

Analysis of Contract Farming Partnership for Sustainable Supply of Tobacco (a Case Study on the Integrated Production System Program of PT. HM Sampoerna Tbk. - Indonesia)

Kartika DS Susilowati*, Asminah Rachmi, Nur Indah Riwijanti

Accounting Department, State Polytechnic of Malang, Malang 65143, Indonesia

Abstract

This study explored the implementation of the integrated production system program established by PT. HM Sampoerna Tbk Indonesia, a leading Indonesian tobacco company, and examined its potential and constraints. The program was intended to develop cooperation between the company and its tobacco suppliers to get a sustainable supply of tobacco from farmers with quantity, quality and price set according to the company's standards. This study employed an interpretive research design, following a post-positivist paradigm. The data were collected by means of in-depth interviews, observation and document study and were analyzed using the key tenet of Martin Heidegger's interpretive phenomenology. The interpretive process was achieved through hermeneutic circle to understand how individuals involved in the program interpreted the program including their own experiences as well as their interactions with other parties. The results of the study indicated that the created contract farming partnership was capable of providing the company with a sustainable supply of tobacco and increasing its production volume. Nevertheless, it was unable to improve the quality of the farmers' lives as it was chiefly intended to meet the company's commercial needs. The results from the study have direct relevance to policy makers in Indonesia, especially those that have been implemented contract farming and to agribusiness companies seeking contractual relationships for commodity production.

Keywords: *partnership, contract farming program, tobacco, PT. HM Sampoerna Tbk Indonesia*

1. Introduction

Cigarettes have become one main source of excise revenue for the Indonesian government which reaches trillion rupiahs annually. The data released by the Central Bureau of Statistics (BPS) (2013) indicated that over the past ten years, this revenue has continuously increased. With the total of 44.68 trillion rupiahs in 2007, it grew to 145.53 trillion rupiahs in 2016. The proportion of tax revenues to the total state revenues was 6.31 percent in 2007. This proportion increased to 7.10 percent in 2012 with total excise revenue 95.03 trillion rupiahs, and 9.59 percent in 2015 with total excise revenue 144.64 trillion rupiahs. In terms of employment, in 2010 the cigarette industry was able to absorb indirect labor as many as 6.1 million people (Yuska, 2014).

With the significant contribution of cigarette industries to the national income, tobacco plantation sector is expected to have an important role in fulfilling raw materials for these industries that in turn may provide employment; add values and increase competitiveness; and optimize sustainable natural resource management. Nevertheless, this sector is not far different from the condition of Indonesian agriculture in general. Indonesia, with all its potential natural resources as well as its strategic geographical location supported by its tropical climate, has not been successful in maximizing its agricultural sector. Agriculture is still weak and lack of government support that make it vulnerable to the volatile global markets. Therefore, it has not yet made a significant contribution to the national income and even the welfare of farmers. Some other factors that have contributed to its low

development and its inability to yield value-added products of high competitiveness include the changing pattern of the farmers' lives and their lack of knowledge of utilization and modern agricultural development, agricultural politics, and the fading cultural and spirit values of the agricultural actors (Martius, 2008). Therefore, a strong commitment to continuous improvement of the agricultural sector is crucial.

One strategic step that has been done by related parties to improve agriculture is building a partnership. Partnership is defined as a form of cooperation between small-scale enterprises and a large-scale enterprise through which the large-scale enterprise provides the small-scale enterprises with guidance and sustainable development and takes into account the principles of mutual need, mutual strengthening and mutual benefit (Law No. 9, 1995). Over the past decade, one form of partnership that has developed rapidly and spread out across various centers of agricultural production in Indonesia is a contract farming partnership system. It is a partnership pattern that connects weak farmers with a relatively strong business entity that provides continuous coaching to the farmers with regard to the principles of mutual need, mutual strengthening and mutual benefit. This contractual model is not only potential to increase the income of the farmers who participate in the contract and alleviate poverty but also has multiplier effects on the rural economy as well as the economy of a wider scale (Saptana, 2006). Therefore, a contract farming partnership program is considered to be capable of overcoming the existing problems in the agricultural sector and improving the farmers' welfare.

