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# A Contractual Perspective on the Norwegian Agri-food Sector

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# Preface

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The Norwegian agri-food sector is under rapid transformation, one aspect of which is the increased use of diverse contractual arrangements between farmers and their customers. The significance of new types of contracts has been more debated in other European countries and USA than in Norway. This situation may be caused by the fact that contract farming has been less frequent in Norway, and that the national framework for regulating farming activities have been very extensive and detailed.

The research project “Market coordination through new contractual arrangements” (Markedstilpasning gjennom nye kontraktsformer) financed by the Research Council of Norway attempts to bring forward information on the use of contracts in the Norwegian agri-food sector, both from a theoretical and practical point of view.

This working paper is a relatively broad discussion of the use of contracts in the Norwegian agri-food sector. What changes in contractual arrangements do we observe? How can they be explained? What changes can be expected in the future?

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Ivar Pettersen  
Director general



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# Summary

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The Norwegian agri-food sector is under transformation, and as part of this the contractual relations between the various parts of the sector are rapidly changing. The purpose of this paper is to answer two questions:

- How can these changes be explained?
- What changes can be expected in the future?

The analysis is based on insight from new institutional economics. The starting point is that the relations between agents depend on institutions and governance structure. Changes in one or both will influence the contractual relations.

The paper focuses on relations between primary producers and first hand buyers of agricultural products. However, since changes at this part of the value chain is influenced by what happens down-stream, we take developments in down-stream parts of the chains into account as far as we find it relevant.

It is well known that agricultural policy and agricultural marketing cooperatives are important institutions for the Norwegian agri-food sector. Market regulation is an important part of the system. The cooperatives are assigned a crucial role as market regulators. Therefore, we find it reasonable to start with a description and analysis of the importance of agricultural policy and the cooperatives for contractual arrangements in the agri-food sector.

For many years there was a tendency towards “more state, less market” in agriculture as well as in many other sectors. Since the 1980s, there has been an opposite tendency towards “less state, more market”. This also applies to agriculture although Norway still is among the countries with highest support for agriculture, measures as percent PSE. However, because of the EEA agreement and the ongoing WTO negotiations, we expect reduced protection for Norwegian agriculture and less national support in the future. One way to meet some of the reduction requirements might be to change the target price system. Such a change would have implications for the market regulation system and the role of agricultural cooperatives.

Traditionally, agricultural cooperatives bought relatively homogeneous products from their members and processed a variety of consumer goods. The membership was regulated through a relatively general membership contract, and pricing was based on well known grading and pricing systems. The cooperation between the cooperatives and the state ameliorated much of the risk that could otherwise have existed. It was no need for special contracts between the cooperative and the individual producers. Some of the products with increasing demand, is based on attributes originating at the farm level, for instance organic food. It is often difficult and costly to measure the attributes and to control that production is carried out in accordance with the principles creating the attributes. In such cases, production contracts might be necessary to assure product quality. Thus, we expect that production contracts will become more frequent even in agricultural cooperatives.

The Norwegian retail sector is very concentrated with four chains having 99% of the market. This concentration developed from the 1980s through the 1990s, which is the period when the agricultural sector became less regulated. The market power shifted to some extent from processors to wholesalers and retailers. The retail chains have been in position to reap much of the benefits from the increased “room” for action and contracting.

A lot of other changes are having an effect on the agri-food sector and the expected use of contracts. One factor is the consumer concerns over food safety. In order to assure food safety, the various elements in the chain want control over production processes at earlier stages of the production. Vertical integration or relational contracts might be the natural response from the involved actors.

Traceability is another important part of quality assurance systems. The food industries in many countries have developed an enormous capacity to track the flow of food along the supply chain. Some systems track the food components back to the farm, while other track it only back to some key point in the production process. Firms have three primary objectives in developing, implementing and maintaining traceability systems; to improve supply management, to facilitate traceback for food safety and quality, and differentiate and market foods with subtle or undetectable quality attributes. Traceability is not the only means to these objectives, and alone it cannot accomplish any of them. For instance, traceability systems do not create credence attributes, they simply verify their existence. Traceability systems will probably be combined with contracts in order to distribute risk.

A system with few retail chains and relatively centralised procurement, leaves little room for local and small producers. Those who do not obtain contracts with any chain, might try to find other marketing channels. Farmers markets, farm shops, and other forms of direct marketing are examples of such marketing channels. The Farmers markets are examples of horizontal cooperation between producers.

Globalisation of food trade (lower tariffs etc.) changes the relation between Norwegian producers, processors, and retailers. The producers and processors will face tougher competition from foreign producers if and when the tariffs are reduced. If the retailers (the retail chains) are not satisfied with the delivery conditions offered by Norwegian producers, the retailers could more and more easily substitute them with foreign producers. One response from Norwegian producers might be to use labelling as a means to secure markets, for instance the protected labels of origin. If the consumers are willing to pay a higher price for Norwegian products, this might be a successful strategy.

Finally, public standards and control schemes for organic farming and organic products mean that processors etc. can rely on these schemes and need not enter production contracts. However, because of logistics and transaction costs the processing industry might offer contract only to producers in certain geographic areas. TINE, the national dairy cooperative, has such contracts.

In conclusion, we expect government regulations of Norwegian agriculture to be important for many years to come. But the agri-food sector will become more consumer-driven than it has been until now. Sales and production contracts will become more common in Norwegian agriculture in the future. Contracts will be more common for value-added products than for “bulk” products. Such contracts will develop also within some of the agricultural cooperatives.



# 1 Introduction

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The main purpose of the project “Market coordination through new contractual arrangements” is to answer the following question:<sup>1</sup>

*What kind of new contractual arrangements between producers and buyers of agricultural products can be expected in periods with changing market structure, government involvement and consumer demand?*

The starting point for this project is that we observe changes in contractual arrangements between agriculture and the buyers of agricultural products. For instance, while it some years ago was a large number of wholesalers selling fruit and vegetables to retailers, the retail sector is now served with fruit and vegetables by three wholesalers, and approximately 75% of Norwegian fruit and vegetables are sold through these wholesalers (Svennerud, 2004). Producers without contract with one of these wholesalers seem to have increasing difficulties in finding market outlets for their produce. Another example is that the state’s obligation to buy all Norwegian grain was terminated in 2001, and marketing contracts between cereal producers and grain elevators are emerging. Moreover, we observe new contractual arrangements in the farmers’ marketing cooperatives for meat. How can these changes be explained? What changes can be expected in the future?

The *purpose* of this working paper is to identify forces driving the changes in contractual arrangements in the Norwegian agri-food sector. It is supposed that changes in the driving forces leads to changes in the contractual arrangements. Therefore, when we have identified the forces and ongoing changes in that forces, we are better able to interpret what we observe in the sector and to predict what can be expected in the future.

It is implicit in the question mentioned at the start of this chapter that market structure, government involvement, and consumer demand have an influence on contractual arrangements in the agri-food sector. But that is not necessary a complete list of important factors. According to Young and Hobbs (2002: 429) changing consumer preferences, biotechnology, information technology, environmental pressure, credit and risk

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<sup>1</sup> The Research Council of Norway, Project No. 147443/110

issues, as well as the reduction in global trade barriers are some of the driving forces behind contractual changes in general, and vertical coordination in particular.

