Stefan Antonić and Darko Jovanović

SETTING UP A PRE-HARVEST FINANCING FRAMEWORK **IN SERBIA**

Over the last 10 years, considerable legislative efforts have been made towards creating a favourable framework for financing agribusiness and agricultural production in Serbia. The latest piece of legislation in that sector is a law on secured pre-harvest financing.

Looking back, in 2005 Serbia introduced the national strategy on agricultural development (the Strategy), which outlined obstacles and set goals with regard to financing agribusiness and agricultural production. At that time, the main problems were a lack of: (i) short-term financing which would bridge the gap between selling newly harvested agricultural products and collecting the purchase price; (ii) mid-term financing for investing in working capital (as such investments cannot be financed by the yield of a single production cycle); and (iii) long-term financing for purchasing agricultural land. In other words, the main issue was a lack of easily accessible financing for inputs, production and the accompanying support operations required for agricultural production. The Strategy aimed to expand the market in which financing was accessible to include all participants in the agricultural production cycle.

However, rather than following the approach outlined in the Strategy, the Serbian state adopted a different approach to solving the problem of financing agribusiness and agricultural production. Specifically, the state was directly involved in financing agricultural production (for example, by granting subsidised loans and interest rate subsidies), while at the same time creating optimal conditions for the financing of agricultural production by developing the existing legal framework.

> "A big step in creating a favourable legal framework for financing agribusiness and agricultural production in Serbia was the law on secured pre-harvest financing."

> "The law aims to finance pre-harvest production, specifically financing the inputs required for agricultural products."

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In 2009 Serbia enacted the law on public warehouses for agricultural products, which was a milestone from a legal framework development perspective. This piece of legislation introduced a rather safe and simple system for pledging existing agricultural products, allowing them to be used as collateral when obtaining financing for agribusiness and agricultural production. In that way, a new avenue for financing agricultural production was created.

The next big step in creating a favourable legal framework for financing agribusiness and agricultural production in Serbia was the law on secured pre-harvest financing (the Law). During the drafting of the Law, all major agrarian business stakeholders in Serbia (that is, banks, insurance companies and agribusiness companies) were involved in providing input, which was used as the starting point for drafting certain solutions introduced by the Law.

The Law aims to finance pre-harvest production, specifically financing the inputs required for agricultural products, with a loan tenor that corresponds to the term of the entire crop cycle. In summary, the main focus of the Law is to help farmers access pre-harvest financing in order to bridge the funding gap between investing in agricultural production and collecting the price upon sale of the newly harvested agricultural products.

The Law not only governs contracts on agricultural pre-harvest financing, but also the registration of such agreements, the settlement of creditors' claims under the agreement (by using future agricultural products as a form of loan security without taking them into possession) and special rights and obligations of the contracting parties in agricultural financing. Specifically, the Law introduces distinct financing/enforcement mechanisms, custom-made for the Serbian market model.

The financing mechanism set in the Law allows the contracting parties to regulate their mutual rights and obligations relating to the financing of agricultural production by concluding an agricultural financing agreement. Since these agreements are subject to specific provisions (for example, exclusion of *force majeure*) prescribed by the Law, financing is provided in a more favourable and secured legal framework. These agreements contain mandatory elements and are entered into a registry of financing contracts run by the Serbian Business Registers Agency.

Besides this mechanism, the Law also introduces a simple, quick and reliable system of enforcement, incorporating new solutions for overcoming impediments encountered in practice when pledging future agricultural products. Under the general legal regime (that is, Serbia's civil law rules), future agricultural products can be pledged but also mortgaged at the same time. However, the way in which these two liens affect each other is unregulated. As such, the Law contains a set of rules to regulate these transactions.

In addition, while enforcement mechanisms introduced by the Law are based on the standard pledge model under Serbia's civil law rules, certain parts of the registration and enforcement procedures have been altered and specifically tailored to meet the particular needs of participants in the agricultural production financing process.

At the moment there are number of financing options offered to the agricultural sector, namely by banks (and affiliated leasing companies), state funds and major agribusiness companies. However, the availability of financing options offered by banks (and affiliated leasing companies) is significantly constrained due to a combination of legal, economic, institutional and behavioural factors, which usually perceive the creditworthiness of borrowers from the agricultural sector as weaker than those in other sectors. In that regard, the Serbian market still lacks banking facilities for agricultural production. Instead, big agribusiness companies are the key figures in financing agricultural production.

