

## ROLE OF FARMER COMPANIES IN THE SRI LANKAN RURAL ECONOMY

By

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### Abstract

*Commercialization and diversification of agriculture and agro-industries are necessary for Sri Lanka to achieve its goals of income, employment, and food security'. But this process should not lead to a dynamic and commercialized agriculture with stagnating or marginalized peasants. Instead, the small farmers, who form an overwhelming majority of the country's population, should actively participate in the proposed agricultural transformation. To maximize the benefits derived from economic liberalization, creating the basic conditions/environment required for a market economy is necessary. Market imperfections—including manipulation and corruption in markets related to small farmer production should be corrected. Exploitation occurs in an environment where perfect conditions for economic liberalization do not exist.*

*It is argued that farmer companies can tangibly address these issues while capturing economies of scale, producing competitive economic ventures, and harnessing the skills of educated youth in the small farm sector. Unlike in the Sri Lankan cooperative sector or in farmer organizations (FOs), in farmer companies the shares are marketable and there exists a direct association between equity participation and voting power. Moreover, farmer companies are less susceptible to political, bureaucratic, and other pressures. Based on the experience of the Shared Control of Natural Resources (SCOR) Project in Sri Lanka, it is argued that FOs can justify their existence within the farmer company framework.*

### Introduction

Sri Lanka's future prosperity depends heavily on the practical approaches the country adopts toward modernization and industrialization as fast as possible. The development strategies to achieve this end, perforce, have to take off from its agricultural base which still covers as much as half of the country's population. In 1996, agriculture contributed 18.8 percent to the nation's Gross National Product, GNP, and recorded a 39 percent share of

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employment (CBSL 1996). Nearly 80 percent of people live in rural areas. As these are predominantly agricultural areas, modernization and commercialization of agriculture and agro-based industries could substantially contribute to the employment and income goals of the country and this, in turn, would help maintain rural-urban migration at favorable levels.

During the colonial period, economic development in general, and agricultural development in particular, were biased toward export-oriented large-scale plantations in the wet zone. Since independence in 1948, food and employment goals have largely determined the basic trends and tenets of development policies which were focused mainly on the improvements in the domestic sector, especially in the dry zone, through the acceleration of investments in irrigated agriculture and associated human settlements. These investments contributed significantly to the dual objectives of food (especially rice) self-sufficiency and increasing employment. Hundreds and thousands of poor, who would have been otherwise unemployed, benefited from these investments, especially in the irrigated agricultural settlements.

However, the performance of most existing irrigated agricultural production systems in Sri Lanka, despite very high costs of construction, has fallen short of expectations and these systems are characterized by low intensity of land use, inefficiencies in water distribution, and rapid deterioration of delivery systems. In both irrigated and rain-fed areas, competing uses of limited resources have not only resulted in the degradation of the production base, but have also led to social conflicts and organizational/institutional problems.

In irrigated areas in the dry zone, key determinants of rice production such as yield level, areas cultivated, and cropping intensity did not show clear rates of growth (Wijayarathna and Hemakeerthi 1992) and the profitability of major non-rice crops shows a declining trend (Wijayarathna et al. 1996). Nevertheless, when all crops were analyzed as import substitutes the results clearly showed that rice as well as other major crops had a comparative advantage for local production (Wijayarathna et al. 1996).

It is argued that a great deal of diversification and commercialization is necessary both in irrigated rain-fed areas of the dry zone and in the small farm sector of the wet zone. Such a process should not lead to a dynamic and commercialized agriculture with stagnating or marginalized peasants. This is important because the average of over three fourths of agricultural holdings in the country is below 0.8 ha. Unlike in the pre-independence era, in the plantation sector too smallholders constitute an overwhelming majority. Therefore, Sri Lanka's agriculture sector should make substantial progress, especially with active participation of small farmers to shift them from a state of poverty and underdevelopment to one of increasing prosperity. They can and will provide reasonably priced food for the increasing population while also earning foreign exchange through exports. To take-off for this transformation, the new agricultural and agro-industrial development policy, in line with the declared policy of the government to broad base the benefits accruing from an open economic policy, recommends to restructure the institutional base of production and related services. It is in this context that this paper examines the role of farmer companies in Sri Lanka.

