



“Pingado Dilemma”: Is formal contract sweet enough?



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ABSTRACT

“Pingado” is a Brazilian beverage similar to cappuccino, macchiato. For a good “pingado”, coffee and milk should be of good quality. The formal institutions ensure the minimum attributes of quality for coffee and for milk in Brazil. However, in order to reach consumer desirable quality attributes for a differentiated “pingado” the transactions between farmers and agroindustry in quality-driven systems is likely to be conducted with hybrid forms. Thus, “Pingado Dilemma” involves the interactions between private and public institutions affect the combination of formal and informal governance mechanisms in transactions, in both chains, and involve complexities in terms of obligations to do and obligations to give in contract farming. This paper aims at analyzing the contract farming and the role of public and private institutions in transactions between farmers and agroindustry in Brazilian high-quality dairy and coffee chains. The research design used in this study is a case study based on multiple cases. The results indicate that while in dairy chain the private institutions reinforce public requirements (formal institutions), for the coffee sector, the role of private institutions is to establish and guarantee a new level of quality and differentiation. Interactions between private and public institutions affect the combination of formal and informal governance mechanisms in transactions, in both chains, and involve complexities in terms of obligations to do and obligations to give in contract farming.

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1. Introduction

Globalization and recent transformations have affected agrifood sector, implying the emergence and consolidation of private standards and the modernization of procurement system (Swinnen and Maertens, 2007; Reardon et al., 2009). Transformations in agrifood chains have implied the emergence of contracts in transactions between small farmers and processing companies (Reardon et al., 2009). Such changes, on its turn, have influenced small farmers, bringing incentives or farmers' exclusions from market (Reardon and Farina, 2002; Henson, 2008; Reardon et al., 2009).

The possibility of differentiation and value adding for farmers in high-quality value chains indicates an important path to promote sustainable growth and the improvement of the income-earning capacities in rural areas. According to Kaplinsky and Morris (2001, p. 25), “(...) the search for sustainable income growth

requires producers to position themselves precisely in non-commodity (...) activities in the value chain”. Nevertheless, it requires the consideration of power and governance relations for value distribution along the chain, especially when it comes to poor and developing countries (Fitter and Kaplinsky, 2001). Thus, appropriate governance structures are important not only to guarantee high quality attributes along the chain, but also to promote the share of value-chain rents and returns to differentiation efforts to poor producers, favoring rural development (Fitter and Kaplinsky, 2001; Maertens and Swinnen, 2015).

High-quality value chains tend to comprise the combination of public and private institutions, demanding higher levels of coordination and the adoption of more complex transaction mechanisms, *vis a vis* commodity chains. Differentiation and high-value chains tend to demand more active chain governance (Fitter and Kaplinsky, 2001; Gereffi et al., 2005; Maertens and Swinnen, 2015). In Transaction Cost Economics approach, it means more complex governance structures (Williamson, 1985), sometimes toward contract farming or even vertical integration (Maertens and Swinnen, 2015). In this context, Trienekens et al. (2012) highlights

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the right balance of formal (contracts) and informal (agreements, trust, commitment and reputation) governance mechanisms as a challenge in complex dynamic food supply chains. According to [Maertens and Swinnen \(2015\)](#), the way contract farming is arranged determines the degree in which small farmers will be integrated to global chains. Thus, contract farming consists on an important mechanism that may include or exclude small farmers, affecting rural development.

Coffee and milk productions are typically developed by small family-based farmers in Brazil. Thus, understanding the mechanisms of governance in high-quality coffee and dairy chains, as well as the role of public and private institutions, seems to be of great importance to analyze chain performance and rural development.

“Pingado” is a traditional Brazilian beverage composed of milk with a coffee drop. Beverages alike are very popular worldwide with different names, such as cappuccino, mocha, macchiato, and so on. For having a good “pingado”, coffee and milk should be of good quality. For food, quality is not limited to safety, although these terms can be confusing. According to [FAO and WHO \(2003\)](#), quality includes attributes that influence the product's value to the consumer. This includes negative and positive attributes. Negative attributes can be considered contamination with filth, discoloration, off-odors, amongst others; positive attributes are the origin, color, flavor, texture and processing method of the food.

Public and private institutions play an important role in governing quality attributes, such as those concerning food safety, food quality and social and environmental aspects ([Giovannucci and Reardon, 2000](#)). Globalization and trade transformations have raised discussions about the role, the complementarities and the interaction of public and private standards in agri-food systems. Private standards are taken as important mechanisms to fulfill public standard gaps, to enable differentiation and to support chain governance in developing countries, including in Brazil ([Reardon and Farina, 2002](#)).

