

**CONTRACTS AND CONTRACT FARMING AS  
POTENTIAL MECHANISMS TO IMPROVE MARKET  
ACCESS FOR BLACK FARMERS IN SOUTH AFRICA**

**BY**

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## **1. Introduction**

The objective of this report is to demonstrate how the South African agribusiness sector can contribute to the transformation of the commercial farm sector by expanding the volume of procured from black farmers through various forms of contracting. The report illustrates a potential ‘win-win’ situation for government, agribusiness, and the agricultural input manufacturers. It also shows how limited government resources can be optimally leveraged by putting the onus on individual agribusiness companies to invest in, and procure from, black farmers and thereby suggesting appropriate government policy and programmes to make this happen.

The potential of contracting and contract farming in developing market linkages for emerging black farmers is explored here in light of the importance of creating market access for black farmers in the context of black economic empowerment in South African agriculture. Contracting and contract farming is increasingly being used by agribusiness firms and retailers in South Africa to secure supply of agricultural commodities from farmers illustrating that South African firms are following similar trends occurring in the US and Europe due to the industrialization and globalization of agriculture, which resulted in the tighter alignment of supply chains and promoted the emergence of fewer larger farms. This trend could exclude small-scale farmers in developing countries from profitable niche markets. In this respect, it is also argued that smaller operations, not linked with agribusiness, will have increasing difficulty in gaining the economies of size and the access to technology that is required in order to be competitive. It is against this background that contract farming has now been recognized as a policy and planning priority, hence the need to provide guidance to the key economic players in agriculture to exploit the potential of this institution.

As more and more agribusiness firms and retailers contract directly with large farmers there still seems to be considerable reluctance amongst them to engage smaller farmers in similar contractual arrangements despite commitments to develop such mechanisms. Given this reluctance – perhaps due to the high transaction costs and limited trust between business and small-scale farmers - there is a strong need to determine ways and means to make it possible for contract farming to be used more to link farmers to markets in a non-exploitative but empowering way. The question is therefore to determine whether there is a role for government through appropriate policy interventions in the context of contracting and contract farming to improve the commercial future of black farmers and land reform beneficiaries.

## **2. Contracting in agriculture**

Contracts in agriculture could take on many forms. The most well known, with a long history of implementation in ‘colonial Africa’, is various outgrower schemes or contract farming. Under these arrangements farmers are contracted to grow commodities such as sugar, tea, coffee, cotton, tobacco on contract for a large agroprocessor. However with the process of agro-industrialisation, and the increased need by agribusiness and retailers to control quality, volume and food safety and to ensure a consistent supply, they have increasingly resorted to contractual arrangements with producers. These arrangements

could vary from verbal agreements, “handshake” agreements, seasonal contracts, and growing programmes, to formal outgrowing schemes. Contracting arrangements mainly include some form of production or marketing contract that specifies the volume to be delivered, the quality of the raw commodity supplied, the contract price and the delivery dates. The contracting arrangement can be as short as three months (fruit and vegetables) or last for many years (tobacco, sugarcane). The nature of the procurement arrangements in selected industries in South Africa are summarised in Table 1 below.