In conclusion, the impact of the Law should be twofold. Specifically, financing/enforcement mechanisms provided by the Law should help to provide financing both to small agricultural producers and big agribusiness companies. Therefore, as financing becomes accessible to all participants in the agricultural production cycle, the Law will not only provide cheaper and more accessible financing for agricultural production (primarily for small agricultural producers), but will also support market development.

The Law was adopted in November 2014 and it should come into effect from 1 June 2015. Although the practical and market effects of the Law are yet to be seen, it is reasonable to expect further development of the financial market in Serbia and especially the market segment dealing with the financing of agricultural production.

From the International Fund for Agricultural Development (IFAD)

CONTRACT FARMING AND SMALLHOLDER PARTICIPATION: **LESSONS LEARNED**

Three-quarters of the world's poorest people live in the rural areas of developing countries. Meanwhile, some 500 million family farms support the lives and livelihoods of 2 to 2.5 billion people around the world, and produce about four-fifths of the food supply in developing countries. Due to the constantly rising demand for agricultural products, there is a greater emphasis on vertical integration among producers, wholesalers and retailers. At the same time, strong links to markets are essential to increase agricultural production and productivity, and improve food security for rural producers and the rural poor at large.

Contract farming (CF) is an important approach, which can help link market needs with production capacities, diversify and increase the availability of products on local and global markets, and improve overall value chain efficiency. The United Nations International Fund for Agricultural Development (IFAD) promotes CF arrangements between smallholders and the private sector in its policies, strategies and operations on the ground. As an international financial institution, IFAD aims to reduce rural poverty and invests in smallholder agriculture by providing concessional loans and grants to developing countries in order to finance innovative agricultural and rural development programmes and projects. By the end of 2013, IFAD had supported 241 such projects with a total investment of US$ 5.4 billion, reaching out to an estimated 430 million rural people globally.[1]

More than half of IFAD's current programmes include a value chain development component. By seeking to integrate IFAD's target groups of small rural producers involved in farming, livestock or fisheries into such value chains, IFAD-funded projects and programmes are able to improve smallholder access to secure markets, thereby raising their incomes.

Agricultural and food value chains are essentially led by the private sector whether said private sector is small, medium or large; local, regional or international. IFAD considers public-private-producer partnerships (4Ps) alongside agricultural value chains as a powerful tool to attract private sector investment in the smallholder sector and in market segments that may otherwise not be profitable to private companies without public support and/or concessional donor financing. IFAD is committed to stepping up its efforts in promoting contractual arrangements to help small agricultural producers seize opportunities in agricultural value chains at lower levels of risk.[2] This article presents ways to create CF arrangements that are advantageous for both producers and contractors. Building on IFAD's work in agricultural and rural development programmes in the Near East, North Africa and Europe region, this article highlights agricultural value chain development projects in Egypt and Moldova. Both projects have unique CF components and serve as case studies that provide critical lessons for policy-makers, investors and agricultural and rural development intervention planners.

SETTING THE STAGE: CONTRACT FARMING AND SMALLHOLDERS

Smallholder farmers in developing countries have limited options when it comes to increasing their productivity and moving from subsistence farming towards market-oriented production methods. Limited access to productivity-enhancing inputs, technologies, information and credit are major obstacles for many smallholders, as are uncertainties over land tenure, which restrict their ability to invest in the land they farm. These obstacles, in turn,

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make it difficult for smallholders to produce the quantity and quality of agricultural goods required by the market. This is where contract farming models can make a difference.[3]

As a means of enhancing market competitiveness and profitability as well as addressing the effects of market failures, contract farming integrates smallholder producers into modern agricultural value chains by providing credit, insurance and information for contracted farmers. Contract farming is an agreement between sellers (producers/farmers) and buyers (processors/traders) of agricultural commodities. The contract covers the obligations of both parties: the producer is required to supply specified volumes and high-quality products, and the buyer must purchase the goods. In addition, buyers provide other services, such as inputs (seeds, plantlets, fertilisers, and so on) and credit or other non-financial services (training and logistics). Contracts vary to a great extent in terms of their form and content, as well as the ways in which they are negotiated and concluded. They can, for example, be formal or informal (concluded in writing or orally), and arranged with individual farmers or groups of farmers (that is, farmer associations). The obligations set forth in contracts can either be left rather ambiguous or specified in detail, and may be long term or cover one season only.[4]

If well managed, CF arrangements can benefit smallholder producers and agribusinesses alike. For producers, CF models offer better and more stable incomes through higher yields and improved access to inputs (in kind or through buyer credits). In addition, where banks accept forward contracts as collateral, access to credit for further investment is improved and credit risks reduced.