## Small Farmer and Market Economy

As mentioned in the introduction, in a developing country where agriculture dominates, the performance of the economy would largely depend on the ability of agriculture to move ahead. This "in turn is determined by the pace at which the rural people respond and adjust to growing integration of village economies with the larger national economy. It is necessary to keep in mind this human dimension of agriculture as liberalization would make it even a more critical determinant of agricultural and rural development" (Rao 1996 p.A-52).

In India, despite the fact that agriculture has diversified and commercialized in the recent past, the number of marginal and small farmers has increased and there is a tendency for new entrants — "gentlemen farmers" and the corporate sector — to displace traditional farmers. Commercialization tends to expose marginal farmers to enhanced market risks and it is recommended that these risks be monitored and appropriate institutional and infrastructure supports extended (Nadkarni and Vedini 1996).

Liberalization not only leaves economic activities open to the market forces but results in a substantial withdrawal of the government interventions.

In a free market economy, every scarce resource is expected to command a price, which is determined by demand and supply forces. It is the profit motive that will guide the operation of this market system. Unjustifiable profits will be eliminated (through perfectly competitive markets) and the resources will be allocated rationally to produce a particular good at its lowest cost. If a producer fails to do so he/she will find his/her earnings decline, even to a point where he/she will be forced out of business by competitors.

To maximize the benefits derived from economic liberalization, the country will have to create the basic conditions necessary for a market economy. These include: perfectly competitive producers, full knowledge of prices and other relevant facts (which are associated with an efficient and transparent information system), adequate knowledge of relevant technologies and most efficient allocation of resources, a large number of firms not only in production proper, but also in input and output markets, unrestricted entry and exit, homogeneous products, easy mobility of factors, etc. The applicability of this basic economic theory to the Sri Lankan agricultural situation is yet to be tested and established.

On the proposals for reducing farm price support levels in the United States (Claudius 1960) argues that perfect competition is neither an adequate model nor an appropriate norm for agriculture, as its assumptions can lead to a conviction that getting the government out of agriculture is an end to be sought as perfection itself. These assumptions insinuate (a) market conduct and performance characteristics are such that market prices are equal to cost including normal profit, and (b) the production adjustments within and among agricultural production units through unrestricted entry and exit are such that supply and demand become equal at satisfactory prices. Implicit in this is that any displacement from equilibrium brings about automatic, swift, and precise restoration of equilibrium again at

prices covering the costs, including normal profits in the agriculture sector. Eventual equilibria are presumed to be consistent with an optimum allocation of natural resources, most efficient production, and payments to factors in accordance "with what they are worth" (Bandusena 1997).

The macro economic perspective related to this issue involves even higher risks. On a review of the liberalization experiences in Argentina, Chile, Brazil, and New Zealand, Valdes (1995) concludes that the highest risk for agriculture comes from the fact that getting inflation under control in most countries takes many years because (i) stabilization programs often lead to very high real interest rates, which adversely affect agriculture, (ii) the exchange rate is often used as a tool of stabilization and the real exchange rate appreciates sharply, thus reducing the competitiveness of agriculture, and (iii) in cutting spending to reduce the government deficit, since governments often cut spending on infrastructure and other public goods required for agricultural growth. Sri Lankan agriculture has little room to avoid this risk.

Moreover, it is not easy for hundreds and thousands of small farmers to exit from agriculture. An adequate "pull force" is required to provide realistic alternatives and to absorb the displaced. In addition, vast information asymmetries exist in regard to agricultural input/output markets in the country. Manipulations and corruption in markets and difficulties in creating a perfectly competitive environment, etc., are notorious.