Nonetheless, the major common practices of contract farming partnerships are found in those done between business enterprises

and large-scale farmers, marginalizing large numbers of small and scattered farmers. In addition, in their developments, these partnerships have brought about inequality to farmers as it is evident from the company dominance in determining the price, the quantity and quality of the commodity produced, the selection of technology used, the planting and harvest time, and all other aspects. In relation to the existing phenomenon, this study aimed at: (1) exploring the technical implementation of contract farming partnership which had been done by farmers and their partner company in East Java with regard to institutional economics perspective and (2) identifying the potential and constraints of the partnership for both parties.

2. Literature Review on Contract Farming System

Agricultural business partnership is a cooperative instrument to create equality, harmony and skills development that are realized in a mutual trust between partner companies, intermediaries and farmers as the basis to work in synergy. Regulation of Law no. 9 of 1995 defines partnership in agribusiness as a mutually beneficial partnership of two or more agribusiness actors. Partnership concept is further elaborated in the Decree of Minister of Agriculture Number 940 / Kpts / OT.210 / 10/1997 concerning Guidance of Partnership in Agricultural Business. Basically partner companies play a crucial role in determining the direction of the partnership, however they are bounded by the responsibility to transparently and fairly share benefits among their partners (farmers, fishermen, farmers' groups, fishermen's groups, cooperatives, or small and micro companies). One relevant theory to explain the pattern of partnerships is Agency Theory. It delineates the relationship hierarchies or the exchange of property rights between individuals or organizations. In the case of agricultural partnership, for example, if the partnership is expected to bring about positive societal impacts on the farmers' welfare, the measures of farmers' economic improvement should be done as an integral part of the agribusiness system. Therefore, as partnership has to be developed based on the principles of equality, mutual need, and mutual benefit and the agreement between the parties involved to share cost, risk and benefit, the success of agribusiness partnerships with farmers should be marked with the economic improvement of the small farmers themselves.

Contract farming system has been widely recognized and practiced in some regions in Indonesia as a model and mechanism of partnership between farmers and buyers (industries) to procure a specific quality and quantity of agriculture product under forward agreement (Eaton & Sheperd, 2001:2). It is the institutional mechanism (contract) that strengthens the bargaining position of farmers, ranchers and fishermen by linking them directly or indirectly to a relatively stronger business entity (Efrif, 2011). The contract model, however, has arisen positive and negative issues. Farmers may benefit from the partnership as they may receive assistance in dealing with technological problems, credit – either in cash or in kind (e.g. seeds, fertilizer, etc.), and marketing (Andri, 2005; Daryanto, 2015). The model may also have a multiplier effects for the rural economy and a more wider scale (Saptana & Indraningsih, 2006). Meanwhile, for the partner companies, they may gain access to cheap labor and land to grow high value agricultural products and able to guarantee the supply of raw materials with quality standards and prices as they wish (Saptana, 2006).

On the contrary, the model has also exerted negative influences as the unequal bargaining power between farmers and large agribusiness firms may weaken farmers' right to negotiate, leading to farmers' exploitation by large agribusiness firms (Efrif, 2011; Minot, 2017 and Singh, 2002). The bargaining power inequality is evident from the buyers' dominance in determining the price, quantity and quality of commodities produced, the schedule of

planting and harvesting, the technology used and so forth without involving the participation of the farmers. The absence of small farmer participation in the contract establishment makes the situation worsened. Small farmers are often excluded from agricultural contract schemes. Buyers in general are more willing to work and make a contract only with larger farmers rather than with small farmers. Working with smaller farmers will lead to high transaction costs for maintenance and supervision because they are numerous and scattered in various places (Andri, 2006). As stated by ADB (2015), for buyers, the cost for making contracts with individual small famers are much higher compared to the cost of handling large-scale farmers.

Despite the weaknesses, contract farming system is also adopted in tobacco plantations in East Java, the largest production area in Indonesia. In the system, smallholder farmers seem to enjoy a number of benefits associated with the contract based farming. Under the agreement, the buyer has commitment to buy a specified tobacco at a guaranteed and more stable price, provides access to markets and may assist farmers in production process with technical guidance, credit, extension and training, and inputs (seeds, fertilizers, pesticides) (Will, 2013). In return, farmers have an obligation to produce specific tobacco at the predetermined quality standards and quantity and agree to sell their tobacco exclusively to the partner companies (Setboonsarng, 2008). In this contract, the buyers benefit from a guaranteed supply of certain tobacco at the quantity and quality standard they have determined, access to labor and land to grow high-standard tobacco and transfers of any production risks onto farmers (Prowse, 2008).