Our point of departure is that the need for contracts, as well as the more specific contract design, is determined by characteristics within each part of the supply chain and in the institutional environment of the supply chains. Changes within the supply chains and in their environment lead to changes in the contractual arrangements.

The project follows the path suggested by new institutional economics (NIE). Contract theory is a part of NIE. We do not find it necessary to give a broad and complete presentation of NIE and contract theory in this working paper.<sup>2</sup> Here we present only some elements that are basic to our analysis, and that we use frequently in the paper. NIE is an alternative to neo-classical economic theory which is otherwise the dominant economic theory. NIE is not as well structured as neo-classical economics, but “there is close to unanimity within the NIE on the idea of limited cognitive competence—often referred to as bounded rationality” (Williamson, 2000: 600). According to Williamson (2000), economic phenomena should be studied at several levels. He discusses four levels, but we are mainly concerned with two of them: (a) the institutional environment, and (b) institutions of governance. The institutional environment includes both the formal rules of the game (laws, polity, judiciary) and the informal rules of the game (customs, mores, norms).

The institutions of governance are also referred to as the play of the game, and include markets, firms and bureaus. Governance structure fall into three broad groups; market, hierarchy and hybrid forms. Market is close to the perfectly competitive economy of textbooks in economics. In that case, independent firms produce goods and services and sell them to other firms or to consumers. Hierarchy, or internal governance structure, is found when all decisions are taken within a firm. There is no open trading of goods. Hybrid governance is somewhere between market and hierarchy, and there are many forms of such governance. Verhaegen & Van Huylbroeck (2002) classify the hybrid forms in three; framework, co-ordinating, and participating governance with framework closest to markets and participating closest to hierarchy. The contractual forms typically vary with institutional framework and governance structure.

Farmers and marketing organisations/processors are contracting for several reasons which can be summarised in a few (partly overlapping) key words; e.g. to increase or secure profitability, to reduce risk, reduce transaction costs, to assure demand or supply, to assure quality, to circumvent asset specificity, to get access to technology, and to get access to capital, (see for instance Hudson, 2000; Eaton & Shepherd, 2001). The “need” for and use of contracts can thus be expected to depend on many factors. In the rest of the paper we try to discuss this within the framework of the Norwegian agri-food sector with special emphasis on the relation between the farmers and the next buyers of agricultural products.

The remaining of this paper is divided into three parts. First, we discuss the importance of agricultural policy and the agricultural marketing cooperatives from a contractual point of view (chapter 2). We underline that these two institutions in combination have secured an outlet for agricultural products and reduced much of the risk associated with fluctuating prices and markets. We also see clear indications of changes in policy. We expect that the room for contracting will increase, and that we will be observing a wider spectre of contractual formats in the next years. Chapter 3 includes a discussion of factors that we believe will be important when the increased room for contracting is to be filled. Some tentative conclusions are drawn in chapter 4.

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<sup>2</sup> New institutional economics and contract theory have been described by many authors, e.g. Williamson (2000, 2002); Brousseau & Glanchant (2002). We have elsewhere (Borgen & Hegrenes, 2005) given a more detailed, but still short, introduction to NIE and contract theory and discussed the relevance of these theories for analyses of the agri-food sector.

## 2 Agricultural policy and the role of agricultural marketing cooperatives

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It is commonly held by observers that the state and the agricultural cooperatives regulate so much of the activities within the Norwegian agricultural sector that there is almost nothing left to contract for. Without going into details on this statement, it is evidently true that the agricultural policy and the farmers' cooperatives form important parts of the institutional environment for agricultural producers. Our point of departure here is that changes in agricultural policy and the role of cooperatives have a significant influence on the current and future design of agricultural contracts. A short review of the Norwegian agricultural policy and the role of agricultural marketing cooperatives is therefore a reasonable starting point for a discussion of forces leading to changes in contracts in the agri-food sector. We focus on the parts of the policy and role of cooperatives that seem to be most relevant for the discussion and do not intend to give a complete picture. Since many of the regulations are rooted in decisions in the 1930s (see for instance Espeli, 2002), we start our brief historical review at that point of time.

### 2.1 Norwegian agricultural policy from the 1930s to the 1980s

Around the 1930s, Norwegian agriculture, like agriculture in many other western countries, experienced falling product prices and increasingly unstable markets. In order to ameliorate the situation for farmers and the nation, the Norwegian government and the parliament (Stortinget) introduced a variety of measures. The greater part of these measures can be classified as market intervention instruments to increase demand and to stabilize and increase agricultural product prices. From 1929, the government entered a legal obligation to buy all grain produced in Norway. In 1930, the Norwegian parliament decided to introduce a regime of quantitative import restriction. Also in 1930, a public organisation, the Marketing Board (Omsetningsrådet), was established to implement and administer market regulations, and levies were introduced to finance market schemes. The farmers' cooperatives were by law given a vital role in implementing the

various schemes. Their obligation was to actively contribute to the implementation of the national agricultural policy (Almås, 2004).<sup>3</sup>

After World War Two, the Norwegian state undertook an even greater responsibility for securing all groups in the nation a decent income and standard of living (Steen, 1988). The Norwegian government and the farmers unions negotiated on prices and other support measures. This policy was formalized in the Basic Agricultural Agreement (Hovedavtalen for jordbruket) from 1950 (revised in 1992). The existence of market regulation schemes was a precondition for many of the price schemes. This system was developed further in the 1950s, especially in 1958 when the government and the farmers unions agreed on target prices for several products, and the farmers cooperatives undertook the task of operating the market in such a way that the agreed prices could be obtained from the market.<sup>4</sup> This corporatist approach to market regulation was conceived of as an innovative way of organizing a sector that is characterized by a substantial level of uncertainty.

In 1965, the Parliament formulated an income goal for agriculture. The income generated by a modern and rationally-managed farm that employed one annual worker had to be at least at the same level as the average wage income in the manufacturing industry. In 1975, the Parliament decided on a timetable for attaining this income goal; i.e. the target of parity was set by 1982. The implementation of this decision led to increased supply of many products while the demand grew more slowly, especially after the partly removal and reduction of consumer price subsidies in 1982. The answer was (partly) to introduce more regulation. For instance, a milk quota system (the “two-price” system) was introduced in 1983. Measures were introduced in order to balance other markets too, for instance the market for meat. Until the early 1980s, the potato market was relatively unregulated. However, the Potato Marketing Board was established in 1982 and quality payments were introduced in order to improve potato quality and to effectively regulate the domestic potato market.

In summary, in this period agriculture and the marketing of agricultural produce were more and more regulated in a relatively close cooperation between the state, the farmers unions, and the farmers marketing cooperatives. Hence, tasks and activities that otherwise could have been regulated by various types of contracts, were instead regulated in a cooperation between these organisations.

## 2.2 Changes in agricultural policy after the 1990s

The 1980s witnessed the beginning of an overall political trend to remove regulations in many branches of the Norwegian economy. Some state-owned monopolies were privatised into public limited companies (aksjeselskaper) competing on freer markets, for instance in broadcasting (radio and television), telephone and telegraph, credit markets and later on the electricity market. The development in Norway was in tune with a more general trend in many western countries. A main reason for this development was the perceived weaknesses associated with the central planning and regulatory policy that were implemented after the 2<sup>nd</sup> World War. These weaknesses were partly due to the tension between plan (state) and market; when the tension becomes too big, it becomes

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<sup>3</sup> See e.g. Norby & Aresvik (1951) and Beal & Nesheim (1966) for a description of the early history of cooperative milk marketing in Norway. Espeli (2002) gives a review of the history of regulations of Norwegian agriculture, mainly since 1970, but with references to the period 1930–1970. Tennbakk (2004) gives a brief description of the present regulatory system.