### **Agrarian Value System**

The discussion in the previous section leads to the conclusion that the environment necessary for market forces to yield benefits (desired by the market economy) should be considered in designing a path to economic liberalization. A related important issue of concern is the agrarian value system prevailing in rural Sri Lanka. A detailed discussion of this subject is beyond the scope of this report. The value system consists of several features which are relevant to those who design/facilitate competitive markets in the agrarian sector. First, a large number of small farmers consider farming as a way of life and as a family enterprise. They would prefer to minimize "shocks" and risks. Given that farming is the predominant form of employment in rural Sri Lanka, it is quite natural that farmers are reluctant to take risks. But commercialization and modernization are associated with input and output profiles that are widely different from existing patterns and are associated with risks.

Similarly, concerns related to equity and resources conservation can also be quoted as important characteristics of rural agrarian value systems.

### **Countervailing Power**

In competitive markets there will be many sellers as well as buyers, each with a small share of the total market. This can be identified as a "check" on the private exercise (or "exploitation") of selling or purchasing power by certain firm(s). Such a check is provided by other firm(s) on the same side (sellers' side as well as buyers' side). However, at the expense of weak suppliers or customers, one or a few firms may establish a strong market position. This in turn may disturb the most efficient operation of the economy. Under such

circumstances, it may be healthier if the firms on other side exert pressure to improve the competitiveness of the market. Introducing countervailing power Galbraith (1962, p. 11) stated "with the widespread disappearance of competition in its classical form and its replacement by a small group of firms if not in overt, at least in conventional or tacit collusion, it was easy to suppose that since competition had disappeared, all effective restraints on private power had disappeared..... In fact, new restraints on private power did appear ..... but they appeared not on the same side of the market but on the opposite side, not with competitors but with customers or suppliers ..... and I shall call it countervailing power".

In the case of agriculture, "the farmer was often made to pay clearly for his lack of market power. It was this that led him to search long and hard for a formula for expressing effective countervailing power" (Galbraith, 1962 p.155). Instead of trying to destroy the monopolistic or oligopolistic powers of those to whom they sell (or from whom they buy), farmers can build their own market power.

### **Farmer Companies in Production and Marketing**

Production inputs such as credit, seeds, fertilizer, and technical information must be available at reasonable effort and cost. The total cost to farmers, particularly to small holders, often includes a high proportion of "transaction costs," monetary and non-monetary payments associated with obtaining necessary approvals, ensuring timely availability of inputs, etc. Some of these input constraints as well as costs can be reduced through organized group action. Two aspects are important here:

1. The ability to organize group action thereby achieving economies of scale, and
2. The availability of support services and access to inputs.

It is argued that the integration of the small farmer production process with the process of (value addition and) marketing can be done in a cost-effective and an efficient way if the small farmers are organized into companies. If the production units/farms are sufficiently large, then direct buying by retail chains and processors from producers could reduce losses, improve market efficiency, increase farm profits and serve the consumers effectively. However, in countries such as Sri Lanka where a large number of small farmers are operating in tiny holdings dispersed over a large geographical area, the condition is different. Such a condition poses difficulties even to the middlemen in capturing economies of scale or the benefits of specialization. Inadequacies in knowledge and information on competitive markets, higher transportation and handling costs, inadequate access to credit, and lack of organization (that are a precondition for achieving economies of scale in collection, handling, storage, transportation, etc.) have compelled small farmers to sell their products in local markets or to middlemen, immediately after harvest. The marketing margin or the difference between the price received by the farmer and the consumer price at distant central markets far exceeds the transfer costs (and justifiable profits). Moreover, the existing process contributes significantly to post-harvest losses. It is argued that farmer companies, as a facilitating organization can guide (through forward contracting, maintaining collection/

bargaining centers and warehouses, etc.) and participate effectively in the procedures of trading so that competitive pricing results.

### **Credit for Economic Ventures**

An analysis of the credit market of the Indian peasantry revealed that "borrowers' tangible assets and income act as entitlement or vehicle to credit markets." Then the only sustainable means to increase poor farmers' access to the institutional loan market would be to enhance the size of their "entitlement set." Given the status of the poor/small farmers, this would only be possible provided they form groups (Basu 1997, p.276). Such group action would also eliminate the problem of economies of scale and reduce transaction costs as well as the risk of credit agencies.