**Table 1: The Procurement of Raw Commodities**

Raw Commodity	How Raw Commodity Procured	Contracting constraints
Fruit and Vegetables (fresh fruit, dried fruit, fresh vegetables for direct consumption, canning, processing)	<ol style="list-style-type: none"> <li>1. Purchased on spot market basis</li> <li>2. Purchased on seasonal production or marketing contract basis (seasonal 3-4 month) specifying quality, price, delivery date</li> <li>3. formal supply contract (long term) indicating a comprehensive set of conditions. Supermarket has high levels of managed control over supplier production. Contract penalties included. Contracted grower must comply with growing program.</li> <li>4. Procured by seasonal “handshake type” contracting arrangement. Agreement includes volume, delivery date, quality and price. No formal penalty re supplier default but arrangement not renewed</li> <li>5. Procured from own estates</li> <li>6. On farm purchasing, agents, other processors, imports</li> </ol>	<ol style="list-style-type: none"> <li>1. Cheap imports, strong Rand, Finance</li> <li>2. Reliability of producers, determination of price, contract enforcement, uncertain demand</li> <li>3. Trust essential, high cost of compliancy (EUREGAP), training, integration of quality and safety</li> <li>4. Ethics of producers, labour cost, limited information</li> <li>5. Procurement cost higher from emerging farmers</li> <li>6. Inadequate demand, non aligned supply chains, insufficient information.</li> <li>7. Capital, water, transport, knowledge, information, Finance, expertise, labour cost</li> </ol>
Potato, maize, peanuts for the snacks industry	<ol style="list-style-type: none"> <li>1. Procured by 1-year prod. Contract that specifies quality, quantity, price, date</li> <li>2. Procured by spot buying on farms and through the national fresh markets</li> <li>3. Procured from a single supplier who contracts with farmers. 1-year production contract that specifies quality, quantity, price (Safex based), date.</li> <li>4. Procured by agent Sometimes agent engages in own production, as well as contracts with other peanut growers.</li> </ol>	Opportunism, greed, grower profile-expertise
Eggs, poultry, meat	<ol style="list-style-type: none"> <li>1. Procurement of eggs by a 7 year production contract quality, qty, price, date (the details of this medium term contract are unknown)</li> <li>2. Procurement from own estates (eggs &amp; poultry)</li> <li>3. Procurement of poultry by a 3 year Production contract specifying quality, quantity, price, date</li> <li>4. Long-term verbal arrangement for a weekly supply of pork. Price paid determined by exchange rate, import volume, Safex maize price</li> <li>5. Beef procured on daily tender basis from local farmers.</li> <li>6. Beef procured from own feedlots</li> <li>7. Beef procured from supplier by long term contract</li> </ol>	<p>High set up cost, Environmental impact study needed, Finance, local demand, expanding cheap imports.</p> <p>Limited number of processors; cost of compliance high.</p> <p>Presence of trust important</p> <p>Maintaining consistent quality</p>
Tobacco, sugarcane, cotton, timber	<ol style="list-style-type: none"> <li>1. Tobacco No Contract Farming - Farmers deliver to co-op or company, co-op/company processes, farmers share in profit when sales made to cigarette companies.</li> <li>2. Procured from own estates (sugarcane, timber)</li> <li>3. Procured by long term production contract (sugarcane, timber). Contract duration from 1-10 year and specifies volume, price, date (contract highly regulated)</li> <li>4. Cotton System 1 (40%) farmers produce/process /market own supply</li> <li>Cotton System 2 (30%) farmers produce, processors charge, farmers market own supply</li> <li>Cotton System 3 (30%) farmers produce and sell to Clark Cotton (Interlocking contract is quite common)</li> </ol>	<ol style="list-style-type: none"> <li>1. Financing, labour intensive, adverse weather, Economies of scale needed,</li> <li>2. Negative business sentiment</li> <li>SA tobacco not competitive on world markets, industry currently restructuring</li> <li>3. Financing, knowledge, water, weather, location, declining productivity on smallholders. Trust has important impact on transaction cost. Volatility of world prices- markets, land tenure issues. Small-scale farmers generate high levels of transaction cost</li> <li>4. Price, cheap imports, macro-economic factors</li> <li>5. Limited growing areas, rainfall</li> </ol>

\*Source: Telephonic-electronic Survey

A majority of the commodities appears to be procured by some form of production or marketing contract. In fact, in South Africa 100% of the supply of tobacco, sugarcane, cotton, timber, meat, poultry and eggs is secured by some form of contracting whilst 78.5% of all fruit and vegetables processed is procured by some form of contracting – usually a pre-season marketing and price agreement. In many instances, however, contracting relies on informal arrangements or “handshake deals” and trust to secure long-term supply. In these processes black farmers – especially those producing smaller volumes - are excluded from potential market opportunities.

### 3. Why a focus on agricultural contracts

The problem of smallholder exclusion is especially problematic in South Africa where historical legacies have contributed to the exclusion of small-scale black farmers in the commercial farm sector (Bundy, 1979; Kirsten & Van Zyl, 1996; Mbongwa et al, 1996; Machethe et al, 1997; Van Zyl & Kirsten; 1999). With procurement of agricultural commodities increasingly bypassing the sport market and procurement deals done on the basis of trust and social networks black farmers find themselves to be even more excluded. Although the increased procurement of raw commodities from black farmers forms part of the national priorities of South Africa there is no specific vision or policy to promote business linkages (of which contracting arrangements can be part) that include this category of farmer in the country’s agro-processing supply chains. There also appears to be a general reluctance, on the part of agribusiness, to include black small-scale farmers in their supply chains because of the incremental transaction cost (See Kirsten & Sartorius, 2002a; 2002b; Sartorius & Kirsten, 2002; 2004 for a summary of the literature on this topic).