Considering that contract farming system has brought about negative impacts on farmers (Efrif, 2011; Minot, 2017) despite its numerous benefits for industries, this study examined further the potential and constraints of the system in a case study at PT. HM Sampoerna Tbk. The research design and the results of the study are discussed consecutively next.

3. Research Design

This study was conducted in few East Java districts covering Jember, Malang, Lumajang and Bojonegoro as the main tobacco production areas in this region. It adopted an interpretive research design, following a post-positivist paradigm. Informants were selected based on snowball sampling with a number of respondents, inter alia, farmers and chairman of farmers group, tobacco warehouse, Tobacco Farmers Association (APT), academicians and government agencies. The key farmer informants were determined using a purposive sampling technique with particular criteria. The criteria comprised tobacco farmers who owned a piece of land, i.e. small land (0-0,499 ha), medium land (0.5-0.99 ha) and large area (≥ 1 ha) (Widiyanto et al, 2010). Primary data were collected by means of (1) observation to determine the social condition of tobacco farmers in the study sites and (2) in-depth interview to examine the impact of contract farming on farmers. The secondary data were collected through document study to examine the contract and the tobacco-related policies as well as the archives owned by government agencies or other relevant resources. The data were analyzed using the key tenet of Martin Heidegger's interpretive phenomenology. The interpretive process was achieved through hermeneutic circle to understand how individuals involved in the program interpreted the program including their own experiences as well as their interactions with other parties.

4. Results and Discussion

4.1. The Contract Farming Model of PT. HM Sampoerna Tbk and its Potential

The condition of tobacco plantation in Indonesia has become a driving force to involve private sector in the plantation development. Climate has greatly affected the quantity and quality of tobacco leaves that may reduce tobacco production from year to year. Furthermore, tobacco is mostly produced by small farmers. Approximately 30% of them own less than 0.2 ha piece of land and 26% of them own 0.2 - 0.5 ha. There are around 550,000 tobacco farmers growing various types of tobacco over vast and diverse regions scattered from Aceh to Celebes (Sulawesi), with an estimated total production area of 198,000 ha. The main plantation areas are situated in Java (70% of the overall production) and West Nusa Tenggara (Lombok) (20%). Table 4.1 summarizes the sizes of tobacco areas in different regions and their production capacities in 2011 – 2016. As stated by Andri (2006) and ADB (2005), these scattered plantations may lead to high transaction costs for maintenance and supervision if partnerships need to be conducted.

Table 4.1.1: Recapitulations of the Sizes of Tobacco Areas in Indonesia and their Production Capacities from 2013 – 2016

Province	2013		2014		2015		2016	
	Area (ha)	Production (tons)						
East Java	83,386	73,998	118,717	108,137	107,104	99,016	107,207	99,531
Midle Java	40,620	30,972	42,653	32,542	50,856	40,504	44,884	40,567
gyakarta	1,307	686	1,595	1097	2,056	1,534	1,882	1,569
West Java	9,973	8,872	9,201	8,146	9,711	8,471	9,355	8,473
West Nusa Tenggara	28,356	38,529	24,611	3,7067	23,760	34,449	23,890	36,074
East Nusa Tenggara	2,986	1,535	2,049	1,304	2,160	1,324	2,170	1,384

Bali	803	975	680	937	782	1,024	752	1,038
Sumatra	7,318	6,534	7,765	7,502	7,002	6,755	5,097	5,362
Celebes	2,380	2,348	2,171	1,569	2,419	1,570	2,158	1,562
Total	177,129	164,447	209,443	198,301	205,850	194,646	197,372	195,560

Source: Ministry of Agriculture

In regard to the issue discussed above, PT. HM Sampoerna Tbk (Sampoerna) had an Integrated Production System (IPS) program to improve the competitiveness of tobacco farmers in absorbing their crops. The IPS had been conducted since 2009 and had also been introduced to farmers in some districts including Jember, Wonogiri, Malang, Rembang, Blitar, and Lumajang. In total, there were about 27,500 farmers joining to work in 24,000 hectares of tobacco land. In this partnership, Sampoerna, however, did not directly buy tobacco from farmers. The company purchased tobacco only through four suppliers, Sadhana, Alliance One International, Pandu Sata Utama and Tempurejo, with whom it had made contracts. These suppliers were specifically selected by Sampoerna with certain requirements, some of which were being a registered company, being able to submit business license and notarial deeds which complied with Phillip Morris International (PMI) code of conduct and with local law and regulations, and having commitment to the implementation of PMI's Agriculture Labor Practice (ALP) program. Figure 4.1 shows the tobacco contract farming model conducted by Sampoerna and PMI.