In terms of coffee, high-quality product is desirable for a good “pingado”, such as a specialty coffee, instead of a commodity one. According to the Specialty Coffee Association of America – SCAA, a specialty coffee in its green state must be free of primary defects, free from unclean odors, properly sized and dried, and must present a cup free of faults and taints and have distinctive attributes ([SCAA, 2017](#)). In Brazil, the designation of specialty coffee follows SCAA methodology, which is a private institution. The Brazilian Specialty Coffee Association – BSCA - also considers certified origin, organic, fair trade and “gourmet” coffee as specialty coffee ([BSCA, 2017](#)).

In terms of milk, the legislation (public institution) states that it should be produced under the sanitary rules (NI62), which ensure microbiological safety. However, the production of high-quality milk usually transcends the public rules requirements, comprising higher microbiological and sanitary standards, as well as higher levels of protein and fat. Thus, interactions between private and public standards prevails in those systems.

In order to coordinate and guarantee required quality, transactions between farmers and agroindustry performed in dairy and coffee chains is likely to be conducted with hybrid forms, as contract farming, or vertical integration.

Under the consideration of: (1) the complex interaction between private and public institutions in food supply chains, especially when it comes to high-quality chains; (2) the emergence of contract farming in developing countries, especially in high-value chains; (3) the need for balance of formal and informal governance mechanisms in transactions between farmers and downstream agents; and (4) the role of governance structures in promoting value distribution and sustainable growth for small farmers in developing countries; the research problem conducting

this study is: “how is contract farming presented in transactions between farmers and agroindustry in high-quality coffee and dairy chains in Brazil?” In this sense, this paper analyzes the contract farming and the role of public and private institutions in transactions between farmers and agroindustry in Brazilian high-quality dairy and coffee chains.

This article is organized in five parts. Following the introduction, the second section presents the theoretical background, based on New Institutional Economics, Transaction Cost Economics and contract farming. The third section presents the methodology adopted to reach this paper's purposes. The fourth section describes the results, an overview of institutional environment for coffee and milk, the hybrid governance structure and multiple case study description. The fifth section outlines the final remarks and research agenda.

2. Theoretical background

The analysis of hybrid forms in this paper, specifically considering contract farming, is based on New Institutional Economics (NIE) and its micro analytical branch of Transaction Cost Economics (TCE).

The institutional environment establishes the “rules of game” that influence the agents' behavior for governance structure choice. According to the New Institutional Economics (NIE), formal institutions (constitutions, laws, and property rights) and informal institutions (taboos, customs, traditions, and codes of conduct) are taken into account, which compose the institutional environment ([North, 1990](#)).

Institutions are devised to reduce uncertainty and to create a favorable environment for decision-making process to the exchange of goods and services ([North, 1990; 1991; 2000](#)). Formal institutions facilitate trade and the conflict solutions, which are relied on centralized third party, such as arbitrations and judges. In terms of informal institutions, the conflicts are carried out through private parties in a decentralized mode ([Aruñada, 2001](#)). Private participants in the exchange of goods and service guarantee the adaptation required from changes ([Jannarelli, 2012; Ferrarese, 2002](#)).

Informal institutions interfere in the coordination process of agricultural production; reduce uncertainties in trade of agricultural goods and services; and guarantee for contract performance through self-enforcement ([North, 1991; 2000; Stzajn et al., 2005](#)). According to [Azevedo \(2000\)](#), informal constrains are present in agricultural transactions in many different ways. Although informal institutions are important to the market by providing flexibility for economic agents involved in agricultural production system, State interference with formal institutions is important to carry out more impersonally exchange of goods and services ([Keefer and Shirley, 2000](#)).

Institutional environment is also considered as a combination of public and private institutions ([Henson and Humphrey, 2010](#)). Private and public institutions coexist and are complementary instruments, providing more efficient outcomes than the use of one type of institution isolated ([Klein, 1992; Lazzarini et al., 2004; Watanabe and Zylbersztajn, 2014](#)).

Once institutions facilitate economic exchange, transaction costs are reduced, enabling the system to work more efficiently. For [North \(2000\)](#), transaction cost is the cost of specifying and measuring the characteristics of what is being negotiated and the cost of forcing the contract performance. In Transaction Cost Economics (TCE), the concept of transaction cost refers to a less costly process of contracting and its *ex-post* alignment ([Williamson, 1990](#)). Economizing transaction cost means achieving the lowest cost of making the economic system work, which is the cost of planning,

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