The problem in the current practice of the provision of credit directly to the individual users through state-sponsored programs has several dimensions.

First, the current practice has proved to be unsustainable since it breeds defaulters with the end result of writing off loans by political processes. Second, it does not lead to recognizing the importance of improving user's creditworthiness that could lead to action improving credit rating of the individual user. Third, it does not recognize the important transactions with user organizations dealing with viable economic ventures in which the individual users are a part. Fourth, it demands certain types of collateral that small-scale users find difficult to produce. Fifth, it involves time-consuming and complex processes through "red tapes" of bureaucracy. Sixth, it incurs heavy administration costs. Because of such costs and high rate of default, the interest rates, if not subsidized, are exorbitantly high. This is true for some existing banking systems as well. The subsidized credit programs of the government take the form of a relief or rescue operation to small farmers but they would be a burden on the government budget.

These deficiencies do not facilitate the emergence of a production environment that would motivate users to engage in profitable economic ventures in an open market setting.

The concept and strategy of the Shared Control of Natural Resources (SCOR) Project for integrating conservation and production recognized that credit to natural resources users should finance/supplement an economic venture. This recognition hypothesizes that a demand would be created for:

- organization, such as a farmer company, where small-scale users could collectively plan their individual economic ventures, and use community action on discipline for credit repayment
- information on technologies related to crops of comparative advantage, processing/ value-added, markets, transport, legal contracts, banking, etc.
- mechanisms among lending institutions to lower transaction costs, and offer better packages of support with relaxed procedures in supply of credit

It is hypothesized that such a demand could activate processes of supplying such support which itself will generate much complementary activity that would enrich production planning and scheduling, forward contracts, exploration of new markets, and other diversified economic activities. Based on such productive activity, the state could provide support where necessary to user organizations or companies to receive loans (or grants at the take-off stage of the company/organization, which will eventually be rotated among organizations or companies which are at "infant" stages) that would be used as collateral to raise bigger packages of credit from lending sources. SCOR provided such grants to be used as collateral utilizing the project's sub-grant component.<sup>2</sup>

### Economic Welfare Effects of Farmer Companies

Total transaction costs can be subdivided into costs incurred by several categories of "actors" involved in the agricultural activities from production through marketing. Other things being equal, the average transaction cost decreases as the size of the transaction increases (economies of scale); as the dependency of shareholders on the company (say for transport, etc.) and the diversity of transactions reduce to a single scope (economies of scope). Let us assume that there are  $n$  farmers. The supply function of the region (covered by company) can be obtained by aggregating the individual functions of  $n$  farmers. Let the transaction cost (at the margin) of a farmer before affiliating into a company be  $\alpha_i$ . If the farmers are to incur the transaction costs as individuals, the aggregate cost would be  $\sum \alpha_i/n$ . It is assumed that by capturing economies of scale, the transaction costs of the farmer company (a) would approach  $\bar{A}a_i/n$ . Then the changes in welfare or the net gain as a result of company formation can be illustrated as in figure 1, and are derived as follows :

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2 In SCOR, for each selected sub-watershed, a participatory resources management "mini project" was formulated. The mini project aims to change the present land and water use pattern to a more profitable and diversified resource use, combining production and conservation using appropriate technologies/ techniques, novel shared control arrangements, and methods of resource augmentation (e.g., conjunctive use of rain water, tank water and groundwater, and conservation farming, water harvesting, etc.). New commercial enterprises and conservation practices in a typical sub-watershed in the SCOR experiment in the Huruluwewa watershed include: integrated wet and dry season water management in command areas (e.g., water-saving techniques to improve cropping intensity, and introducing short-duration commercial crops in the dry season, cultivation of medicinal plants, fruits and vegetables in chena, processing industry for medicinal plants, stabilized cropping patterns for chena and highlands, contour bunds to cover the entire area, water harvesting techniques, etc.). This means that the villages in such pilot sub-watersheds have "action plans" that guide them along a path to the planned future from the current status of resources use. The banks have agreed to provide a loan four times larger than the SCOR grant for the user organization using the grant deposit as collateral. In many cases, production enterprises and production scheduling are linked with firm plans of output disposal. For example, in some cases, Colombo-based private companies as well as State agencies offered forward contracts to the farmer companies to purchase most of the expected produce under "mini-projects."