<sup>4</sup> This refers mainly to meat. The agreement is printed several places, e.g. Bonden (1973). Kaldahl (1994) gives an evaluation of the agreement, both as it was perceived in 1958 and at the time of writing in the 1990s.

too profitable to use resources to evade the regulations (Hagen, 1997: 1). A part of this phenomenon goes under the name “regulatory capture” in the scholarly literature (see e.g. Levine, 1998).

The Norwegian state was never so directly involved in production activities in agriculture as in some other sectors of the economy, for example telephone and telegraph and some manufacturing industries. However, as seen in section 2.1, the state had a substantial influence on the agricultural sector through a set of financial and legal regulations. Around 1990 critical observers claimed that the benefits of the agricultural policy were not large enough to justify the costs (see for instance NOU 1988: 21, especially chapter 7.5; OECD, 1990; Brunstad, Gaasland & Vårdal, 1995). The overall rationality of the policy was questioned. At that time it was quite clear that the GATT negotiations would have an influence on agricultural policy, and a Norwegian membership in the EU was launched as a realistic option. In 1992, the government published St.prp. nr. 8 (1992–93) and clearly signalled that policy changes had to be implemented. Since then, the income level for Norwegian farmers has been conceived of as a means to reach other political goals, more than a goal in itself. These other goals concern domains such as protection of the environment, viable rural areas, food safety and food security. As seen through the lenses of the principal agent framework,<sup>5</sup> this implies that the government (the principal), has some objectives it wants to realize, and tries to incite farmers (the agents), to act in a way that contribute to fulfil the objectives. The government and the farmers do not write formal contracts to achieve the goals, but the government uses financial support to both relatively general support measures and measures aimed at specific tasks in order to get the incentives right. The costs of implementing, administering and controlling the working of the political measures represent transaction costs. As emphasised by e.g. Vatn (2002), it is potentially a conflict between targeting and transaction costs. In Norway, many subsidy measures are relatively broad-spectred in the sense that the farmers do not have to comply with a set of very specific rules in order to be eligible receivers of the subsidies.

The GATT/WTO agreement of 1993 implied a change from quantitative import restriction to a system based on import tariffs combined with rules for market access and restriction on subsidised export. The government (and parliament) decided to abandon the state monopoly on import of grains and replaced it with an import tariff system, but the state still had the obligation to buy all Norwegian grain.

However, the binding import tariffs were so high that for most products Norwegian agriculture still had an effective border protection. The national target prices were in most cases lower than world market prices plus binding import tariffs.<sup>6</sup> For some products, for instance cereals, Norway used actual tariffs lower than the binding tariffs, but still the tariffs gave a protection for Norwegian cereals.

The Potato Marketing Board was closed down in 1998, and some of the subsidy schemes were terminated while others were increased to compensate the producers for the income loss. The main reason for this change in policy was that it should be left for the market to demand and pay for quality. The subsidy schemes had been targeted towards the producers, and the quality was normally high when potatoes were sold from the potato producers. Yet the quality of potatoes sold to consumers had not improved, in fact it had decreased, according to the Ministry of Agriculture (St.prp. nr. 67 (1997–1998)). Approximately 60% of the damages to potatoes occurred beyond the farm-gate.

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<sup>5</sup> “Principal Agent Theory is concerned with situations in which one party, namely the principal requires a second party, namely the agent, to undertake an action on the principal’s behalf.” (Hornibrook & Fearn, 2001).

<sup>6</sup> It is no import tariff on wool and fur from fur bearing animals (mink and foxes). There are import tariffs for part of the year for fruit and vegetables. It is free import of some products from less developed countries.

The quality subsidy scheme, therefore, had only had minor effects on the quality of potatoes sold to consumers.

In 1999, the government produced a white paper on agricultural policy (St.meld. nr. 19 (1999–2000)). According to this white paper, the focus of the agricultural policy should be shifted from producer interests to consumer interests. Increased efforts to secure food safety were an important part of these changes. Control measures to secure food safety were extended or introduced, partly as a response to “food scandals”, such as the BSE scandal in UK and other countries.

The production of food was still considered to be a major task for agriculture, but agriculture should also produce public goods such as attractive landscapes, viable rural areas, food security etc. Organic farming was emphasized and stimulated, partly as an environmental friendly way of producing and partly as a means of increasing food diversity.

The government’s obligation to buy grain was terminated in 2001, and a system of target prices was introduced for cereals. The relatively low import tariffs (compared with the binding tariffs) were replaced by a system of binding tariffs and import quotas at a lower tariff. The market regulation scheme for grains is now quite similar to the schemes for milk and meat. Several reasons can explain the change in 2001, for instance that the system existing in the late 1990s was evaluated to be too expensive, increasing regional price differences for concentrates were observed, and a perceived possibility of surplus supply of grains caused by too much import. (See Forsell & Hegrenes (2000) for a summary of the discussion leading to the changes in cereal marketing order in 2001).

The fundamental role of farmers’ cooperatives came gradually under public scrutiny. The regulatory model applied in Norwegian agricultural markets exhibits a basic paradox: On the one hand, the large marketing cooperatives are assigned a crucial role as market regulator, and on the other hand, competition is encouraged even though competition weakens the coordinating power of the cooperatives (Tennbakk, 2004). For instance, in the milk sector, where the cooperatives had benefited from a 100 per cent share of milk deliveries (at first hand), the government encouraged competition from other domestic dairy companies. The authorities faced the challenge of how to design a regulatory framework that secured equal terms for all competitors. A new market regulation scheme for milk was implemented as of January 1, 2004 after several changes during the period 1997–2004 (see e.g. Bergset et al. (2004) for a description of the regulation system since 1930).

The general trend since the 1990s has been to deregulate agricultural markets. However, more and more regulation is implemented to take care of food safety and other consumer concerns. As member of the WTO, Norway is obliged to adapt the domestic support to agriculture to the agreed WTO regulations. Norway has a relatively high support for agriculture, measured as percentage PSE (Producer Subsidy Estimate) (OECD, 2004). Norway is one of six WTO member states that continue to use the “Blue Box” (Hart & Beghin, 2004: 20), and Norway has notified a relatively large part of her agricultural support as “Blue Box” support. The WTO (2004) framework agreement from 2004 says that the “Blue Box” support should not exceed 5% of the production value, but with possibilities for special treatment, to be negotiated on, for member states with a large share of such support. Anyhow, there is a pressure on import tariffs and domestic support, and the ongoing WTO negotiations can be expected to result in further reduction in trade restrictions. The national target price system might be challenged also. Already there is increasing competition from imports, not least for processed food, partly because of the trade agreement between Norway and the EU (Kjuus, 2004).

In conclusion, it seems clear that the Norwegian government tries to stimulate competition in the food sector. More focus is set on consumer concerns. The nature of the market regulation is changing. An important objective of the present regulation is to

secure competition on equal terms between marketing cooperatives and other firms. New regulatory measures are introduced in order to secure food safety. Subsequently, the role of the marketing cooperatives is subject to change, as will be explored further in the next section.