Although black farmers are contracted in many agricultural industries, the volume of supply from this source is limited. For example, the procurement of fruit and vegetables, illustrated in Table 2, suggests black farmers supply less than 5% of the total volume of commodities procured.

**Table 2: Smallholder contracting: Fruit and Vegetables\***

Number of companies responding	Commodity	Annual volume of commodity procured by responding companies (tons)	Annual volume of commodity procured through contracted farmers (tons)	Annual volume of commodity procured through contracted black farmers (tons)	# contracted farmers	#Black contracted farmers
6	Apples	98,506	18,466	40	250	1
9	Apricots	28,066	26,508	86	483	6
3	Carrot	7207	6994	0	12	0
1	Dried fruit	400	267	0	6	0
2	Mangoes	9,800	9,200	900	170	90
3	Ginger, figs	54	49	1	37	5
2	Grapes	2,932	2,932	0	44	0
3	Groundnuts	9,000	4,500	0	50	0

5	Guavas	5,377	2,877	0	20	0
2	Lemons	10,015	10,015	0	171	0
2	Melons	526	526	0	6	0
7	Naartjie, orange	3021	3021	123	179	25
7	Peaches	76,622	72,053	496	566	4
6	Pears	86,086	45,939	1,050	397	4
2	Pineapples (fresh)	100,027	100,027	3,000	38	0
2	Plum, prunes	2,328	2,328	0	225	0
3	Guava, figs	1104	1104	58	41	5
2	Raisins	17,665	17,405	334	631	66
4	Strawberry	17,668	17,408	334	898	71
1	Baby marrows	50	25	0	4	0
2	Beans	8992	8642	0	3	1
2	Beetroot	5,887	5,887	0	9	0
2	Brinjals, butternut	113	75	19	15	7
1	Cabbage	91	46	0	3	0
2	Chillies	622	538	7	70	2
2	Cucumbers	1,687	1,664	169	29	4
1	Mushrooms	30	30	0	3	0
3	Onions	1,286	554	0	14	0
1	Peas fresh	4,358	4,358	0	50	0
3	Peppers	5,324	4,902	300	70	17
4	Potatoes	79291	63629	0	31	0
1	Sweet corn	10,940	10,940	0	16	0
3	Tomatoes	127,047	123,973	19,663	182	75
Total	99	722222	560582	26580	4723	455

**\*based on companies responding – 60% return**

Other documented examples of smallholder contracting are found in the tea, fruit, sugar, flower, cotton, vegetable, timber, tobacco, mariculture and beverage industries (Levin, 1988; Porter & Phillips-Howard, 1997a; 1997b; Van Rooyen, 1999; Karaan, 1999; Tregurtha & Vink, 1999; Weatherspoon et al, 1999; Sartorius & Kirsten, 2002; 2004; Kirsten & Sartorius, 2002a; 2002b). Certain raw commodities like sugarcane, timber and cotton have a long history of procurement from contracted small-scale farmers and over 67 500 smallholders are contracted to agribusiness partners in these sectors. Smallholder contract farmers in South Africa are also actively involved in the supply of fruit, vegetables, paprika, mangoes, naartjies, raisins, strawberries, and tomatoes. Finally, although the barriers of entry are high, a limited number of smallholders are contracted to supply poultry and eggs.

#### **4. The Potential Role of Agribusiness**

Agribusiness can assist small-scale farmers and farmers entering commercial agriculture to overcome the barriers of entry to high value raw commodities by providing inputs and a guaranteed market. A number of disadvantages, however, confront agribusiness companies that select small-scale farmers as suppliers.