As can be seen from Figure 4.1.1, tobacco farmers or groups of farmers had undertaken an indirect partnership contract with Sampoerna through intermediaries, tobacco suppliers. Sampoerna guaranteed the absorption of tobacco products of its farmers as long as the products met the agreed standard. In return, the farmers received technical assistance such as information and guidance for good tobacco farming practices. They were also provided with an access to capital, both facilities and infrastructure finance. In addition, they were introduced to the application of agricultural labor practices aimed at creating a safe and fair working environment for farmers and their workers in all plantation areas under contract. Furthermore, they received a technological support, including a new rocket-burning technique capable of saving fuel consumption by up to 16%, and a budding inhibiting tool capable of saving up to 60% work time. Through the IPS program, they were able to increase productivity by 25 percent, thus the program had a direct impact on increasing their income.

With the program, Sampoerna had slowly abandoned the conventional purchasing system of tobacco and would continue to improve the adoption of direct purchasing systems through tobacco suppliers. Currently the purchase of tobacco from contract farmers grew significantly from 12% in 2011 to about 70% in 2017 (Nabhani, 2017).

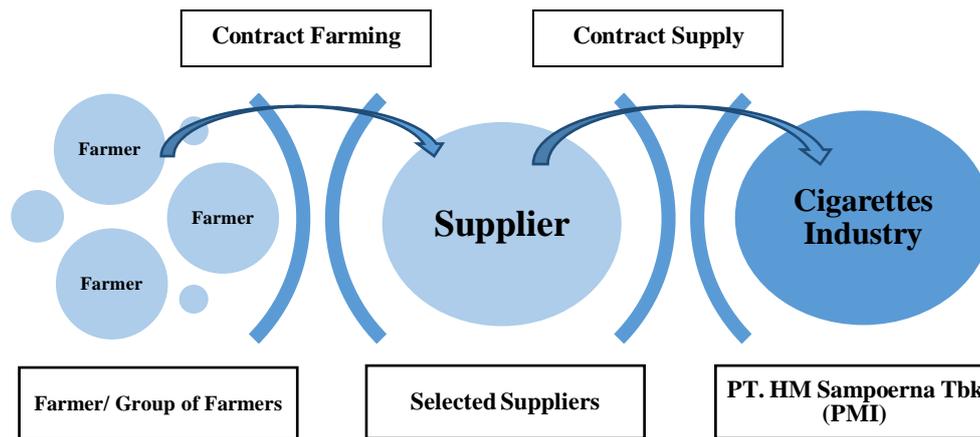


Figure 4.1.1: Tobacco Contract Farming Model (PMI, 2015)

4.2 The Constraints of the Contract Farming Model

Contract farming however is a complex process requiring major investment in human resources, infrastructure and empowerment

framework to continuously build mutual trust between the parties involved. One important element that may contribute to the building of

Table 4.2.1: Rights and Obligation of Each Partner

No.	Contract Partner	Rights	Obligations
1.	Supplier (PT. Sadhana ArifNusa)	<ul style="list-style-type: none"> provides training and direct/indirect supervision. is entitled to collect all crops and price them according to the quality standards. is entitled to cut the revenue of the harvest with the intention to pay the installment of the capital borrowed by partner farmers. where farmers do not act in compliance with the agreed terms, they are then considered as being negligent in the agreement and Sadhana is entitled to terminate the cooperation unilaterally and partner farmers are required to return the loan capital they have received . 	<ul style="list-style-type: none"> provides fertilizer, pesticide, and medicine. provides technology and knowledge transfer such as cultivation management, harvesting and post harvesting management. provides free seedlings. secures markets and contract payments. is obliged to provide capital assistance to farmers
2.	Sampoerna	<ul style="list-style-type: none"> has the right to purchase tobacco with the price, quality and quantity specified in advance. 	<ul style="list-style-type: none"> receives all the farmers' harvested products at prices equal to the predetermined standard quality which may in turn function as an incentive to the farmers' hard work.
3.	Farmer/ Farmers	<ul style="list-style-type: none"> is entitled to get the results of the toil during the management of the tobacco plant. 	<ul style="list-style-type: none"> implements good farming practices which are compatible with the company's standards of the Good Agricultural Practices. sells all crops to the company and obey the rules set by the company. all needs (land, workers, seeds, fertilizer etc.) during the production process are prepared independently by farmers.