Proper CF arrangements can also help ensure reliable and stable market access. Longer-term farm planning, greater access to inputs, advisory services and new technologies help to minimise market and production risks, and increased diversification improves food security.[5]

As for contractors, they profit from guaranteed volume and product quality, which minimises the supply risks associated with non-organised or traditional markets, reduces reputational risks and improves marketing.[6] Contractors also have the opportunity to expand their business activities without large-scale investments, as operational and staff costs are cut through subcontracting. Transaction costs are, therefore, reduced owing to a regular and stable supply of produce, and investment risks are minimised due to a more efficient use of capacities.

However, CF arrangements can also bear risks, both for producers and contractors. First, contractual arrangements may be costly to set up, implement and enforce. Smallholders, for example, may face the risk that buyers fail to deliver on the terms of the contracts (such as agreed prices or embedded services). Second, contractors could encounter problems (such as side-selling and side-buying) when working with smallholder farmers. Third, smallholders sometimes fail to meet quality standards required by the market, even when inputs are provided. For example, climatic conditions (extreme temperatures) often lead to significant crop losses, which impede production. Lastly, weak law enforcement and the lack of a formal code of conduct among buyers and producers impose additional constraints.[7]

CASE STUDIES: IFAD IN EGYPT AND MOLDOVA

The following case studies are two classic examples of IFAD-supported agriculture and rural development projects. The rationale for selecting these cases is as follows: (i) they were designed and supervised by IFAD's Near East, North Africa and Europe Division (NEN), which mirrors a similar region covered by the EBRD; and (ii) the two projects/programmes have at least one specific component addressing CF development that is already showing results. The two case studies build on project design, evaluation and completion reports.

EGYPT WEST NOUBARIA RURAL DEVELOPMENT PROJECT

From 2003 to 2014, the West Noubaria Rural Development Project (WNRDP)[8] supported smallholder farmers and young graduates working on small holdings (1-2 ha). The WNRDP focused on increasing agricultural and livestock productivity and profitability, strengthening community development, and providing support to small and medium-sized enterprises to help them gain access to credit, establish market links and increase employment opportunities. Some 36,180 households (or 228,000 individuals) benefited from the project. The project is valued at an estimated US$ 55 million, of which approximately US$ 19 million was financed by an IFAD loan, US$ 30 million by the Italian-Egypt Debt Swap programme and US$ 6 million from Egyptian government contributions.

Under its marketing component, the WNRDP helped link small farmers to big businesses. With the WNRDP's support, a total of 30,571 smallholder farmers were able to organise themselves into six marketing associations (MAs). The MA members were not only trained in pre- and post-harvest marketing of fruit, vegetables, groundnuts and dairy products, but also in the cultivation of medicinal, aromatic and organic crops (including harvest and post-harvest techniques, as well as food technology and processing methods). In addition, farmers learned how to build enterprises and meet quality control standards, such as those required for Good Agricultural Practices certification. The formation of marketing associations helped farmers benefit from economies of scale and enhanced their ability to better bargain with traders. By helping farmers improve their brokering skills in business relationships, MAs also succeeded in developing contracts with larger processors, exporters and suppliers in domestic and international markets. In particular, the WNRDP helped to increase exports of non-traditional and organic agricultural products to Europe, mainly as a result of enabling the MAs to sign contracts with private companies in the area.[9] This proved to be the best option for a farming environment characterised by low farm-gate prices, a predominance of traditional crops and a lack of efficient marketing.