A principal disadvantage frequently associated with contract farming in developing countries, is the high level of transaction costs. Transactions costs are often excessive because supply arrangements involve large numbers of small-scale farmers that are spatially dispersed, that require high levels of inputs and support and because smallholders make smaller, more frequent deliveries to agribusiness. (Key and Runsten, 1996). Excessive transactions costs are also generated as a result of the need to structure, administer and enforce a large number of contracts (Barry et al, 1992). Moreover, the agribusiness partner incurs additional supervision and monitoring costs in conjunction with the non cost effective delivery of services and inputs to farms that are small and spatially dispersed. In this regard, it is estimated that dealing with larger farmers, who make less use of inputs and deliver in greater volumes, costs less than dealing with smallholders (Runsten & Key, 1996; Key & Runsten, 1999). Illustrating this, Coulter et al (1999) refer to an example of horticultural exporters in Zimbabwe who paid their smallholder suppliers 30% of the price per kilogram paid to the large-scale farmers in order to break even. Despite these disadvantages, the agribusiness sector can if appropriately incentives play a significant role in expanding marketing opportunities for smaller farms through various forms of contracting linkages.

The question remains, however, whether these agribusiness companies can, or are willing, to significantly expand procurement from and linkages with black small-scale farmers. Supply by black farmers – mostly on smallholdings - is already significant in the sugarcane, timber and cotton industries and long term plans clearly intend to further expand their contribution. Similarly, various other supply chains, in conjunction with the help of various research institutions like the ARC and CSIR, have invested in plans and technologies to assist black farmers in producing beef, hides, mohair, wool, ostrich meat and hides, fish, poultry and eggs, sorghum, groundnuts and tea. According to a survey of South African agribusiness plans to include black farmers in their supply chains, therefore, it would appear as if considerable potential exists to significantly expand the involvement of black farmers in many supply chains. It should not be forgotten, however, that many of these initiatives could be a “window dressing” exercise or alternatively become non-viable supply sources in the long run and that black farmers continue to supply less than 10% of all raw commodities processed. Despite this, the agro-processing sector of South Africa clearly has the potential to significantly expand their procurement from black farmers especially those entering the commercial sector for the first time.

## **5. The Issues and Constraints**

A wide range of issues and constraints act as barriers of entry for smallholder black farmers. These include general and specific barriers of entry to the various raw commodities, a move away from the open market to closed markets and country specific historical legacies that continue to retard the transformation of agriculture.

The traditional constraints for agribusiness or market agents to procure from (or contract with) small commercial farmers relate to the fact that these farmers often find it difficult to produce a commercial volume. This is usually a consequence of a lack of finance, the high level of set up cost in certain industry sectors, a lack of knowledge and a general

lack of infrastructure and poor access to transport and communication. Furthermore, issues that appear to restrict procurement opportunities include opportunism and greed. In recent times, moreover, the strong performance of the South African currency and cheap imports have resulted in the increased purchase of raw commodities (chickens, beef, pork) and fruit concentrates from international markets. Many South African retailers in the fruit and spice sectors, for instance, are importing cheap overseas products rather than engage local sources. Similarly, local manufacturers in this sector are importing a range of concentrates.

Other factors acting as constraints include a lack of labour for certain labour intensive production systems, the inability to generate economies of scale because of farm size. Further issues like adverse business sentiment, financing constraints, economies of scale and weather conditions also have a negative impact.

### *Historical Legacies*

Historical legacies influencing the South African commercial farm sector have resulted in the establishment of unequal power relationships, skewed development patterns and unequal access to markets, infrastructure and services. The development of trust between agribusiness partners and contracted growers, especially emergent small-scale black farmers, will, therefore, be a vital pre-requisite to ensure the success of future vertical co-ordination partnerships. A lack of trust has also been demonstrated to increase transaction costs in the wine industry of South Africa (Weatherspoon et al, 1999) whilst the development of trust in the beverage industry has reduced the transaction cost of small-scale farmer barley supply (Tregurtha & Vink, 1999). Other issues that have emerged are the unequal power relationship between agribusiness and the farmers (Mbongwa et al, 1996; Machethe et al, 1997) and the existence of managed small-holder contracting schemes has been associated with top-down management structures, political economy objectives and agribusiness paternalism (Levin, 1988; Porter & Phillips-Howard, 1997a; 1997b).