For a viable "mini project," SCOR provides one-third or one-fourth of the total external funding requirement. The farmer organization/company negotiates (with the assistance of SCOR staff) with the bank and gets the balance (2/3 or 3/4) as a loan. The farmer organization/farmer company deposits the SCOR grant in the bank and this (money "frozen" in the bank) is accepted as the collateral for which the farmer organization/company earns interest. Hence, the effective interest rate is less than the market rate. This is useful for the farmer organization/company at the initial "take-off" stage.

- $S_0$  : Supply curve derived by aggregating the supply curves of farmer shareholders
- $S_1$  : Supply curve of the farmer company
- $P_0$  : Market price
- $Q_0$  : Equilibrium quantity without the farmer company
- $Q_1$  : Equilibrium quantity with the farmer company
- $D$  : Perfectly elastic demand curve (the most unfavorable to producer)
- $\alpha_1$  : Transaction cost of individual farmers
- $\alpha$  : Transaction cost of the farmer company =  $\Sigma \alpha_1/n$

**Change of welfare analysis**

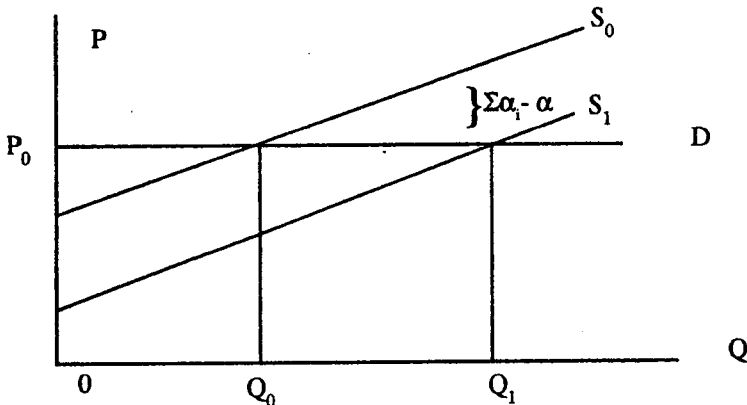
Producer surplus, pre-farmer company situation = a  
 Producer surplus, with farmer company = a + b + c  
 Change of welfare = (a + b + c) - a = b + c,  
 where b + c > 0

(Producer surplus : producers' willingness to accept below the equilibrium price)

**Cooperatives, Farmer Organizations, and Farmer Companies**

The history of farmer organizations in Sri Lanka goes back to ancient times. In the early post-independence era, the institution of Vel Vidane (irrigation headman), established during the British colonial period, was continued. The Vel Vidane was appointed by the government and was given power to execute decisions for the operation and maintenance of minor irrigation systems. In the late fifties, the institution of Vel-Vidane gave way to an elected committee of farmers known as the Cultivation Committee. This institution dealt with nonirrigation (yet agricultural) functions as well. In the early seventies, Agricultural Productivity Committees (APC) were established to oversee the work of the Cultivation Committee. Later on, these were abolished and a new institution known as the Agrarian

*Figure 1. Welfare gains through farmer companies*



Service Center was established. These centers are being re-organized at present and Agrarian Development Councils are being established at this level. At the lower level, there are over 10,000 farmer organizations, country-wide.