As a result of the project's support, 63 contracts were established with 56 private companies. The largest of these was with Heinz. Under the contract, which was signed in 2012 and is ongoing, Heinz buys 6,000 tonnes of tomatoes each year from some 300 farmers to process into tomato juice, ketchup and salsa. As part of the contract, Heinz provides farmers with adapted cultivars and high-quality seedlings. Initially, contracts covered only two types of crops with a total cultivated area of 12 ha and 20 greenhouses, but by September 2013 contracts covered eight types of crops with

a total cultivated area of 5,520 ha and 52 greenhouses. Thanks to successful contract farming arrangements, the existing cropping systems were diversified into more than 26 field crops, fruits and vegetables. Furthermore, the adoption of more advanced production and irrigation technologies, artificial insemination, improved management practices and greater marketing opportunities, resulted in a significant increase in crop yields and livestock production (milk and meat).

In collaboration with the USAID-funded Premium Project, the WNRDP also trained agricultural cooperatives and MAs to meet certification requirements and helped them register with GlobalGAP and Fairtrade's FLO-Cert. Through this cooperation, 1,192 farms across five cooperatives obtained GlobalGAP certification for the production of seven crops and Fairtrade certification for three crops. In 2013-14, four contracts were signed with four cooperatives under GlobalGAP and one contract with one cooperative under Fairtrade.

The six marketing associations are becoming financially self-sufficient by buying inputs at wholesale prices and selling them to their members at a reasonable profit margin, and by collecting a 1 per cent service charge from the companies with whom they sign marketing contracts. The region has been transformed into a recognised and specialised area for the production of high-value fruits and vegetables. Over 1.4 million tonnes of the region's fruits and vegetables are being supplied to national fresh produce markets, the food processing industry and export markets. In addition, over 1 million tonnes of field crops are destined for the market.

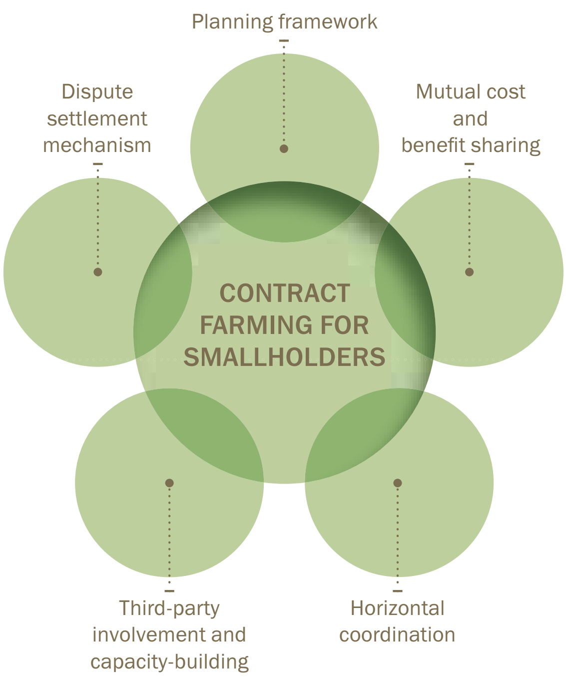
More recently, the government of Egypt requested assistance from IFAD to design another project, Sustainable Agriculture Investments and Livelihoods, in some of the newly settled lands. The government identified nearly 100,000 feddan (42,000 ha) spread over 30 new settlements encompassing around 40,000 rural households (or 280,000 people). The proposed project has been designed on the back of the WNRDP's success in establishing and strengthening rural institutions – especially community development associations and agricultural cooperatives – and aims to support water management arrangements and establish MAs with links to a variety of value chains (fruit, vegetables, aromatic and medicinal products).

LESSONS LEARNED: SUCCESS FACTORS FOR SMALLHOLDER PARTICIPATION IN CONTRACT FARMING MODELS

Markets for smallholder agriculture in developing countries are often characterised by imperfections. These can range from low levels of trust and power imbalances between suppliers and buyers to inadequate road and market infrastructure, highly volatile prices, inconsistent produce quality and a lack of reliable harvest forecasts or market information systems. Against this difficult background, CF arrangements have emerged as a powerful tool to build and strengthen self-sustaining situations that are mutually beneficial for smallholders and other market participants.

The IFAD-supported projects in Egypt and Moldova show that successful CF arrangements have great potential for generating economic growth and enhancing food security for smallholder farmers and the rural poor, as long as critical design factors are duly considered (see Chart 1) and common implementation pitfalls avoided.