## **6. The Way Forward:**

Kurt, here we need to basically what you have said in bullet number two and delete the rest: I thought our report should basically say what government should do. Could you draft something that basically give detailed proposals.

- This report should clearly highlight how agribusiness can contribute towards key government transformation objectives, as well as create a 'win-win' situation for agribusiness, government and the input players. From a government perspective, therefore, the report should clearly show how limited government resources can be optimally leveraged by putting the onus on individual agribusiness companies to invest in black farmers.

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I would delete the rest – because we are not getting to a proposal..

On the basis of the current status that exists with respect to the relationship between agribusiness and black farmers, a number of steps are required in order to contribute to the expansion of contract farming in South Africa. They are

- The identification of the key players. These include agribusiness (specifically the agro-processing sector), the government, input suppliers, farmer associations and research institutions. In this regard, associations representing emerging black farmers must be developed/upgraded if they do not exist or, alternatively, are inappropriately structured.
- Government should be presented with a report (this report) that clearly demonstrates the feasibility of expanding black contract farming. This report should clearly highlight how agribusiness can contribute towards key government transformation objectives, as well as create a ‘win-win’ situation for agribusiness, government and the input players. From a government perspective, therefore, the report should clearly show how limited government resources can be optimally leveraged by putting the onus on individual agribusiness companies to invest in black farmers.
- A series of meetings and workshops should then be convened amongst all the players in order to establish a joint structure and vision to expand the institution of black contract farming. In addition, the roles of each of the players should be articulated.
- More specifically, the role of agribusiness must include the social responsibility of expanding contract farming opportunities for smaller farms in their supply chains. Although widespread evidence exists that numerous black farmer projects are in progress, there is a need to ensure that these projects result in long term contractual arrangements. Agribusiness, moreover, will be the first line initiators of contract farming projects that will require the provision of a wide range of inputs. In addition, the individual agribusiness companies will act as facilitators for finance and land.
- Government must also undertake to promote the institution of contract farming by developing the necessary regulation and policy in order to facilitate the growth of contract farming (see policy brief in Section 7).
- Simultaneously the development of suitable contractual arrangements should ensure that agribusiness companies do not use this legislation to entrench white

power. New black farmers (in the SA context) should be adequately represented in the establishment of the contract and, in this respect the use of powerful farmers associations could ensure that farmers are not exploited.

- The input suppliers including seeds, services, fertilizer, power, finance and transport to also undertake to support the development of black contracting farming by customizing small-scale farmer input packages.
- Black farmer organizations to sell the opportunity to their members, as well as act as a conduit for developing the necessary structures and to facilitate training and other inputs. The development of representative farmers associations, in this regard, could mobilize black farmers, increase economies of scale, reduce transaction cost and ensure the representation of this sector. Other forms of securing the horizontal coordination of farmers can also be examined to ensure the coordination of production, processing and marketing, as well as land, labour, water and equipment.
- Research organizations to investigate optimal ways to create linkages between agribusiness and small farmers, to investigate the suitability of various raw commodities for contract farming projects and to develop small-scale technologies. Research is also required with respect to the role of farmer associations, as well as investigating the suitability of different types of contracting arrangements. Finally various other ways in which farmers can be horizontally integrated, similarly to the collaborate clustering that is precipitated by common interests, historical experience, should be investigated.
- After a joint vision is developed a project by project approach should be adopted as a specific agribusiness company decides to initiate a contract farming project. For interest, a specimen approach to initiate a specific project, assuming certain conditions are complied with, are suggested in Annexure 1.

## **7. Policy Recommendations**

You basically need to exactly spell out the details for each of the recommendations mentioned here....

There are four principle policy recommendations. Firstly, policy in particular was required to convince agribusiness to undertake large scale investment in smallholder contract farming projects. Some form of relief/reward is, therefore, urgently required for agribusiness companies who invest large sums of money to initiate smallholder projects, as well as incur higher levels of transaction cost because of interacting with large numbers of small-scale farmers and/or their farmer associations. Secondly, it is suggested some form of policy is required to ensure the representation of smallholders in a contract farming relationship. This policy is twofold. On the one hand policy is required to

promote the existence and efficiency of farmers associations whilst on the other hand if a farmers association is not developed, policy is required to protect smallholders in the unequal power relationship. Thirdly, it is suggested some form of policy is developed, where possible, with respect to regulating the price structure of certain raw commodities in a similar fashion to determining the price paid for sugarcane or maize. Fourthly, regulation is urgently required to ensure that legal systems is capable/prepared to guarantee contract enforcement, facilitate land tenure problems and traditional authority structures<sup>1</sup>. Finally, policy also needs to be enacted to ensure female farmers operate as freely as their male counterparts, as well as to restructure regulation with respect to the minimum wage legislation in the farm sector.

