### Contract Farming

#### Contract farming background

In this bulletin, a farming contract is defined as an agreement between farmers and processors for production and supply of agricultural products, often at specified prices, quantities, and quality levels. The key feature of farming contracts is that they provide a framework for developing a relationship between farmers and processors. Contracts provide the basis for sharing value, risk, and decision making power between farmers and processors in a way that is mutually beneficial.

Contracts tend to work better where markets are stable and greater demands for quality and coordination exist in the value chain. If production is less specialized and relatively undifferentiated, contracts may be suboptimal, compared with market forms of procurement, due to high levels of transactions costs in coordinating small producers. Balance in concentration, power, and organization is needed among players in the value chain to facilitate relationship building.

#### Contract farming in Viet Nam

Contract farming is a relatively new development in Viet Nam. However, asagro-industry (particularly processing) commercializes further, there will be an increasing need for contract farming systems for larger firms to link effectively with smallholder farmers.

The concept of contract farming is strongly supported by the Government. This support includes Decision 80/2002/Ttg on contract farming which regulates the mechanisms and policies for promoting the consumption of agricultural products through signed contracts between enterprises and farmers and which promotes cooperation between the "four houses" - state, farmers, researchers and enterprises. This support for contract farming is linked with government support for the development of "new cooperatives" to organize smallholder production.

Since the enactment of the Law on Cooperatives in 1997, a large number of new cooperatives have been formed, and many old cooperatives have been updated. However, the majority of both old and new cooperatives are still involved in providing inputs and other services, rather than marketing outputs. If cooperatives are to play a role in supporting smallholder involvement in value chains and contracting, then they need to have a greater focus on output marketing.

One form of contract farming system that is now emerging in Viet Nam is a two-contract system, where a processing company will make a single contract with an organization representing farmers (for example, a cooperative) and then the farmer organization will make a number of individual contracts with members.

As with any relatively new organizational system, contract farming systems have been both successful and unsuccessful. This bulletin aims to highlight some key issues related to contract farming that have developed in Viet Nam, and to draw some lessons that will contribute to the successful development of contract farming in the future.

#### Key issues

Four of the key issues will have an impact on the success of contract farming systems in Viet Nam in the future.

1. Clear and strong relationships between participants are necessary for effective contract farming.
2. Participants in the contracting system should be well organized.
3. Contract farming is not suitable for all products and situations.
4. Contracts should be made in appropriate forms.

### Partnership:

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1. A value chain is defined by Kaplinsky (2000) as "The full range of activities which are required to bring a product or service from conception, through the intermediary phases of production, delivery to final consumers, and final disposal after use.
authorities, management boards, and mass organizations. Strong links can help facilitate and improve contracting arrangements.

Many analyses have discussed a need for "strong enforcement mechanisms" for contracting. In reality if the contracting relationship is only held together by the existence of "strong mechanisms," then the relationship between the contracting parties will likely not result in a good partnership.

Incentives: Strongly related to the issue of partnerships is the issue of incentives. To sustain and strengthen a contracting relationship in the medium to long term, incentives should be given to both sides. This means that both parties to a contract should derive benefits from the contractual relationship. The payment level and negotiations must be attractive for both suppliers and purchasers and risk must be shared between the parties.

Other incentives include cross-ownership and convergence of interest of both parties, for example where farmers are also shareholders in the purchasing company. To develop a genuine long-term relationship, incentives must be based on market forces. When a cooperative is formed and operated or contracting systems undertaken on the basis of subsidies, genuine long-term incentives for the relationship do not exist.

Participants in the contracting system should be well organized

To enable a group of farmers (either small or large) to enter the value chain and deal effectively with contract farming situations, some form of organization should take place. The organization acts as a "peak body" for numerous farm households, effectively representing their interests, coordinating logistics, and often entering into contracts on behalf of the group members.

Numerous formal and informal groups in the agricultural sector in Viet Nam exist, including farmer groups, farmer "clubs," and community groups based around a representative farmer. However, the form of farmer organization with the highest level of legal recognition and the ability to sign farming contracts is the cooperative.

One of the vital ingredients for success of such organizations or forms of collective 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. Also, if the leaders of the organization are themselves also farmer members of the organization, then they have a stronger incentive to act in the interests of the farmer members.