## 2.3 The role of agricultural cooperatives

Several authors have emphasised that the function of agricultural cooperatives is to protect farmers' interests from being jeopardized by external integrators (Nesheim, 1964). The (British) Committee of Inquiry on Contract Farming (1972: 67) found that "(t)he impression from visits to Europe and America is that nowhere is contract farming practised more than in the UK (perhaps because where agricultural co-operation is more extensive there is less need for *ad hoc* contracting." As the Norwegian agricultural cooperatives have more tasks and serve more purposes than agricultural cooperatives in other countries, we will take a closer look at the role of the Norwegian agricultural cooperatives from the perspective of contracting.

### 2.3.1 Cooperatives as policy agents

Since the 1930s, farmers' marketing cooperatives have had important roles in implementing agricultural policies. The role as market regulator was clearly defined in the 1950s. The government and the farmers unions negotiate annually on target prices for many agricultural products (the Agricultural Agreement). It is the responsibility of the farmers' sales cooperatives to balance the market to make it possible to obtain the target price, but not a higher price. If the production is too high and presses the prices below the target price, the cooperatives implement measures to handle the "surplus". Export was earlier a usual way of disposing of surpluses, but this possibility is reduced according to the WTO agreement, and might be reduced further. The market regulation is financed by a levy on agricultural products. A semi-public board (Omsetningsrådet) administers the funds.

The market regulators have three specific obligations (Landbruksdepartementet, 2003):

- Provide information; i.e. all actors have a right to obtain full information on all activities that the market regulator conduct as market regulator
- A duty to buy the produce
- A duty to treat all actors on equal terms concerning supply of raw materials and at equal prices.

The market regulators have an obligation not only to buy what their members want to sell, but also produce from others, in accordance with the specific regulations for each product. The market regulation is most extensive for cereals, milk, meat, and poultry (egg and chickens). The system is much less developed in the case of fruit and vegetables.<sup>7</sup> The cooperative sale organisation in horticulture is since 1998 a producer organisation attached to one wholesaler (Bama). This organisation has not been delegated any role in market regulation. But there are still target prices for potatoes, apples, and some vegetables for part of the year.

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<sup>7</sup> The Market Act lists the products which are included in the market regulation system: meat of cattle, calf, mutton and lamb, reindeer and poultry, pork, cereals and oil seeds, milk, butter, eggs, fur, reindeer hides, and products from horticulture and green house products. The by-law (forskrift) on the authority of The Marketing Board (Omsetningsrådet) explicitly mentions cereals, meat, eggs and poultry, and milk. (Landbruksdepartementet, 2003).

In order to carry out their tasks as market regulators, it is an advantage (and probably a necessary condition) for the cooperatives to have a high market share at the first hand market. The cooperatives in milk and meat have market shares of more than 75 per cent. On the other hand, Felleskjøpet, which is the market regulator for cereals, has a market share of approximately 50 per cent as a buyer of cereals (Table 2.1).

To some extent the Norwegian cooperatives are delegated functions that in other countries is handled by public or semi-public institutions, like marketing boards. In Norway, there has been a close cooperation between the government and the farmers' organisations. There has also been a close cooperation between the state and business and labour federations in general. The notion "corporatist state" has been used to describe the situation.<sup>8</sup>

The combination of governance and cooperative regulation has secured that all domestic producers have had the possibility to sell their produce at the prevailing conditions, and secured equal treatment of all actors. Risk and transaction costs have thereby been reduced for all involved parties.

**Table 2.1 Market shares for the main Norwegian agricultural sales cooperatives. 2003**

| Organisation  | First hand<br>(raw material) | Processed<br>food <sup>1)</sup> |
|---|------------------------------|---------------------------------|
| TINE BA, Norwegian Dairies  | 98                           |                                 |
| Milk  |                              | 95                              |
| Butter  |                              | 100                             |
| Yoghurt   |                              | 84                              |
| Cheese (brown)  |                              | 93                              |
| Cheese (white)  |                              | 78                              |
| Processed cheese (Smelteost)  |                              | 18                              |
| Gilde Norsk Kjøtt BA, (Norwegian Meat Cooperative)                              | 75                           | 53 <sup>2)</sup>                |
| Prior Norway  |                              |                                 |
| Eggs  | 67                           | 66 <sup>3)</sup>                |
| Poultry meat  | 81                           | 82 <sup>3)</sup>                |
| The Norwegian Fur Breeders' Association   | 100                          |                                 |
| Hoff Norwegian Potato Processing Industries                                     | 35                           | 38                              |
| The Norwegian Honey Association   | 59                           | 92                              |
| Gartnerhallen (Sales Organization for Horticultural Producers)                  | 61                           | 66                              |
| The Norwegian Agricultural Purchasing and Marketing Cooperatives (Felleskjøpet) |                              |                                 |
| Cereals (bought)  | 53                           |                                 |
| Concentrates (sold)   |                              | 70                              |

1) Including retail market, institutional households, and private brands

2) Measured as percentage of cuttings

3) Measured as inputs to service final markets

Source: Norsk landbrukssamvirke (2004).

<sup>8</sup> Dryzek et al. (2003: 8) describe Norway as an example of a corporatist society. They define corporatism in terms of a tripartite concertation under which policy is made by agreement between the executive branch of government and peak business and labour federations. Business and labour federations agree to discipline their members in return for privileged access to policy making.



This advanced planning system is now challenged for many reasons. The import protection has been reduced, especially for potatoes, fruit and other vegetables. The system is likely to be reduced further as a consequence of the ongoing WTO negotiations. In order to adapt to possible future restrictions on the WTO “amber box”, cf. the WTO framework for modalities from 1 August 2004 (WTO, 2004), a change or even removal of the target price scheme might be an option. The effects of such changes will probably depend on, inter alia, the reductions in import tariffs.

### 2.3.2 Agricultural cooperatives as marketing cooperatives

If the agricultural-policy related tasks become less important or are removed from the cooperatives, they would still have the functions of “pure” marketing cooperatives and processors. Membership of a farmers’ sales cooperative might be regarded as a kind of long term marketing contract. As long as a producer is member of the cooperative, (s)he has the right and the obligation to sell the products to the cooperative,<sup>9</sup> and the cooperative has an obligation to buy the products. The payment is based on classification systems<sup>10</sup> and price systems that are known in advance.

As already mentioned, many cooperatives have a high market share, see Table 2.1. Especially in the dairy sector, the government has encouraged the establishment of dairy plants independent of the cooperative dairies. This has been regarded as an element to increase competition in the sector and to increase the product spectre. The new dairy plants have to buy milk from the farmers’ cooperatives or to have deliveries from their “own” milk producers. In any case there might be a need for contracts to protect the large investments involved.

To get a more complete picture of the driving forces behind new contractual relations in Norwegian agriculture, focus should also be set on the changing distribution of power between all players in the value chains of agri-foods in Norway. This analysis is deferred to section 3.4, where particular emphasis is set on the role that the retailer chains now play as “chain captains”.