CHART 1 SUCCESS FACTORS FOR CONTRACT FARMING AND SMALLHOLDER PARTICIPATION



Source: IFAD

MOLDOVA RURAL FINANCIAL SERVICES AND AGRIBUSINESS DEVELOPMENT PROJECT

In Moldova IFAD is engaged in two projects with specific contract farming subcomponents, under which it seeks to develop producers' business skills and increase input supply, marketing, technology transfers, and ultimately, income.

The Rural Financial Services and Agribusiness Development Project (RFSADP) is an ongoing project (2011-16), with a total investment of approximately US$ 40 million.[10] The project aims to help smallholders establish competitive commodity value chains by creating links with local and regional markets and promoting access to financial services. It also provides support for market research and development, business development services and the setting-up of producer associations. By linking producers (or SME entrepreneurs) to agricultural commodity chains, these types of CF-related activities seek to address the need for sustainable enterprise development, market efficiency, the adoption of new technologies and employment in rural areas.

The main findings of a CF analysis under the RFSADP recommended: (i) greater involvement of banks in tripartite agreements with producers and contractors; (ii) the formation of producer groups similar to the MAs in Egypt; and (iii) a general step-by-step approach to improving the performance of producers. In 2012 processing companies were selected as value chain drivers and technical innovation studies were conducted. According to the studies, potential partners for contract farming along the value chain (producers, processors, financial institutions, input suppliers, and so on) indicated a high degree of risk aversion towards the existing market environment and thus considered themselves rather conservative when making decisions to enter into any agreement.

In 2013 the RFSADP started working with three groups of cucumber producers (22 members with a cultivation area of 72 ha) and contracts were signed with specific production targets. From a market perspective, the potential for cucumber production and processing is high. Therefore, the project is seeking to build greater capacity among farmers to access finance and improve their production technologies in order to reach economies of scale and enter into contractual agreements with processors.

While fruit, vegetables and dairy were set as the main priorities for contract farming, the RFSADP also supported sugar beet producers in the north of Moldova. Sugar beet production is primarily based on contractual arrangements, and production must take place in the vicinity of the processing plant. A total of 11 farmers, with a production area of 3,250 ha, received support to develop their production technologies, which improved productivity, increased yields and raised product quality.

Farmers and agribusinesses in Moldova do not have a long history of operating in an internationally competitive environment. The main participants in agricultural value chains are farmers and agribusinesses that have surplus production and high-quality goods, which is attractive for buyers. However, small producers may also enter into the market if they pool their small quantities of produce and improve the quality of their goods through marketing groups, cooperatives or companies.

While Moldova has a number of producer organisations, they are not engaged in joint marketing. Instead, they provide advocacy, general market promotion and information on regulations, prices, markets and technologies. In Moldova IFAD's value chain development support – including contract farming – is through a phased approach, which is initially aimed at developing capacities, thus creating a foundation for future value chain development.[11]

The first factor for successful CF schemes is an adequate planning framework. A careful analysis of conditions such as policies, legislation, administration and infrastructure are crucial for setting up CF arrangements that are competitive in national, regional and international markets. Furthermore, CF schemes need to be adapted to local circumstances, and the relationships between different actors along the value chain must be balanced adequately. CF arrangements must also take into account existing services, specific agricultural commodities and production processes, market opportunities, and the capacities of farmers and buyers. It is also important to set up monitoring and evaluation systems at the beginning, to accommodate for lessons learned through the actual contract phase and to be able to modify CF arrangements where necessary. As evidenced by the Moldovan case study, a comprehensive situational analysis on contract farming opportunities and constraints is a necessary first step before any CF subcomponent can be carried out. The situational analysis in Moldova identified the causes and drivers of low competitiveness among Moldovan farmers. The results were fed into the development of the project's plan, which led to the creation of producer groups and tripartite agreements with banks, producers and contractors.

Mutual cost and benefit sharing can be considered a second key element for success. Whether or not smallholders can engage profitably and with low risk in modern agricultural markets depends on the willingness of private actors to engage with them, and vice versa. Contract farming is a distinct business model in which the parties aim to make profits through improved access to supplies and markets, and where the partnership is mutually beneficial for both farmers and contractors. The arrangement that lays the ground for future business relationships needs to provide all parties with sufficient incentives to comply with their respective contractual obligations.