Organizing small farmers is particularly important in Viet Nam's context. While the agriculture sector will inevitably modernize and commercialize, the majority of agricultural production will continue to be undertaken by smallholders in the future. The only effective way for smallholders and poor farmers to become actively involved in an increasingly commercialized and globalized value chain for their product is to become organized and coordinated.

Contract farming is not suitable for all products and situations

Contract farming systems are not appropriate for all types of agricultural products, nor are they appropriate in all situations or environments. Contract systems work generally better if the product is more specialized and differentiated.

If 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.

This can clearly be seen in the case of contract farming in Viet Nam, where a proportion of contracts for undifferentiated products (such as regular varieties of rice) have been successful. On the other hand, specialized products such as Japanese rice or baby corn have had high proportions of successful contracts.

A "one-size-fits-all" approach to contract farming will not be successful in Viet Nam, as contract farming is certainly not the optimal type of market arrangement for all types of commodities, nor is it the optimal type of market arrangement for all types of farmers or localities. Decisions on adopting contract farming systems should be made based on local conditions.

Contracts should be made in appropriate forms

The form of contracts should also be suitable for the conditions of both parties. In the case of a contract between a cooperative and a farm household, it is in the interests of both parties to ensure that the contract is as simple as possible.

A number of cases in Viet Nam has shown that a farming contract becomes very effective if it has a set of clearly defined points for renegotiation of conditions. This allows flexibility in the contracting relationship, and can reduce incentives for breaking contracts.

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issues

Clear and strong relationships between participants are necessary for effective contract farming

In my opinion, mutual trust between the mill and farmers is the key for contract farming to go smoothly, successfully, and effectively. The mill really considers farmers as "family members," understanding that its benefits are closely attached to the benefits of farmers and that farmers in weak positions need help from the mill. With such awareness, Lam Son Sugar and Sugarcane Company has helped farmers remove the three difficulties-capital, knowledge of science and technology, and outputs for agricultural products. In my opinion, the factory can achieve the ultimate benefits for itself only if it voluntarily and enthusiastically supports and invests in farmers and is closely linked with farmers. In addition, farmers need to be assured of a market for their produce and be made aware of the need to provide products for the factory only.

Chairman of the Board of Directors
Lam Son Sugar and Sugarcane Company (LASUCO)

To accelerate contract farming, the most important factor is to create a feeling of confidence between farmers and the company through a system where the company will supply inputs for production on credit for farmers. This will create a binding link between both sides to help guarantee commitments to fulfill the contracts. Generally, one or both sides will tend to break the contract if there are no binding links and benefits. Farmers tend to think that if they do not borrow from

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the company, breaking a contract is as simple as breaking a promise as they believe both sides do not lose anything and cannot sue each other.

Tran Huu Du
Farmer, An Giang Province

When entering contracts, the thing we need the most are binding conditions to guarantee contract implementation. For example, the company could provide capital and inputs for farmers to produce and the local authorities certify and supervise the implementation of contracts. To implement specialized contracts, farmers often need capital to invest in seed production, technology, and to expand the scale of production. As a commercial farmer, I can be sure that I can produce the quantity agreed at a price between the production costs and floating market price. The important thing is that I would not sell at a higher price in the open market, but I would prefer to build a stable and long-term relationship with my contracting partner.

Do Quy Hao
Commercial Farmer, Kien Giang Province

Contracts between the cooperative and its members specify binding provisions and responsibilities for both sides if they do not implement the contracts. However, cooperatives normally do not sue farmers when they have broken the contracts. Instead, they use persuasion and advocacy.

Nguyen Van Dam
Chairman of Hoa Thuan Cooperative, An Giang Province

Participants in the contracting system should be well-organized

A company is generally not able to sign contracts with thousands of farming households to fully procure products. Cooperatives or any other organizations of farmers signing contracts with the company play a very important and necessary role. Depending on the capabilities in terms of capital, scientific and technological, and managerial levels, cooperatives can support farmers in production in general and in contract farming. Besides cooperatives, cooperative alliances play an intermediary role, providing information on seasons, agricultural products, and enterprise demands. Cooperative alliances can also consult, support, and facilitate cooperatives and companies to agree to farming contracts.