Certain farmer organizations emerged as forceful pressure groups and they manage to organize water distribution, input supply, and, in a limited way, sale of production. The fact remains, however, that a major breakthrough was not seen to ensure small farmer's economic and social well-being through profitable economic ventures. The farmer continued to be the victim of the vagaries of weather, as an individual. The absence of a combined set of interventions to promote year-round cropping, crop scheduling, value-added production and other agro-industries, market links in the form of forward contracts of sufficient scale as profitable business for farmer organizations, the absence of procedures for decision making in the implementation of trade policy sensitive to farmers promoting partnerships between farmer organizations and the organized private sector as well as between state and farmer organizations — all these remained obstacles. On the other hand, farmer companies have better legal power and recognition and are readily accepted by the organized private sector. This is important for business ventures. For example, farmer companies could establish legal contracts with organized private sector companies for forward sale of agricultural products. Moreover, farmer companies are independent business organizations which could avoid political and other problems. Investments through farmer companies can produce competitive economic ventures for which a necessary condition will be the partnerships with the organized private sector and the State. Further, one of the biggest national riddles, for which a sustainable solution has not been found by any government with continued donor assistance, is the inadequacy of income earning opportunities for the landless rural youth. Farmer companies can tangibly address this issue and also harness the skills of the educated youth in making most of them important actors in profitable business.

Cooperatives, on the other hand, are “associations of persons with common needs, who join hands for self-protection, promote social cohesion, encourage individual initiative through collective actions. Cooperatives have an ideological base, economic objects, and a social approach. They are based on social parity and equality” (Dwivedi 1996, p.714). The concept of cooperatives was born in England in 1844, in the environment of a free economy to protect consumers' against exploitation by the traders. It can be argued that exploitation occurs in an environment where perfect conditions for economic liberalization do not exist.

“Even today in the highly market-oriented countries like the USA, Scandinavian countries, Japan, etc., cooperatives play a significant role in influencing markets. In the USA, for example, cooperatives annually account for nearly 70 percent of fluid milk, 80 percent of fresh fruit, 35 percent of agricultural credit of all types, 30 percent of grains, oilseeds and a major share in the rural electrification production, transmission, and distribution; the bulk of fertilizers and petroleum is handled by the cooperatives. Similarly, in Japan, cooperatives are fairly strong in the field of agriculture, consumers, fisheries and forestry” (Dwivedi 1996, p.723).

In companies, shares are marketable. Therefore, shareholders are interested in speculating potential gains from buying or selling stocks. This in turn could provide an

incentive for them to monitor the performance of their firm. In cooperatives or farmer organizations, shares, in general, are non-tradable. Moreover, unlike in companies there is no direct association between equity participation and voting power. Usually, as in the case of Sri Lanka, cooperatives and farmer organizations are comparatively more susceptible to political, bureaucratic, and other pressures.

Farmer organizations and farmer companies are expected to perform different roles at different levels and it is maintained that the farmer organizations can justify their existence within the farmer company framework. The major attributes of farmer organizations and farmer companies, as experienced in the Shared Control of Natural Resources (SCOR) Project (see next section) are :

- i) Farmer organizations. Useful as an initial/preparatory step for collective functioning with conservation oriented production activities; one vote for each member; device for collective operation rather than an economic organization; and largely dependent for success on the maximum participation of a great majority of (if not all) members
- ii) People's companies (aimed at small farmer development for active participation in production and resources conservation). Can take the natural resource endowments and technology into consideration in an economically and socially optimal manner; can go for relatively larger investment scales; have vote for x number of shares; can afford to invest in indivisible capital intensive service functions, yet opening equitable opportunities for a given member to benefit; operational device and an economic organization; and can afford to bargain at the market. In people's companies farmers can rely on selective participation and individual farmers have:
  - ownership advantages (right of farmer to do business with the company)
  - internalization advantages (avoidance of search and negotiation costs, etc.)
  - competitive advantages in generative businesses and shared businesses over farmer organizations, where the latter have to rely on coincidental businesses (Bandusena 1977).