### 2.3.3 Traditional contracting in agricultural cooperatives

In the 1950s and early 1960s, contract farming and vertical integration were under debate in Norwegian agriculture (e.g. Aresvik, 1955; Nesheim, 1960, 1962, 1964; Landbrukets Sentralforbund & Norges Bondelag, 1962). At that time, there were some examples of contract farming in the vegetable sector and in the meat production (Landbrukets Sentralforbund & Norges Bondelag, 1962). The slaughterhouse provided animals and credit, and the producer agreed to sell the animals to the slaughterhouse. There seem to have been two main reasons for the cooperative slaughterhouses to enter into contracting at that time: (1) competition from other slaughterhouses that had introduced contracting, and (2) the cooperatives were able to and wanted to provide credit to farmers (Landbrukets Sentralforbund & Norges Bondelag, 1962:31).

With a few exceptions<sup>11</sup>, however, contract farming did not evolve as an important governance mode within the Norwegian agriculture (see chapter 4 for a short descrip-

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<sup>9</sup> The statutes of Gilde Norsk Kjøttssamvirke BA (The Norwegian Meat Cooperative) § 7 states among others that ”Medlemmene har rett og plikt til å levere hele sin produksjon av slaktedyr til laget eller den mottaker det bestemmer. Unntatt fra dette er slakt til eget forbruk, til kårfolk og ansatte på gården.

Medlemmet kan ikke selge varer i konkurranse med laget, men styret kan gi dispensasjon etter regler fastsatt av årsmøtet.”

<sup>10</sup> For meat the EUROP system is applied. This is an EU/EEA system.

<sup>11</sup> Production of seed, vegetables for the cannery industries etc.

tion of the present situation). This situation is probably due to the combination of governmental regulations and strong agricultural cooperatives with the authority to regulate markets. Another possible explanation is the introduction of a bank overdraft system in 1968. The system is a co-operation between the banks and the agricultural cooperatives (and some other companies) and gives farmers access to credit.

Nonetheless, since membership in a marketing cooperative might be regarded as a long-term marketing contract, contracts have been an important part of Norwegian agriculture for a long time. However, such constitutionally oriented contracts do not specify production quantities and prices which are usually integral parts of contracts.<sup>12</sup>

### 2.3.4 New contractual formats in agricultural cooperatives

Traditional agricultural cooperatives have been oriented towards handling relatively uniform raw materials that were transformed into a variety of products. The number of products has increased over time. Lately, the demand is even more differentiated, and some of the product qualities originate at the farm level (Bogetoft & Olesen, 2004). It is often difficult or costly to measure the differences objectively. This is a situation that calls for production contracting or other coordination mechanisms (see for instance Hennessy (1996)). Sørensen (2005) has developed the classification system further, see Figure 2.1, also taking into account the significance of “vertical” differentiation which here refers to increasing degree of value-added production at the cooperative plants. A traditional cooperative is characterized by low differentiation of inputs and low differentiation of outputs; i.e. a relatively limited number of products. A second type of cooperatives (value-added cooperatives) has a higher degree of processing. Higher differentiation of inputs means that the cooperative moves towards a specialised traditional cooperative or a specialised value-added cooperative. The specialised cooperatives have a high degree of differentiation of raw commodities. They might have one standard raw commodity and one or more specialised commodities. Standard pigs and specialty pigs are one example. Bogetoft & Olesen (2004: 120–122) discuss how to construct a payment system in order to exploit synergies between producers of standard pigs and specialty pigs. The criterion they suggest is “that no coalitions of producers should obtain a profit smaller than the coalition’s stand-alone profit, i.e. the amount of profit which the coalition can obtain outside the cooperative.”

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<sup>12</sup> Members of marketing cooperatives usually have an obligation to sell all their marketed produce to the cooperative, but the members are free to produce what they want.

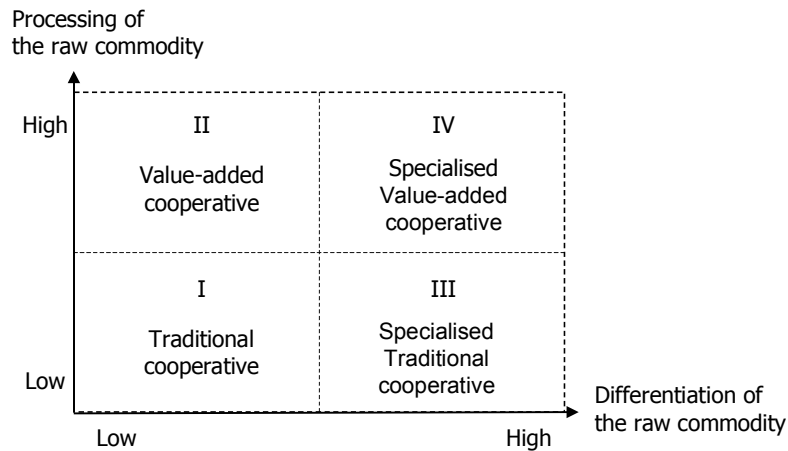


Figure 2.1 Classification of cooperatives according to differentiation of inputs and outputs

Source: Sørensen (2005)

## 2.4 Summary

For decades, Norwegian agricultural policy has been characterised by numerous ambitious goals. At institutional level, a range of measures, including market regulation, have been implemented to achieve the goals. An advanced corporatist model for regulating domestic food markets has been developed. This model has served as a solution to key economic questions; determination of prices, regulation of aggregate production quantities, and handling of produced quantities. Strong regulation of imports has been a fundamental part of the policy.

The majority of the agricultural producers are members of marketing cooperatives. These cooperatives have a duty to buy what the members produce. In addition they have important tasks in implementing the agricultural policy and market regulations in order to obtain the target prices. All producers have had an almost unconditional right to deliver their products at the time they prefer.

In this context there has been relatively few issues left over for contracting as it is found in for instance the US agriculture. However, contracts have been applied in some parts of agriculture, for instance in the fruit and vegetable sector where the public involvement is less than in many other sectors.

However, the agricultural policy and the role of cooperatives have been changing recently and might be changed even more in the future. The room for contracting is increasing. Although agricultural policy and agricultural marketing cooperatives are important parts of the institutional environment for farmers, they are far from the only important factors. In the next chapter we shall look at other factors that have an influence on the agri-food sector. Our assumption is that these factors will to a large extent determine how the enhanced scope for contracting will be filled.



### 3 Other factors leading to new contractual arrangements

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In Chapter 2, we have briefly outlined some core characteristics of the Norwegian agri-food sector that have had wide ramifications for the type of contracts in this sector. The market regulation model is withering, and the cooperatives are adapting to new and more demanding competitive conditions. The inevitable consequence is that many new sources of uncertainty are becoming increasingly more significant. The involved actors are exposed to increased uncertainty in many new ways and forms.

As formulated in the vocabulary suggested by Transaction Cost Economics, the transactional nature of agri-food production and distribution is subject to increased complexity. The major drivers of transaction costs—asset specificity and transactional uncertainty—can easily be identified. Consequently, the straightforward prediction as seen through the lenses of Transaction Cost Economics is that the governance form will become more complex too. The nutshell version of this theory is that “simple transactions are governed by simple organizational structures, whereas complex transactions are governed by complex structures”. From this simplified basis, it is natural to predict that more complex contractual formats will unfold in the Norwegian agri-food sector the next decades. But this is nothing but a starting point. The more specific task at hand is to clarify the nature of the ongoing (and future) transformations in the sector, to substantiate them, to qualify their consequences for novel contractual arrangements, and to clarify how various players are influenced. Attention is paid to the new rules of the game (read: changes at the institutional level; macro) as well as to the strategic play and interplay between the involved actors (read: changes at the governance level; micro). To the largest possible extent, the changes will be interpreted from the perspective of the Transaction Cost Economics (see Borgen & Hegrenes (2005) for a more detailed review of this perspective).

