearranged price.

Farmers must sign a contract to sell their harvest directly to the sourcing company, and in exchange, they get support in the form of agricultural inputs, technical assistance, and financial help. Contracts will only work if both parties meet the required conditions and if they believe that by signing the contract, they are creating a win-win situation for themselves.

As we heard many times before, the health of a supply chain is the health of the company. Many stakeholders in the agricultural value chain (e.g., retail chains, wholesale traders, cooperatives) source crops from farmers and they all have two final goals in mind—achieving sustainability and profitability.

But like we discussed in our previous blogs, successfully managing networks of farmers, regardless of their size, can often be challenging work and if they're not managed properly, the crop sourcing company can face financial setbacks and losses.

<u>A transparent contract and compliance with the agreed terms is a precondition for the successful long-term sustainability of contract farming.</u>[10]

Therefore, a long-term partnership with the growers is achieved by creating a transparent and commercially viable contract that will be satisfactory to both parties. First and foremost, contracts should be flexible and provide clear, simple specifications regarding three key areas:

1. Quantity; specifying the amount of the desired product (crop)
2. Quality; agreeing what quality levels and standards the product needs to meet
3. Price; stating a specific price for the crops, set by the farmers

Secondly, it should also have a defined risk management strategy in case of extreme events such as high market prices or bad weather.

By creating the contract, a processing company wants to ensure contract execution that meets their targets. If the farmers fulfill the desired targets stated in the contract and comply with the agreed conditions, then the crop sourcing company can be sure that the supply chain is healthy and prosperous. Contracts should be flexible and provide clear and simple specifications.[11]

Contract farming arrangements are often criticized for being biased in favor of firms or large farmers, while exploiting the poor bargaining power of small farmers.

- Problems faced by growers like undue quality cut on produce by firms,
- delayed deliveries at the factory, delayed payments, low price and pest attack on the contract crop which raised the cost of production.
- Contracting agreements are often verbal or informal in nature, and even written contracts often do not provide the legal protection in India that may be observed in other countries.

- Lack of enforceability of contractual provisions can result in breach of contracts by either party.
- Single Buyer – Multiple Sellers (Monopsony).
- Adverse gender effects - Women have less access to contract farming than men.

II. Conclusion

With effective management, contract farming can be a means to develop markets and to bring about the transfer of technical skills in a way that is profitable for both the sponsors and farmers. The approach is widely used, not only for tree and other cash crops but, increasingly, for fruits and vegetables, poultry, pigs, dairy produce and even prawns and fish. Indeed, contract farming is characterized by its "enormous diversity"2 not only with regard to the products contracted but also in relation to the many different ways in which it can be carried out.

The contract farming system should be seen as a partnership between agribusiness and farmers. To be successful it requires a long-term commitment from both parties. Exploitative arrangements by managers are likely to have only a limited duration and can jeopardize agribusiness investments. Similarly, farmers need to consider that honoring contractual arrangements is likely to be to their long-term benefit.

Contract farming is becoming an increasingly important aspect of agribusiness, whether the products are purchased by multinationals, smaller companies, government agencies, farmer cooperatives or individual entrepreneurs. As noted above, the approach would appear to have considerable potential in countries where small-scale agriculture continues to be widespread, as in many cases small-scale farmers can no longer be competitive without access to the services provided by contract farming companies. It must be stressed, however, that the decision to use the contract farming modality must be a commercial one. It is not a development model to be tried by aid donors, governments or non-governmental organizations (NGOs) because other rural development approaches have failed. Projects that are primarily motivated by political and social concerns rather than economic and technical realities will inevitably fail.[12]

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