#### **Process of Establishing Small Farmer Companies -- Experience of Shared Control of Natural Resources (SCOR) Project**

Shared Control of Natural Resources (SCOR) Project is a collaborative effort of the Government of Sri Lanka, United States Agency for International Development (USAID) and the International Irrigation Management Institute (IIMI). SCOR, in collaboration with the Ministries of Irrigation, Power and Energy; Agriculture, Lands and Forest Resources; Fisheries; Plantations and several government and nongovernment agencies and the organized private sector, has been testing methodologies to increase sustainable productivity of

land and water resources in Huruluwewa and Nilwala watersheds in Sri Lanka. SCOR hypothesizes that, the small farmers/resources users, if organized — as groups of organizations or companies — with an appropriate package of technology (crops, cropping patterns, conservation measures, value-addition, etc.), policy (for example adequate usufructuary rights), and resources linked with markets, will increase and sustain productivity of land and water resources (in a watershed context) while making profits. Such gains will motivate the users for market-oriented conservation. In short, SCOR assumes that “organized user efforts can produce viable economic ventures in conservation-based production.” In this approach and with the assistance of SCOR professional staff and the Government of Sri Lanka, the beneficiaries address the question of how they (the small farmers) can coexist in a market economy, by combining technology, organization, resources, and policy in managing resources for productive and profitable ventures by farmer companies.

In facilitating endeavors responsive to the government policy, SCOR Project assists farmers of Huruluwewa and Nilwala watersheds to “produce for identified markets” using the methods mentioned above. Forming farmer companies as an organizational arrangement is promoted by SCOR to test the possibility of the small farmers to pool resources through profitable business ventures.<sup>3</sup>

Based on SCOR experience, five major stages can be identified in the process of establishing small farmer companies in Sri Lanka :

- venture seeking stage
- company formalizing stage
- market links building/expanding stage
- (strategic) planning for long-term sustainability
- sustainable business operations (high degree of autonomy and self-reliance)

### **The Need for Market Facilitators/Catalysts**

At the initial stages of this process, SCOR staff performed the functions of a change agent/catalyst as well as a market facilitator. The role of a catalyst/market facilitator is outlined below:<sup>4</sup>

1. Identify and estimate market potential for selected agricultural enterprises (crops, livestock), fisheries, etc. For scheduling production in a given farmer company the initial role of the market facilitator would be to inform the farmer company and other technical officers (such as the Agricultural Instructor, relevant officers of the

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3 SCOR Project employs a professional team comprising consultants and specialists in agricultural production, conservation, marketing, and institutional building, living in the field and working with the farmers and their organizations. At present, the project has at least one of its production and conservation practices in about 12,000 hectares of lands involving 14,000 farm families, 40 farmer organizations, 4 service organizations, and 3 farmer companies in 30 sub-watersheds in 2 watersheds.

4 This was required at the “take-off” stage. At a later stage, farmer companies will employ their own staff for such purposes.

- Departments of Agrarian Services, Irrigation Department, etc.) of the availability of markets for enterprises that would match with the agro-climatological and socio economic conditions of the area.
2. Estimate the production of these selected enterprises jointly with the farmers and then arrange for forward contracts with identified markets/buyers. In this way, the facilitator will link the producer groups/companies/organizations with potential markets/private sector firms. This process will include market surveys and discussions with buyers and farmers, providing market information to the farming community, training farmers on the required quality, quantity, and grading, and other aspects expected by the buyers, etc.
  3. Monitor the feasibility of meeting the contractual agreements by the farmer organizations/companies. For this, he/she will join the local staff of government agencies such as agriculture, plantation, and agrarian services in checking, on a monthly basis, whether there are any constraints faced by the farmers in the production process which may affect the quantities and quality standards included in the forward contracts or other agreements. If the organization or company is unable to produce the required amount, this will be known in advance (based on monitoring information) and the market facilitator will assist the company, purchasing the balance amount from other areas of the country to meet the contractual obligations. The monitoring process will be a joint exercise involving farmer organizations/companies.
  4. Arrange for expert advice as well as other needs of the organization/company. These will include all aspects of marketing such as storage, cropping, packing, transport, etc. The objective is to evolve the required business mode of operation within the organization/company.
  5. Be accountable to the producer's organization/company. During the pilot phase, the market facilitator will be paid by the project. However, the performance of the facilitator will be evaluated jointly by the farmers and the government or the respective facilitating agency from time to time. After 2 years, the facilitator is expected to be absorbed by the organization, or the company will select and employ someone else.