Our ambition is to contribute to clarify the most relevant questions rather than claim definitive conclusions with respect to the future contractual situation of the Norwegian agri-food sector. We start our exposition with a brief discussion of new consumer trends and new technology, both of which are interpreted as very broad driving forces.

### 3.1 New consumer trends and new technology

It is well documented that new consumer trends play a decisive role in the current transformation of the agri-food sector. In their study of innovation processes in the EU-countries, Traill & Grunert (1997: 38) have shown that there are multiple innovation drivers at the consumer level, such as:

- Consumer concerns; such as environmental consciousness and food safety.
- Demographic factors; such as increased share of women in the paid labour force, which has contributed to the increased demand for convenience products. The demand for more processed foodstuffs has increased rapidly as well.
- Easy availability of food products, which implies that the same food are available throughout the entire Europe. This situation imposes new pressure on local food manufacturers who were previously more protected from competition.
- The increasing significance and wider distribution of processed food. New product introductions have made available a huge range of processed foods, for instance ready-prepared chilled, frozen, canned, dried or ambient meals, based on many different ethnic and traditional cuisines. Another example is the wider range of functional foods designed to promote positive health, such as “live” yoghurts, sports drinks, high-fibre foods and vitamin-enriched foods. To some extent, functional foods blur the distinctions between foods and pharmaceuticals. A last category of examples is all manner of sauces, fresh and frozen desserts, snacks (sweet and savoury), “mood” foods, “impulse” foods, regional specialities etc.

These “new” foods are variously packed in all shapes and sizes of containers which are increasingly recyclable or produced from recycled materials.

These aspects are just to illustrate, and other examples could clearly have been mentioned. The main point we want to make here is that these new demand-driven changes serve as a trigger of new governance forms at the supply side. An example from the Norwegian potato processor Hoff Norske Potetindustrier is informative. Changes in consumer pattern trigger this company to regularly change the attributes of their products. These changes in attributes are not easily transmitted backwards throughout the value chain to producers. Standing alone, prices and other incentives are not sufficiently specific. More detailed specifications of the quality level are called for, in order to transmit the necessary signals of expected quality to the producers. For instance, all suppliers of potatoes intended to pommes frites must live up to detailed specifications as regards colour, size etc. This is an illustration of situations where the qualities of the end product to a large extent are determined by specific qualities of the raw product, e.g. organic food, animal welfare in production, functional food, etc., see for instance Boehlje (2002). Producers become more and more like tailors, in the sense that they must adapt to the detailed specifications of the end product.

Differentiation in processing is not a new phenomenon, but the demand for qualities that originates at the farm level has increased the last decades (Bogetoft & Olesen, 2004). These properties and qualities are not always easy to observe. For instance, it may be difficult to distinguish organically produced product from conventionally produced products. It is typically a situation where the information is asymmetrically distributed between buyer and seller. Subsequently, it will be necessary for the seller to transmit some quality signals or guarantees. This calls for quality signals in the form of branding (private control and enforcement), certification (third-party control and/or enforcement), or even public control. We also expect that production-management contracts will, to an increasing extent, replace “conventional” sales contracts or spot markets.

New technology developments are spurring solutions that were unthinkable a few years ago. Some technological advances have a substantial influence on transaction costs. For instance, the food industries in many countries have developed an enormous capacity to track the flow of food along the supply chain. Some systems track the food back to the farm, while other track it only back to some key point in the production process (Golan et al., 2004). According to Golan et al., firms have three primary objectives in developing, implementing and maintaining traceability systems; to improve supply management, to facilitate traceback for food safety and quality, and differentiate and market foods with subtle or undetectable quality attributes. Traceability is not the only means to these objectives, and alone it cannot accomplish any of them. For instance, traceability systems do not create credence attributes, they simply verify their existence.

Other technological changes are connected to logistics. New applications based on information technology make it easier to monitor sales and to order the “right” quantities at the “right” time. For some products this might reduce waste, thus reducing transaction costs, and also contribute to improved product quality. This technology lays the foundation for more demand-driven—and less supply-driven—value chains.

Therefore, changes in technology may influence the level of transaction costs, and have a substantial impact on the possible scope of action. Such changes make it possible to meet new consumer demands at a “reasonable” cost. What was technologically impossible or too costly some years ago, is now possible and affordable. Thereby, changes in transaction costs might have an impact on governance structure.

## **3.2 Changes at the international institutional environment level**

Through the last decades, the Norwegian agri-food sector has been increasingly influenced by the dynamics at the international, institutional level (Veggeland, 2004). This is part of a broader globalisation. Here, we shall briefly pay attention to three important domains; i.e. food safety in general, GMO-based food, and organically produced foodstuffs. In all three domains, international agencies are gradually developing international standards that are either binding or semi-binding for the involved nations. In most cases, these internationally developed standards constitute reference points for commercial actors who engage in economic transactions with the relevant foodstuffs.

The agreement on the European Economic Area (EEA) and the GATT/WTO agreement mean that restrictions are imposed on national support for agriculture and on import tariffs. In addition, there is a globalisation of standards and reduced technical barriers to trade. The increasing globalisation of the agri-food sector implies that national producers to a greater extent face foreign competitors. National regulations are increasingly harmonised. Accordingly, both producers and traders must take international standards into account, see more on this in Section 3.2.3.

### **3.2.1 Food safety**

The food safety aspect has been increasingly pronounced in most western countries throughout the last decades. Not surprisingly, incidents of bovine spongiform encephalopathy (BSE), E.coli, Salmonella and Listeria have heightened consumer concern over the safety of food supply. The food safety domain includes incidents of food-borne illness as well as assessment of the safety of specific food production and processing methods.

The increased concern for food safety has motivated governments to introduce stricter food safety regulation. Public concern over outbreaks of food-borne diseases also prompted voluntary actions on the part of many industries. Quick identification and

isolation of the actor of the supply chain that is responsible for the outbreak is recognized as critical by both industry and government (Hobbs and Young, 2001). Subsequently, many countries are working toward traceability of individual animals through the supply chain. Many industries are developing food safety standards and undertake the administration of those standards, which require close industry coordination. In addition, some manufacturers and retailers adopt hygiene and manufacturing standards that are more stringent than public standards. It is often costly to test for food safety, at least far more costly than to secure that production and distribution are made in a way that reduces the probability of food safety problems. However, as incomes increase, consumers are probably willing to pay more for higher food safety standards to minimize risk (Hobbs & Young, 2001). In this respect, documentation of production processes and of product quality is an important instrument.