Mai Thanh Hung
Deputy Chairman, Cooperative Alliance, Dong Thap province

In Lam Son Sugar and Sugarcane Company's experience, a strong form of connection and cooperation between the mill and the farmer is needed to effectively consolidate the link. In this case, the Lam Son Sugarcane and Sugar Association has been formed, with the participation from both sides-farmers and the mill. With clear regulations and articles of association, this association plays an important intermediary role in securing benefits for farmers and ensuring farmers are not “inferior” in negotiations and agreement with the mill. In the contract implementation process, if any problem arises on any term and condition, the association will represent farmers in submitting requests to the mill. Another crucially important role of the association is to use its risk prevention fund to guarantee living standards and income for farmers when the sugar market fluctuates or natural calamities affect sugarcane output. The association raises funds from both farmers and the mill. Specifically, when the sugar price increases, farmers set aside a portion of money from selling sugarcane to contribute to the fund, and the mill also contributes an equivalent amount taken from its profit. This fund will be used to offset prices for farmers whenever the sugarcane price decreases so that farmers are not too disadvantaged and are able to continue producing in the next season. The fund has had an excellent stabilizing effect in sugarcane seasons in 1992, 1993, 1995 and 1997.

Le Van Tam
Chairman of the Board of Directors
Lam Son Sugar and Sugarcane Company (LASUCO)

In the past, Antesco signed individual contracts for purchasing baby corn with 11,000 farmer households but now the company signs only 15 contracts with cooperatives and representatives for farmer households (traders). The signing of contracts through cooperatives helps the company save management and transaction costs, creates a stable supply of material, and lays the foundation for making profit.

Huy Hung Quang Dau
Director
Antesco Company

The role of the cooperatives in contract farming is crucial. The failure of contract implementation between Antesco and farmers in the past showed that the company did not have sufficient ability to sign directly with each farmer household, and to supervise the production process, quality, control, and procurement of products from each household. On the contrary, since the Hoa Thuan cooperative came into existence and represented farmers in signing contracts with Antesco, the process for production and procurement has been smooth and the procurement amount has increased every year.

The cooperatives have helped farmers in terms of input services such as seeds and irrigation and have only deducted from the sugar market, rather than fighting for its end of the season. In procurement, the cooperatives purchased all products from farmers, including the low-quality products normally rejected by traders, and did not put undue pressure on farmers in terms of classifying product quality.

Nguyen Van Dam
Chairman of Hoa Thuan Cooperative, An Giang Province

Based on farmers' production abilities of a specific agricultural product, the cooperative representing farmers looks for markets for these products. More specifically it searches and proposes contract signing for full procurement with companies and suggests the binding provisions of the contracts. After signing the contracts with the companies, the cooperatives will sign contracts for agricultural product procurement with each household. The cooperative will play the intermediary role in implementing the full procurement contract between the farmers and the company, more specifically the organization for producing, giving technical guidance, providing seeds, promoting product quality control, and buying and assigning products to farmers.

Nguyen Van Muoi
Chairman of Binh Tai Cooperative, Tien Giang Province

Due to limited awareness, farmers tend to reject a contract when the contract contains unequal or disadvantageous provisions for farmers. They are unable to propose changes and agree to more reasonable provisions. Therefore, it is hard to find a common voice between the company and farmers. There should be an intermediary organization representing farmers in contract negotiation.

Tran Huu Du
Farmer, An Giang province

Contract farming is not suitable for all products and situations

Farming contracts in An Giang are mainly implemented for four kinds of agriculture products: ordinary rice, high-quality rice, baby corn, and organically produced fish. Among these kinds of farming contracts, contracts for producing “specialties” such as high-quality rice and baby corn have been implemented better than those for ordinary rice due to clear and strict terms and conditions provided with fixed price and concrete remedies. When producing specialty products, it is difficult for farmers to find alternative markets. Hence, there is little opportunity...
for them to break signed contracts, and they prefer to maintain long lasting relationships with contracting partners. In addition, specialty products normally have brand names, stable quality, and less variable prices. Before signing contracts for specialty products, farmers are able to reach agreements on prices with procurement companies. Besides, producers are normally provided with seeds and technical assistance by companies. Meanwhile, standard agricultural product contracts have generally had a low implementation rate. The reasons were that contracts did not specify concrete prices; rather they were agreements to procure paddy rice at market price. Therefore, although they are called farming contracts, these contracts are similar to a memorandum of understanding and are not binding for contracting parties. Contracts have a low implementation rate because these agricultural products did not have brand names, which leads to variations in quality and price and hence fixed price contracts were generally not successful. If more agricultural products had brand names, producers would have an incentive to maintain quality to keep credibility and companies would also be more willing to sign contracts on a long-term basis to ensure a stable provision of products.

