

Contract Farming in India: An Introduction

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The Indian agri-food system is undergoing rapid transformation and there is growing evidence that contract farming will have an important role in this transformation. An important concern in Indian agriculture is that while “front end” activities – including wholesaling, processing, logistics, and retailing – are rapidly expanding and consolidating, the “back end” activities of production agriculture have been continuously fragmenting (Gulati, 2008). The challenge lies in linking the two ends and ensuring viable business opportunities for both farmers and agri-businesses.

Establishing farm-firm linkages is not only about providing assured markets, reducing risk, and ensuring ‘remunerative’ prices, but also providing critical services such as credit, insurance, grading and inspection, technology extension, and market information. These institutional services can help elevate the scale at which small holders can operate, raise their productivity and income, and mitigate the risks involved in participating in markets for high value horticultural, livestock, and fishery products.

The recent growth and diversification of consumer demand and the expansion of organized agricultural processing and marketing ventures in India has the potential to boost the market opportunities, productivity, and incomes of farmers, including small holders. However, achieving these goals will likely require creation of new institutions and innovations to develop supply chains and facilitate linkages between farmers, wholesalers, processors, and retailers. Among these institutions and innovations are various models of contract farming, including those led by cooperatives, by farmer groups, and by various types of private sector resource intermediation that develop backward linkages to growers.

Consolidation at the Top of the Value Chain

India is currently riding a tide of organized retail expansion, especially in the food and grocery segments, which have been growing at annual rates between 16 and 50 percent over the past few years (Reardon and Gulati, 2008). The top 10 Indian organized food and grocery retailers grew at the rate of 72.4 percent from 2002 to 2007 (Planet Retail, 2008). While total food and groceries account for nearly 60 percent of total retail sales in India, food and grocery sales by organized sector firms account for only a little more than 10 percent of total organized sector retail sales, indicating that there is ample scope for scaling up of organized food and grocery retailing. The high growth rate of the top players in India’s organized food and grocery segment suggests that this sector will occupy a growing share of both the food and grocery market and the overall retail market in India.

Growing demand for processed food products is an important component of India’s expanding food and grocery business, providing a boost to India’s food processing sector,

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which has grown about 13 percent annually from 2002-03 to 2006-07 (Trivedi, 2008). As in retailing, the role of organized food processing firms within the overall food processing industry (organized and unorganized) has increased from 64 percent in 1984-85 to 81 percent in 2000-01, and is likely to have grown further in the last couple of years (Bhavani et.al. 2007).

Considerable new capacity is being added in the organized food processing sector. The expansion of organized food processing and food and grocery retailing is inducing greater competition among multiple private sector players, contributing to a virtuous cycle of growth, consolidation, and modernization, capturing scale economies in line with the rising market demand. This competition among firms has created pressure to compress supply chains, cut costs, and achieve increased competitiveness in the domestic and global market. In this context, contract farming models are among the mechanisms for streamlining procurement and logistics services that are high on the agenda of organized retailers and agro-processors.

Fragmentation at the Bottom of the Supply Chain

In production agriculture, the trend in India is towards fragmentation rather than consolidation. The average size of landholdings declined from 2.2 hectares in 1970-71 to 1.06 hectares in 2003. Nearly 88 percent of the farmers have less than 2 hectares of land, and account for about 44 percent of the operated area (NSSO, 2006). Although these farms are small, indications are that they are more efficient than larger farmers in terms of land productivity, presumably due to a high share of family labor on small farms. The share of marginal and small farmers (of less than 2 hectares) in the total value of agricultural output is about 51 percent, substantially higher than their 44 percent share of area operated (Srivastava, 2008).

While smallholders, by virtue of available family labor and intensive cultivation practices, can be highly productive, they typically have a small marketable surplus and face high transaction costs in marketing their produce. Diversifying out of traditional crops towards high value agriculture poses two key challenges. First, higher production risk (susceptibility to pest attack and climatic adversities) and price risk associated with high value agriculture compared to grains often deters diversification. Second, lack of resources (financial assets as well as access to credit) coupled with inadequate market and crop knowledge often restricts shifts to new enterprises and investments in variable and fixed inputs. Small farmers often find themselves locked in a situation of income uncertainty and low risk bearing capacity, thus constraining shifts towards higher value and income generating activities. Again, contract farming models that can share risk and overcome resource constraints emerge as a possible approach to facilitate the transformation of small holders to high value agriculture.

Contract Farming and Farm-Firm Linkages

Indian agriculture has begun to diversify and future sources of agricultural income are likely to come increasingly from the high value segment, driven by rising demand for high value horticultural, livestock, and fishery products. While the potential benefits of high value agriculture, including higher income and employment, are significant, it will be necessary to overcome key challenges associated with meeting farmer resource needs and mitigating

production and marketing risk. The challenge is to identify innovative solutions, possibly based on contract farming models, that are efficient and competitive and also ‘inclusive’ in terms of working with small holders on sustainable basis.