Compiled from different sources

Trust was the clarity of contract clauses. Table 4.2.1 shows the rights and obligation of the three parties involved in the IPS contract.

The results of the field observation indicated that contractual partnership in IPS had only been successful in increasing tobacco productivity, but had not yet improved the farmers' welfare. This might be due to the contractual agreements that were still pseudo or vague and did not facilitate negotiations. The price, quality and quantity of tobacco had been determined beforehand by the suppliers. On the other hand, all the needs during the production process were prepared independently by the farmers. In addition, even though in the contract it was stated that the company would buy tobacco at prices equal to its quality, information related to the intended quality was not made explicit. The farmers thus felt being treated unfairly.

This situation was in contrast to that of farmers who were not bound by any partnership with the company. The farmers chose

this path because they were able to negotiate prices with tobacco merchants. Nevertheless, many contract farmers preferred to partner with the company because of the purchase guarantee. They stayed afloat in such circumstance, because the option of abandoning the contract required them to confront a number of larger economic, social and political interests.

When looking into the interests of every actor involved in the partnership, it appeared that the contract farmers were posed to conditions that made them dependent upon their partners (suppliers). This was evident as the suppliers played a dominant role in the development process of tobacco production and put the farmers in a weak position in which there was hardly any chance to negotiate the purchase of their products and get access to other parties who might be interested in their products. In such a situation, the farmers were practically not able to significantly enhance their prosperity. Thus, the active involvement of

government as a facilitator is crucial. This is discussed in the next session.

4.3 Government Involvement as a Facilitator

To improve the competitiveness and bargaining power of farmers towards partner companies, the government as a facilitator needs to actively bridge the unequal communications between farmers and companies through policies to regulate and facilitate the program for more economic empowerment of tobacco farmers. The policy may cover:

- 1). Legalizing tobacco price benchmarking in order that farmers can determine fair prices of their tobacco when selling their products to the warehouse.
- 2). Standardizing tobacco quality policy of A, B, and C levels as so far the quality has been solely and subjectively determined by the buyer/ warehouse.
- 3). Facilitating the procurement of capital for tobacco farmers as during the tobacco planting season, farmers' capital is obtained by selling their gold or cattle or borrowing money.
- 4). Providing tobacco warehouses in sub-districts to accommodate farmers' tobacco when price is unstable.

5. Conclusion

PT. HM Sampoerna Tbk has been in partnership with farmers in tobacco procurement for almost ten years. The partnership involves a third party as an intermediary whose authority is to determine the price, quality and quantity of tobacco purchased from the farmers. With such a partnership model, this study concluded that

- 1) the partner company had been able to secure its sustainable supply of tobacco through the partnership. In return, the company provided the farmers with technical assistance, knowledge and technology transfer and capital access.
- 2) despite the fact that the partnership had assisted the farmers to some extent, the intermediary's sole authority for determining the prices, quality, and quantity of tobacco might constrain negotiation opportunities for the farmers and lead to the intermediary's unfair pricing. This in turn undermined the farmers' trust and discouraged them from a long mutually beneficial partnership.
- 3) The prolonged imbalance partnership that excluded the farmers from any forms of negotiations required the involvement of government to regulate more mutually beneficial partnerships for all the parties involved and for the empowerment of farmers.

Acknowledgements

We especially appreciated the inspiring discussions we had with all partners involved in PT. HM Sampoerna Tbk's integrated development program. The discussions had provided us with invaluable insights into the nature of the partnership program. It was a real pleasure and a great help for us to exchange ideas and learn from highly experienced company management and staff of PT. HM Sampoerna Tbk (Phillip Morris Indonesia) and their stakeholders. Our deepest gratitude also goes to the Research, Technology and Higher Education Ministry of Indonesia which has assisted us in financing this research.