This situation might have an influence on new contractual arrangements between national actors at various stages of the value chain, but also between national and foreign actors in order to protect market shares and/or get into new markets. Increased consumer worries about food safety greatly impact legislation and regulation within this area, both at national and international level. For instance, such worries are voiced through international standard setting agencies within human health (Codex Alimentarius Commission), animal health (Office International des Epizooties, OIE) and plant health (International Plant Protection Convention, IPPC). The WTO agreement plays a particularly influential role. Norway's obligations as WTO member imply that all national measures and regulations at the food safety area must be in accordance with the SPS agreement and TBT agreement.<sup>13</sup> There is now an increasing pressure to harmonize national food safety standards into regional standards (e.g. EU standards) as well as global standards (e.g. Codex).

Food quality standards have a long tradition in Norway as well as in other countries. Norway has established "Norsk Standard", and other countries have similar systems. The standards specify some basic rules concerning products and services. It is often voluntary to follow standards in a strict legal sense. In other cases the law specifies that a certain standard has to be met, e.g. Norway's obligations according to the EEA agreement to adapt to EU standards. However, the great advantage of following standards is to reduce transaction costs, especially when the same standards apply to many countries, as mentioned above.

### 3.2.2 GMO-based food

Genetically Modified Organisms (GMO) techniques refer to manipulation techniques that open the door for more tailor-made production of foodstuffs. So far, however, there is a widespread scepticism towards GMO food. The uncertainty associated with the product properties is high, and all necessary information cannot be conveyed through prices. Norwegians are among the most sceptical in Europe towards GMO food (Mykeltvedt, 2004). GMO-free food can be regarded as a credence good since information is asymmetrically distributed between buyers and sellers. Quality standards are necessary supplements to price information. The international food authorities (particularly the Codex) play an important role in implementing the required standards.

### 3.2.3 Organic farming

Organic farming illustrates a situation where a public certification system is used in order to clarify the operational definition of the involved quality attributes. Norway complies with the EU regulations regarding marketing of organic produce. In Norway,

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<sup>13</sup> SPS agreement: Agreement on Sanitary and Phytosanitary Measures, TBT agreement: Agreement on Technical Barriers to Trade.



the Debio quality certification system has been delegated the right to develop a legally binding definition of “organic farming” and to certify organic producers and processors. The actors in the food supply chain can and will rely on these systems, and possibly add some special contractual conditions regarding logistics etc.

The regulations regarding organic farming and food safety might be regarded as a kind of standardisation although they are not formulated as “Norsk standard” or an international standard. Standards and standardization have gained more attention during recent years. One reason is the SPS and TBT agreements as part of the GATT/WTO agreement which became effective in 1995 (Veggeland, 2004). Both the SPS and the TBT agreement refer to international standards as important measures to prevent technical barriers to trade.

One hypothesis is that “...new commodity standards created by a fall in the cost of measurement turn private information about commodities into a public good; shift self-enforced components of agreements into their contractual, state enforced components; lead to less vertical integration, increase the incidence of theft; make the contents of commodities clearer, more comparable and easier to enforce; and thus make competition more ‘perfect’.” (Barzel, 2003: 1). It is in accordance with this hypothesis that Gilde Norsk Kjøtt no longer has contracts regarding organic meat. However, it is necessary for the farmer to be Debio-certified and to inform the slaughterhouse that the animal for slaughter is produced organically. The animals must have Debio’s organic ear-mark. The farmer has to notify deliveries at least 2–3 weeks in advance, depending on kind of animal (cattle and lamb and to some extent pigs) (Wold, 2004).

### 3.3 Changes at the national institutional framework level

As discussed earlier, there is now a development towards deregulation of national food-markets. We have witnessed a change in the agricultural policy from “less market, more state” to “less state, more market”. The change is more pronounced in some sectors (e.g. the fruit and vegetables) than in other sectors. Regulation represents bonds for the actions and interaction of the players, and the market regulation mechanism take care of some tasks that could be expected to be contracted without public regulation, such as securing an outlet for the primary producers. Deregulation typically leaves more room for “private” agreements of various kinds (bilateral and/or multilateral).

At the same time as the traditional market regulation is reduced, however, regulation regarding e.g. food safety is increasing in importance. The state also introduces new labelling schemes, e.g. labels of origin, regulations for production and marketing of organic food etc. The state alters its role and function; from direct regulation to a third party role in various “guarantee-securing” arrangements (quality standards, labelling). Such arrangements help to fill in information gaps in the sense that they guarantee a certain quality level in a situation when properties are hidden for consumers. Given the vocabulary suggested by Transaction Cost Economics, these are all special cases of authority mechanisms (Hegrenes and Borgen, 2005).

An increasing share of the consumers demands a more transparent production and distribution process. The establishment of quality certification systems such as KSL, Matmerk etc.<sup>14</sup> can be interpreted as an institutional response to such demands. These certification systems imply that essential parts of a bilateral contract can be settled by simply prescribing that the parties respect the rules and standards of the body in question. For instance, most wholesalers take for granted that their suppliers of agri-food products live up to the relevant KSL standards in order to qualify as supplier. In other

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<sup>14</sup> KSL (Kvalitetssystem i landbruket) means Quality System in Agriculture. Matmerk is a labelling institution.

cases, these standards serve more as a point of reference to which all involved parties may refer. In either case, transaction costs are significantly reduced as compared to the situation where all contingencies are subject to detailed negotiations.

### **3.4 Changes at the governance level (hybrid forms)**

When it comes to governance level—i.e. what Williamson (2000) refers to as the level of second order economizing—significant changes can easily be observed in the Norwegian agri-food sector. To a large extent, they are linked to the new “rules of the game” that unfold at the international and/or national institutional level. But they are not fully determined by these new rules, since scope remains for other drivers too. Here, we shall briefly mention the most important factors.

#### **3.4.1 Changes at the retail level: Concentration and vertical integration**

The Norwegian retail industry is among the most concentrated in Europe (Hughes, 2002). The four large retailer chains have a market share of 99%. We have emphasised—among other factors—the significance of changed consumer patterns and more market oriented political ideology. What are the consequences of this high concentration for the contractual arrangements in the sector?

The first factor to take into account is increased vertical integration. For a long period of time, the farmers were the main integrators. Farmers established sales cooperatives to sell and process their products. Possibilities for productivity gains and cost reductions along with a wish to increase market power were important incentives.

Lately, both horizontal and vertical integration have been increasing within the retailer and the wholesaler sectors. The retailer sector is now dominated by four chains which are integrated with wholesalers.<sup>15</sup> In large, the market power of the retail sector has increased, whereas the power of the processing industry and the farmers has diminished. Earlier the processors could be regarded as agents for the farmers, and the retailers as agents for the processors. Now the retailers might be regarded as principals and the processors as agents, and the processors are agents vs. the farmers (Hornibrook & Fearn, 2002).

This development is consistent with the process that Boehlje (1999) has referred to as “the new manufacturing philosophy”. So far, the expanding retailer groups have utilized the benefits of vertical and horizontal integration best. They have streamlined the value chains and reaped benefits. This represents a significant push towards more unilateral contracts.

The retailers as a group are now in a very strong position when negotiating terms of trade. Retail chains introduce more and more private labels with specific quality requirements. In order to guarantee a specific quality level, the owners of the brands have a need to control the whole production process. The retail sector does no longer “take what they can get”, but instead decide what they will have (Busch, 2004). In the same spirit, Kinsey (2002) talks about “The Big Shift from a Food Supply to a Food Demand Chain”. Such trends indicate a wish from the wholesalers and retailers to have more influence on how production is carried out.