Doan Ngoc Pha
Deputy Director
Department for Agriculture and Rural Development, An Giang Province

As enterprises mainly trade rice of unclear origin, this has not created credibility and responsibility for the quality of their own products. Therefore, the momentum for connection and binding between enterprises and farmers is very weak. At present, companies can buy quality rice from many sources and hence they do not need to sign contracts in advance. However, if enterprises wish to sign procurement contracts with farmers so that both sides can produce and trade items with secured quality and with brand names, the profit for both sides can be increased because the products can be consolidated, more effective, and more stable. In the case of the joint venture company Kitoku, the company signed contracts for production and procurement of jasmine rice. Contract farming will be brought in to play the highest degree when items for production and procurement are specialized ones with brand names.

Nguyen Tr Khiem
Dean of Faculty of Economics Business Administration, An Giang University

One advantage for contract implementation with farmers is that our products are unique and highly specialized for the Japanese market. We have not met a situation where farmers broke contracts. Our experiences also showed that this model has attracted the participation of poor farmers because they did not have to compete in terms of productivity and output with rich farmers. When entering into contracts with our company, poor farmers with small land areas often achieved better quality products since they were able to take care of their rice more carefully than farmers with large land areas who have had to hire workers.

Shinichi Emori
Senior Consultant
Angimex Kitoku Joint Venture Company

Contracts should be made in appropriate forms

In 1989 and 1990, contract conditions and terms between the company and farmers were quite simple and were not certified by the local authorities. Gradually, we have established a more clear-cut contract format including many basic clauses including planting area, seed specifications, harvest time, negotiated price, responsibilities of contracting parties. Any contract also has had the certification and supervision for implementation by local authorities.

Le Van Tam
Chairman of the Board of Directors
Lam Son Sugar and Sugarcane Company (LASUCO)

The contract signed between the company and representative farmers in communes near the factory clearly specified the rice area, purchase price of the company based on technical standards and quality, and the rights and responsibilities of both sides. The representatives are entitled to enjoy commission on the amount of rice sold to the company. Rice prices agreed in the contracts were defined based on the season and were made available to farmers and the representatives. Therefore, the representatives have information to decide whether to sign the contracts with the company or not and farmers have sufficient information to decide whether to produce. After that, farmers from each commune who want to take part in Japanese rice production will register with the representatives of their communes (each representative is in charge of 60 farmers at the maximum) and the representative will directly negotiate with them in terms of price and other conditions. The company will provide seeds for farmers through their representatives and send its technical officers to instruct farmers at the paddy fields. When the harvest season comes, the company will procure all the outputs, even the low-quality rice is also purchased at a lower price than the agreed one with farmers.

Shinichi Emori
Senior Consultant
Angimex Kitoku Joint-Venture Company

Among cooperatives providing materials for the company, Antesco has signed contracts for procuring baby corn with Hoa Thuan farming cooperative, Cho Moi district, An Giang province for 3 years. Under this contract, the cooperative will plant 400 hectares of baby corn every year, purchase price would be fixed at the beginning of the season and the company would sell seeds to cooperatives on credit and then deduct this amount of money when procurement takes place. After signing the contracts with the company, cooperatives would sign separate contracts with their cooperative members, providing them with seeds on credit and guaranteeing the sales of com by farmers to cooperatives, not to the free market.

Huynh Quang Dau
Director
Antesco Company

Normally contracts are signed for each production season on the basis of rice varieties, production processes, and an agreed floor price at the time of signing the contracts. The contracts specify the provision that both sides would have 3 times to negotiate the purchase price at the time near the harvest so that it is close to market prices. If the parties cannot reach agreement after this set of negotiations and the contract is not completed, then the cooperative will generally assist the farmers in selling through other channels. In these circumstances, it is clear to all sides that the contract was not completed only after all avenues of negotiations were exhausted. Hence, the non-completion of a contract in one season generally does not result in parties being unwilling to enter a contract arrangement in following seasons.

Nguyen Van Muoi
Chairman of Binh Tay Cooperative
Tien Giang Province