References:

- [1] Andri, Kuntoro Boga & Shiratake, Y. (2005), Empirical Study of Contract Farming System Conducted by Dairy Cooperatives in East Java, Indonesia. Review of Agricultural Economics Journal Edited by the Kyushu Society of Agricultural Economics Vol. 55, No.2, 2005, pp. 73-8.
- [2] Badan Pusat Statistik. 2013. Pertumbuhan Ekonomi di Indonesia. Press Release. No. 14/02/Th. XVI, 5 Februari 2013
- [3] Daryanto, Arief (2015). Partnering for Smallholder Inclusive Agricultural Development Models in Indonesia: Lessons from Dairy Industry Development Models in Indonesia, Working Paper presented at Workshop on "Developing Smallholder Inclusive Value Chain Models for Local and Global Markets" 8-9th December 2015, Hanoi -Vietnam
- [4] Eaton, Charles & Shepherd, Andrew W. (2001). Contract Farming: Partnership for Growth, Food and Agriculture Organization Services Bulletin No. 145, Roma.
- [5] Efrit (2011). Model Kemitraan Contract Farming Pada Agribisnis Hortikultura (Contract Farming Partnership Model in Agribusiness, Jurnal Embrio (4) (1) (6-17).
- [6] Erfit (2011), Analisis Komparatif Kemitraan Kontrak Farming dan Nonkontrak Farming pada Agribisnis Holtikultura, Jurnal Paradigm Ekonomika, Vol. 01, No. 3, April.
- [7] Furubotn, EG and R Richter. 2000. Institution and Economic Theory. The Contribution of the New Institutional Economics. Ann Arbor. The University of Michigan Press.
- [8] Kaur, Bisant; Kamarulzaman, Nitty Hirawaty and Hamzah, Nur Amalina (2015). The Impact of Public-Assisted contract Farming Programmes in Malaysia, Jurnal of Agribusiness Marketing
- [9] Kementerian Pertanian (2017). Kebijakan Pengembangan Tembakau Nasional, Jakarta, www.pertanian.go.id
- [10] Martius, Endry (2008). Kemitraan Agribisnis Untuk Memberdayakan Ekonomi Rakyat, dalam Jurnal Agribisnis Kerakyatan, Vol. 1, No. 1.
- [11] Minot N. 1999. Effect of Transaction Costs on Supply Response and Marketed Surplus: Simulations Using Non-Separable Household Models. MSSD Discussion Paper No. 36. International Food Policy Research Institute. Washington, DC.
- [12] Nagaraj, N., Chandrakanth, M. G., Chengappa, P. G., Roopa, H. S., & Chandakavate, P. M. (2008). Contract farming and its implications for input-supply, linkages between markets and farmers in Karnataka. Agricultural Economics Research Review, 21, 307-316.
- [13] Priyanti, Atien & Soedjana, TD (2015). Indonesian Dairy Industry Perspective within the ASEAN Economic Community, WARTAZOA Vol. 25, No. 4, pp. 159-170 DOI: <http://dx.doi.org/10.14334/wartazoa.v25i4.122>.
- [14] Prowse, Martin (2007). Making Contract Farming Work with Cooperatives, ODI Opinion 87, ODI, London, UK.
- [15] Saptana, Sunarsih & Indraningsih, Kurnia Suci (2006). Mewujudkan Keunggulan Komparatif Menjadi Keunggulan Kompetitif Melalui Pengembangan Kemitraan Usaha Hortikultura, Forum Penelitian Agro
- [16] Setboonsarng, Sununtar (2008). Global Partnership in Poverty Reduction: Contract Farming and Regional Cooperation. ADBI Discussion Paper 89. Tokyo: Asian Development Bank Institute. Available: http://www.adbi.org/discussionpaper/2008/02/25/2491_global_partnership_poverty_reduction.
- [17] Singh, S. (2002). Contracting out Solutions: Political Economy of Contract Farming in the Indian Punjab, World Development, 30 (9), 1621-1638.
- [18] Sulistiyani, Ambar Teguh (2004) Kemitraan dan Model-Model Pemberdayaan. Yogyakarta, Penerbit Gaya Media.
- [19] Widiyanto, Suwanto dan Setyowati, R., (2010). Dinamika Nafkah Rumahtangga Petani Pedesaan Dengan Pendekatan Sustainable Livelihood Approach (SLA). Jurnal Transdisiplin Sosiologi, Komunikasi dan Ekologi Manusia 28(2).
- [20] Will, Margret (2013). Contract Farming Handbook, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, Zimbabwe.
- [21] Williamson OE. 2000. The New Institutional Economics: Taking Stock, Looking Ahead. Journal of Economic Literature, 38: -651935
- [22] <http://www.sjih.depkeu.go.id/fulltext/1995/9TAHUN-1995UU.htm>
- [23] Yuska, Nofri., 2014. Kepentingan Indonesia Tidak Meratifikasi Framework Convention On Tobacco Control (FCTC). 1(2): Universitas Riau