Direct Procurement –There are different models of farm-firm linkage ranging from simple marketing agreements, to risk sharing, to forward marketing and futures contracting. In a bid to keep their supply chain moving, processors and retailers may choose to source raw materials from government regulated market yards, small traders, or directly from farmers. Direct procurement may be preferred given the transaction costs and quality problems associated with procuring from government regulated markets (*mandis*). In such an arrangement, there is no contractual tie-up with the farmers and anyone is free to sell their produce subject to certain quality criteria. Indian retailers such as Reliance, Spencer’s, Subhiksha, and Food Bazaar currently use this procurement model. Direct procurement from farmers can be done only in states that have amended their Agricultural Produce Marketing Committee (APMC) Act to permit buyers to purchase directly from producers, farmers in line with the Model Act 2003 proposed by the central government.² In states that have not amended their APMC Act, purchases must be through government regulated *mandis*, paying the commissions and marketing fees imposed in those markets.

Some retailers and processors, such as Field Fresh, Pepsico, and Nijjer, have contractual buyback arrangements with the farmers that specify quantity, quality, and a pre-agreed price. Some of these firms provide back end support to farmers – including extension services, provision of seed and other inputs, and credit facilities – with the costs often adjusted in final payments made to farmers. Such backward linkages are primarily driven by the size and quality requirements of the market and the need to ensure smooth and regular supply of a product that meet certain quality standards.

Open-Source Intermediation – Another variant of farm-firm linkage is open-source intermediation, involving provision of information about market prices, crop, and good cultivation practices to farmers without any buy back guarantee. The idea is not to create a backend supply line of a particular company, but bridge the knowledge and information gap that exists at the farm level, and also supply inputs to farmers without any ‘lock in’ agreement. However, in due course, the model of open-source intermediation can be adapted for specific supply lines, as and when an opportunity arises. This is well observed in the case of the Choupal Sagar and Choupal Fresh models adopted by ITC following the success of e-choupal.

There appears to be a large unmet demand for agricultural services and creation of rural service platforms that has given rise to another option for forging effective firm-farm linkages. Research and development activities lose their effectiveness unless they reach farmers’ fields, and much depends on the effectiveness of the extension service network. Rural business or “agri-hubs” led by public-private partnerships between panchayats and the private sector (CII in partnership with the Ministry of Panchayati Raj) provide input services for farmers and provide markets for their produce. Several private sector players are also

² Details of the Model Act 2003 are available at <http://agmarknet.nic.in/amrscheme/modelact.htm>, accessed on 10th July, 2008.

developing the concept of business hubs to reach out to farmers, including DSCL Hariyali Kisan Bazar, TATA Kisan Kendras, Godrej Aadhaar, and ITC e-Choupal and Choupal Sagar. The scale of these operations remains small in comparison to the needs of farmers and rural areas, but this model may offer an opportunity to rapidly scale up the activities of private firms, and resulting farm-firm linkages. These “agri-hubs” potentially can provide ‘one stop shopping’ for farmers by providing inputs such as seed, technology, and credit, and services such as extension and insurance, as well as daily household products.

Limitations of Contract Farming

Theoretically, farmers stand to gain from contractual agreements that provide lower transaction costs, assured markets, and better allocation of risks. On the other hand, contracting firms have the advantage of more assured supplies, and reasonable control over quality and other specifications. However, in practice, there are practical problems that emerge in agricultural contracting that can result in losses to both farmers and firms.

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 other countries. Lack of enforceability of contractual provisions can result in breach of contracts by either party. In India, there have been instances of farmers refusing to sell to contracting firms when market prices exceed the contract price, and of firms refusing to purchase contracted quantities or pay contracted prices due to market conditions. Neither the contracting firm nor the farmers are keen to contest these issues in a court. Most often, it is mutual understanding and faith that drives contractual relationships and it takes a long time to win mutual trust and confidence. 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. In such situations, a viable approach seems to be to form clusters of small farmers that can create a scale effect and also enhance the bargaining position of the farmers. Success in developing contracting models or other forms of farm-firm linkages that are effective for small holders will be a key challenge to small holder participation in the transformation of Indian agriculture.

Scope of this Resource Book

The idea of this online resource book, and the workshop sponsored by the India-U.S. Agricultural Knowledge Initiative on which it is based, is to bring together U.S. and Indian experiences with contract farming, and create an opportunity for mutual learning. The papers and presentations provided here address a range of economic, legal, and operational issues involved in contract farming drawing on both the U.S. and Indian experience. Topics addressed include:

- *The role of contract farming in India:* A paper analyzing the potential role of contract farming in linking farmers to markets and supporting growth in Indian agriculture, and a presentation on the growth in modern food retailing in India.
- *The experience with contract farming in India:* Two papers and two presentations describing and analyzing the Indian experience with contract farming, including the implications for smallholders.
- *Meeting quality requirements using agricultural contracting:* Two papers describing U.S. grading and inspection procedures and analyzing the performance of quality specifications

in contracts for U.S. crops, and a presentation on strengthening India's grades and standards.

- *Delivery of inputs and extension services through agricultural contracting*: Three papers examining the impacts of input provision through agricultural contracting in India, the U.S. approach to providing agricultural extension services, and finance for agricultural contracting in India, plus a presentation on the delivery of inputs to smallholders in India.
- *Legal issues in agricultural contracting*: Two papers on legal aspects of agricultural contracting, one from the Indian perspective and one from the U.S. perspective.
- *U.S.-India cooperation in agricultural contracting*: A presentation on potential lessons from the U.S. experience in contract farming.
- *Asian experience with contract farming*: A presentation on the experience with agricultural contracting and smallholders in other Asian countries.
- *Online resources on contract farming*: A directory of links to selected online Indian and U.S. resources related to contract farming.

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