Major activities undertaken (or planned) under each one of the stages of the process of company formation is briefly discussed below with special reference to the Huruluwewa Farmer Company (HFC) facilitated by SCOR.

#### **Venture-Seeking Stage**

SCOR experience suggests that it would be difficult to establish a farmer company just by persuading farmers to contribute share capital. A great majority of members of the farming community operate at subsistence level and therefore, at the outset, the market facilitator, other technical staff, and farmers may select a few enterprises which have a good market potential.

For example, the Huruluwewa Federated Farmer Organization (HFFO), with assistance from the Irrigation Management Division, Irrigation Department, staff of other line agencies such as the Department of Agriculture, launched a water management program in the wet season of 1994/95 and saved water for the next dry season. SCOR facilitated this process.

Next, SCOR provided information on the market potential, enabling the farmers to select a cash crop (soybean) for the dry season and arranged, in consultation with HFFO, a market link between HFFO and a private company (Thriposha Ltd.) that provides soybean to the Ministry of Health to be used in a country-wide nutrition program. The underlying assumption is that forward contracting systems can help small producers to minimize fluctuations of income due to undesirable changes in price which could be caused by factors such as seasonal changes in weather (which could lead to surplus production that would lower the price), and corruption and malpractices in the output market, etc.

Production scheduling and other arrangements for cultivation, harvesting, collection, storage, transport, and other post-harvest operations as well as monitoring were conducted jointly by HFFO, line agencies, and SCOR staff. With SCOR assistance HFFO obtained two loans, each amounting to Rs. 4 million, from a state bank (People's Bank) and from the Ministry of Agriculture, Lands and Forestry Resources.

Farmers received Rs 20/kg, a price which is about 50 percent higher than the normal farm-gate price (offered by intermediaries). In general, activities during this initial stage could be identified as follows :

- Review current income/profit generating activities and identify new activities with high market potential.
- Arrange (sign) forward contracts.
- Arrange for production planning, input supply, credit, other production-related activities, and monitoring and evaluation.
- Monitor production and arrange for post-harvest requirements as per contract.
- Motivate farmers/farmer organization to build up initial share capital (or pool part of profit earned from business).

#### **Organization Formalizing Stage**

The HFFO initiated dialogue on the formation of a farmer company. SCOR facilitated this process and provided technical inputs. The total accumulated capital was Rs 1.4 million (each farmer allocated Rs 2 per each kilogram of soybean sold, to purchase company shares). The Huruluwewa Farmer Company was registered by the Registrar of Companies, under the Company Act on July 03, 1996. By this time the company had a constitution or memorandum of articles, a board of 7 directors, etc. Subsequently, the company recruited a manager. The general steps in this stage included :

- determine geographical area/membership partners/shareholders
- build up share capital
- establish constitution or memorandum of article to elect the board of directors
- register the company (legalize the company)
- appoint a manager

### **Building Stage of Market Links**

Subsequently, HFC initiated several business ventures including a sales center for agricultural inputs and produce. The steps/activities at this stage would include :

- negotiate for forward contracts
- negotiate for partnerships for business
- negotiate for sales agencies status for marketing products demanded by farmers as for farming inputs
- negotiate agency status from banks for supply of farm inputs on bank credit and credit recoveries from farmers

### **Detailed strategic planning stage**

- combine investment decisions with production targets
- set short-medium-and long-term targets for business
- finalize cash flow for operations
- finalize details of strategy for operations
- finalize mobilizing of funds for capital generation and credit for operations

### **Business operations stage**

- determine staff requirements/recruitments
- recruit management staff
- procure office/storage space
- operationalize production and marketing links

The last two stages (strategic planning and operating sustainable business) are in progress. The HFC has conducted workshops on strategic planning and has already launched several medium-term and long-term businesses. For example, the company has recruited additional staff, and strengthened links with farmer organizations. Jointly with "Dambulu Janatha Govi Samagama," another farmer company established in the SCOR project area, the HFC is about to sign a forward contract to supply 2,200 tons of soybean and 3800 tons of maize, annually. In addition, they have entered into marketing of rice, chili, and several other products as well as agricultural inputs.

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