The WNRDP connected small farmers with the entire value chain, from input supply and capacity-building (seeds, fertilisers, pesticides, drip irrigation systems, food safety certification, and so on) to packaging and merchandising. As a result of obtaining GlobalGAP and Fairtrade certifications, farmers were able to gain access to larger markets and export certified produce to foreign markets in the European Union, Turkey and the United States, in addition to selling their produce to domestic markets. This led to a nearly fourfold increase in the average yearly income to US$ 8,857 per household compared with the yearly minimum wage of US$ 2,200. Owing to the success of the project, the farmers were also able to move up the value chain, thereby gaining additional margins for many crops. For example, growing and marketing organic potatoes led to a 66 per cent increase in the farm-gate price from US$ 110 per tonne to US$ 183 per tonne. An important consideration when introducing the contract farming system is to improve producers' access to loan financing for working capital – lack of such access is identified

NOTES

1. IFAD (2014), *Reforming IFAD, Transforming Lives*, Rome.
2. IFAD (2011), *IFAD Strategic Framework 2011-2015*, Rome.
3. IFAD and Technoserve (2011), *Outgrower Schemes – Enhancing Profitability*, *Technical Brief*, available at http://www.ifad.org/ruralfinance/pub/technoserve.pdf (last accessed 9 December 2014).
4. C. Eaton and A. Shepherd (2001), "Contract farming: Partnerships for growth", *FAO Agricultural Services Bulletin No. 145*, Rome.
5. M. Will (2013), *Contract farming handbook: A practical guide for linking small-scale producers and buyers through business model innovation*, GIZ, Germany.
6. IFAD (2010), *Rural Poverty Report*, Chapter 4, Rome.
7. IFAD (2010), *Rural Poverty Report*, Chapter 4, Rome.

as a major constraint to improved production. Establishing closer links between projects and private sector partners may require considerable time and a change in mindset. With a growing market demand, the existing capacity and the use of processing plants are expected to increase. This, in turn, may create more favourable conditions for future cooperation between producers and processors.

This is why a horizontal coordination of smallholder farmers through farmer associations and cooperatives is considered another important factor for success. Such groups can negotiate more favourable agreements and they have more opportunities to realise economies of scale and share the burden of market risks. Group contracting arrangements can also support the internal handling of grievances and compliance issues. For contractors, dealing with well-established and functional smallholder groups also minimises risks, as smallholder groups are more likely to fulfil their contractual obligations than individual farmers. As evidenced by the case study in Egypt, organising groups of small farmers into MAs allowed them to compete with larger farmers and agribusinesses. Meanwhile, in Moldova the competitiveness of smallholder farmers is a major constraint because producer organisations are not engaged in joint marketing activities.

Involving third parties can further facilitate brokering links between contracting parties. Neutral actors such as IFAD can provide assistance when it comes to negotiating and monitoring the observance of CF schemes, particularly where market failures constitute a major obstacle to CF development. Neutral actors not only facilitate and advocate for the involvement of suitable agribusiness firms, but also build the capacity of local producer groups. Of particular relevance is the transfer of knowledge and technologies through capacity-building that comes with the involvement of development partners such as IFAD.

Lastly, CF schemes should also include a dispute settlement mechanism to further minimise risks, taking into account the different capabilities of the contracting parties. Based on clear contractual obligations and pricing structures, the mechanism should be equally accessible and mutually recognised by the involved business partners.

For the five factors to be mutually reinforcing and effective, they need to be underpinned by complementary and supportive institutions and partners – be it contractors and farmers, policy-makers, civil society organisations or donors – who trust each other. IFAD, as an organisation working in partnership with, and investing in, rural people, strives to facilitate and foster these CF arrangements, and is committed to scaling up those projects that have proved to be successful, as in the case of Egypt.

"If well managed, contract farming arrangements can benefit smallholder producers and agribusinesses alike."

[8] See http://operations.ifad.org/web/ifad/operations/country/project/tags/egypt/1204/project_overview (last accessed 9 December 2014).

[9] See http://operations.ifad.org/documents/654016/f24b8e29-24fc-4862-b84d-caa15c326be3 (last accessed 9 December 2014).

[10] See http://operations.ifad.org/web/ifad/operations/country/project/tags/moldova/1562/project_overview (last accessed 9 December 2014).

[11] See http://www.ifad.org/evaluation/public_html/eksyst/doc/country/pn/moldova/moldova_full.pdf (last accessed 9 December 2014).