Traceability is another part of food safety guaranties. From a contractual point of view, risk sharing and how to share responsibility are among the interesting issues.

Furthermore, there seems to be a preference among consumers for both low prices and a variety of commodities to choose among. In Norway, discount-chains have a large

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<sup>15</sup> The German retail chain Lidl opened its first shops in Norway in autumn 2004 and is a fifth chain.

market share. The vertical integration of the wholesaler and retailer sector might be interpreted as part of a cost reducing strategy; to get control over the logistics and to reduce the number of transactions might be an efficient means to reduce transaction costs. This effect is additional to the effect of greater bargaining power.

Discount concepts often imply a relatively narrow spectre of varieties with little room for specialty products. The ordinary marketing channels will be interested in specialty products only if the producers can “guarantee” high volume and sufficient profit. Concentration of retail chains might exclude some producers and products from the shelves, also some innovative products and products demanded by a relatively small group. Producers of specialty products and innovative products might have to develop alternative marketing channels (Jervell & Borgen, 2004). Farmers Market is one example of such “new” marketing channels.

The development within the Norwegian apple sector the last decades might illustrate some of the implications of these trends for the sales cooperatives. In the 1980s, the horticulture sales’ cooperative (Gartnerhallen) benefited from a strong market position. Gartnerhallen did not find it necessary to build its own brands, but had significant market power as compared to the other wholesalers. In the 1990s, Norway experienced the consolidation and concentration of the retail/wholesale sector. Gartnerhallen got fewer and larger customers. Finally, Gartnerhallen lost all delivery contracts. In order to save as much as possible of its assets, Gartnerhallen entered into a strategic alliance with BAMA/Norgesgruppen. The role as market regulator was partly taken over by other institutions, partly terminated. The producers ended with a significantly weaker market position.<sup>16</sup>

### 3.5 Summing up

As illustrated in this chapter, the Norwegian retail sector is in a period of rapid transition. Consumers are demanding lower prices and more varieties. They also demand more product information and quality guaranties. Producers and retail chains develop quality assurance systems. In some cases, public standard or regulations can be relied on, as in the case of organic farming and organic products. In trade politics, the nations partly rely on international standards, as in the case of SPS and TBT, to prevent undue protection. Internationally developed standards will more and more serve as reference points for commercial actors who engage in trading. Thereby, these standards will indirectly constitute a significant part of the bilateral or multilateral contract(s) by which economic transactions are settled.

The retail and wholesale sectors have become more integrated and concentrated. To a greater extent than before, the retail sector can now decide on their own premises what they want to sell. They do not have to sell what the farmers and the manufacturers want to sell. The control of the time and conditions of delivery, and the quality and appearance attributes<sup>17</sup> is to a larger part than before in the hands of the retail chains. The retailer chains have increased their market power.

The effects for contracting formats of the trends illustrated in this chapter must be view in the context of the changes discussed in Chapter 2. The retailer chains are in position to profit from these changes. This sector will have a strong influence on the contractual developments that will develop if and when the border protection is reduced and the national agricultural policy is changed.

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<sup>16</sup> The development in the apple sector in general and in the Hardanger region especially is described by Knutsen et al. (2001).

<sup>17</sup> The terms “control of the time and conditions of delivery, and the quality and appearance attributes” are borrowed from Wilcox & Cochrane (1960, Chapter 9).



## 4 Some expected consequences for contract design in the Norwegian agri-food sector

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In this chapter we draw some general conclusions on what can be expected in the future. The topic is discussed in more details in Borgen & Hegrenes (2005).

Profitability is regarded as an important goal, but not necessarily the only goal, for the actors in the agri-food sector. In a competitive situation cost-reduction is an important strategy for firms in their struggle to improve profitability. Changes at the institutional level will have an influence on what is feasible for the various actors. Some possible changes are briefly mentioned in the following.

Import protection (high import tariffs) is an important part of Norwegian agricultural policy. Less protection, for instance through a new WTO agreement, might become of great importance for Norwegian agriculture, the processing industry, the retail/wholesale sectors, and the consumers. At present it is impossible to gauge the outcome of the negotiations with certainty. However, based on the framework agreement from 2004 (WTO, 2004), one can expect reduction in export subsidies and import tariffs, and increased market access. In addition, reductions in trade-distorting national support (“amber box” and “blue box” support) can be expected. However, much remains to be negotiated about, and the outcome is uncertain.

The differences between the target prices and the reference prices are important element when estimating “amber box” support. If Norway has to reduce the “amber” box support as a result of the WTO negotiations, one alternative measure is to dispose of the target price system for some or all products. We expect that the rest of the market regulation system could be continued. To dispose of target prices would change the market regulation schemes quite substantially, and could potentially increase the frequency of contracting.

Globalisation of food trade (lower tariffs etc.) changes the relation between Norwegian producers, processors, and retailers. The producers and processors will face tougher competition from foreign producers. If the retailers (the retail chains) are not satisfied with the conditions offered by Norwegian producers, the retailers can more easily trade with foreign producers if the import tariffs are lower. The producers might react to tougher competition from foreign producers by more extensive use of country

of origin labels and other labels. If the consumers are willing to pay a higher price for Norwegian products, this strategy might be successful. Such a strategy will have consequences for the contractual formats of the sector.

Although the implementation of the new WTO agreement will be some years from now, WTO will more and more influence Norwegian agriculture. In the meantime the public market regulation schemes will be important for most products in Norwegian agriculture (milk, meat, eggs, cereals and some other products). Agricultural cooperatives will still be important in implementing the policy. We do not expect contracts, in addition to membership in cooperatives, to become very frequent or very extensive for the main products from Norwegian agriculture in the near future.

Some trends that are relatively independent of the development within WTO can also be expected to be of great interest for contractual arrangements. Some of these trends have been explored in some detail in case studies in this project or in other projects. We briefly mention some of the conclusions:

- Contractual arrangement will be developed for products where the public market regulation schemes are terminated or become less important. The retailer/wholesaler chains have the power to “decide” the terms of the contract. An important question is to what extent they will exercise the power (Knutsen et al., 2001; Borgen & Hegrenes, 2005).
- Consumer concerns for food quality and food safety create a need for more extensive traceability systems and quality assurance systems. This can be expected to increase the use of production contracts.
- The quest for profitability and the competitive situation call for efficient logistics. Contracts can be expected in order to simplify logistic and to reduce transaction costs.
- “New” marketing channels will develop for products that are not marketed through the integrated supply chains. Farmers’ markets and other forms of direct marketing are examples of such new marketing channels (Jervell & Borgen, 2004; Svennerud & Jervell, 2004; Svennerud, Jervell & Øyen, 2004).
- Farmers’ marketing and processing cooperatives will develop contracts to handle specialty products where the demanded quality originates at farm level (Sørensen, 2005).
- Public standards and control schemes for organic farming and marketing of organic products will serve as reference points for bilateral contracts. This implies that processors need not necessarily have to enter detailed production management contracts (Borgen & Hegrenes, 2005), but their obligations will probably be just as demanding.

In conclusion, we expect government regulations of Norwegian agriculture to be important for many years to come. But the agri-food sector will become more consumer-driven than it has been until now. Sales and production contracts will become more common in Norwegian agriculture in the future. Contracts will be more common for value-added products than for “bulk” products. Such contracts will develop also within some of the agricultural cooperatives.

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