## **8. Summary and Conclusion**

The suppression of black farmers has a long history in South Africa. Despite a new dispensation since 1994, the emergence of new entrants to the commercial farm sector has been limited. In this regard, no specific regulation has been adopted to specifically promote the institution of contract farming. Furthermore, the agribusiness sector appears to have serious reservations about contracting with large numbers of small-scale farmers. Despite this, the agribusiness sector has enormous potential to expand the institution of smallholder contracting. A number of issues, however, will need to be addressed in order to entice agribusiness to promote smallholder contracting. These issues include the general high level of transaction costs, the influence of country specific legacies, the absence of regulation, issues surrounding trust and contract conflict. In order to resolve these problems, a forward is proposed that suggests the adoption of a common vision by the key players in the agricultural sector.

The success of the approach, therefore, depends on a mutual vision developed by the government, agribusiness, research institutions, farmers and the input suppliers of agribusiness supply chains. In this regard, suitable government policy will ensure that agribusiness alone is not expected to bear full cost of expanding smallholder procurement programs. On the other hand, agribusiness must guarantee a minimum level of procurement from black farmers in a majority of supply chains that process raw commodities are suitable for smallholder production. In addition, the input suppliers like the banks, transport, fuel, seed and fertilizers must combine with this vision in order to provide inputs for smallholders. At the centre of managing the entire process, with respect to each individual project, will be the individual agribusiness company. The management of the process is therefore privatized and the collective resources of agribusiness and their small farmer partners form the nucleus of the scheme.

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## **Annexure 1. Case Study XYZ Company**

1. XYZ agribusiness company wishes to contract small-scale farmers to supply a raw commodity.
2. Evaluate proposed grower-processor supply chain for specific commodity. Document the activities including start-up, training, land preparation, growing, harvest and delivery. Configure activities with spatial area, number of farmers, average distance to processor, presence of roads and communication facilities. Establish exact size, location of new supply area as basis for land reform program.
3. Determine contract conditions of supply in supply chain. These include the separate identities of the parties, ability to walk away from the contract, the duration, the presence of substitutes, the level of ex ante control, the level of ex post importance, the level of shared information and how contract enforcement can be assured. Establish supply contract and configure with check list of factors including trust, land tenure arrangements etc
4. Determine transaction characteristics of supply including frequency of transactions, the level of asset specificity and the level of uncertainty. These transaction characteristics will be determined on the basis of coordinating the activities of the raw commodity supply chain.
5. On the basis of the activities stated in 2 and the contract conditions and transaction characteristics in 3 and 4 an optimum supply structure will be proposed. This structure will take into account a check list of factors including trust, land tenure, gender factors etc.
6. Using a combination of ABC costing, logistics software and spread sheet facilities, the activities of small farm supply will be costed that includes start-up activities, land preparation, growing, harvesting and delivery. What if analysis will be performed to evaluate the effect of different ways of coordinating small farm supply including the presence of a farmers association. Transaction cost of supply can be determined and compared to that of larger suppliers. This costing exercise can be used as basis to apply for relief or alternatively charge back amount to small farm associations.
7. Project cash flows will be determined and net present value ascertained on basis of an acceptable cost of capital. Project cash flows subjected to what if analysis and this can include receipt of subsidies, implication of charge backs.
8. Capital investment decision taken. Proceed or Stop. If proceed go to Step 9.
9. Final decision to be made with respect to representation of small farmers.
10. Screen prospective farmers. Select on basis of ability.
11. Development of long term contract. Contract establishment must be configured for gender and tribal authority issues.
12. Final documentation of supply chain, liaise with minister of land affairs, banks, development of facilities, inputs, training.
13. Establish management structure to include small farmer inputs
14. Establish provision of finances and inputs until first harvest.
15. First deliveries commence