

Microeconomic theory and practice of formation of contractual relations in agribusiness

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* 1. Introduction

Contractual relationships play a very important role in agribusiness, and therefore a thorough understanding of the formation and management of these relationships at all levels from primary production to the final consumer is essential. Contractual relations can be viewed from both theoretical and practical perspectives. From a theoretical point of view, it is possible to look for solutions to complex situations in contractual relations using a certain simplification of reality. Such an approach may help to clarify and understand the basic processes that occur in contracting, but also to overlook the empirical importance of essential processes and their alternatives. The practical approach tends to be based on improving contracts only based on gradually emerging shortcomings, and such a trial-and-error method can have relatively high risks and costs due to its random nature, see e.g. Bečvářová et al (2015). Therefore, it is useful to use both approaches at the same time, where existing theoretical knowledge leads to better empirical outputs, which then again becomes a source for newly generalized theoretical knowledge. This ar-

ticle aims to evaluate the functional mechanisms of contractual relations in the economic theory and practice of agribusiness.

2. Theoretical background of contractual relations

Cotula (2021) describes contracts as the sinews of economic organization as they coordinate production and trade, linking input suppliers to farmers, all the way to end-buyers such as big brands and supermarkets. They distribute risks and rewards among value chain actors and often regulate aspects such as seeds, farming techniques, and product quality. (Cotula, 2021). Massey et al. (2020) add that at least three business decisions are involved in every business transaction and these three elements along with the relationship between output and input should be reflected in the amount of detail in the contract:

- the allocation of decision rights
- the allocation of reward, or value
- the allocation of risk and uncertainty.

Contractual relations in economic literature are a relatively fragmented topic with various method-



→ ological strands that are often narrow in their focus and therefore require further research, see Wu (2014). A deep insight into production relations and productivity in agribusiness was developed by Al Mahmud Titumir (2023). Meemken and Bellemare (2020) describe the specifics of smallholder farmers regarding contract farming which is a term for a pre-harvest agreement between farmers and buyers and is commonly understood as a useful tool to mitigate prevalent market failures and to reduce the risks facing smallholder farmers. According to the duration of the contractual relationship, we can distinguish three basic approaches to contractual relations: classical, neoclassical, and relational approach. According to Slangen et al. (2018), the classic approach is characterized by the short-term nature of contractual relationships, with price being the most important of the coordination mechanisms, assets being relatively unspecific, the identity and personality characteristics of the contractual parties are not considered essential, and guarantees are less significant. Logically, capturing all possible eventualities due to limited rationality is never fully feasible. One of the understandable weaknesses is also the fact that the classical concept does not address the issue of identity and personality characteristics of the parties of contractual relationships and that it assumes quite clearly specified specific transactions, which is an ideal state, but in reality it may not always be met. Written contracts are considered the basis of contractual relations, where the decision in case of potential disputes is left to the law courts. According to Slangen et al. (2018), the neoclassical approach is characterized by medium-term contractual relations. Price then represents a less important coordination mechanism than in the classical approach and, conversely, identity, personality characteristics of the contracting parties and guarantees become more important in contractual relations. Assets are moderately specific, the duration of contractual obligations is usually fixed, and written contracts are the basis for future negotiations. In this case, the possibility of introducing arbitra-

tion mechanisms is foreseen and therefore it is not necessary to specify all possible eventualities in contracts (Palát and Palátová, 2021).

The last approach allows for an even greater loosening of the contracts concluded. Within the relational approach, contractual relationships of a long-term nature are addressed (Lyons and Metha, 1997; Flanigan and Sutherland, 2016), where the duration of the contractual relationship is usually not specified. A relational contract specifies only basic general data and objectives and specifies mechanisms for dispute resolution and adjudication (Milgrom and Roberts, 2019). According to Slangen et al. (2018), the price represents a relatively insignificant coordination mechanism compared to the classical and neoclassical approaches, but the identity and personality characteristics of the contracting parties are crucial. The assets are highly specific and the guarantees are very substantial. Written contracts are a record of the contractual agreement, but in potential disputes, the values and norms of conduct of the parties to the contractual relationship play a more important role than the written contracts themselves. While in the classical approach written contractual relations are placed at the top of contractual relations and the role of verbal contractual relations is completely ignored, in the neoclassical approach these contracts already provide a basis for further negotiation, and in the relational approach, the mutual long-term relationship of the contracting parties often becomes more important than the specific written definition of this contractual relationship (Dvořáková and Palát, 2014; Palát and Palátová, 2021).

3. Theory and practice of contractual relations in agribusiness

Theoretical approaches to contractual relations and the dissemination of knowledge and information can lead to a useful enrichment of the practice of contractual relations in agribusiness. Wu (2014) discusses the current state of contract theory and

its usefulness for conceptualizing issues related to agricultural contracting. He illustrates how classic methodological approaches can be combined with recent developments in contract and game theory to construct applied theory models that are useful for capturing some important features of agricultural contracts. According to Bogetoft and Olesen (2004), who dealt with the relationship between contract theory and practice, there are some limitations. According to them, real contractual relations can only reach the current level of contractual relations theory, and therefore it is necessary to strive for a correct understanding and rationalization of real contractual relations in everyday practice. They also noted that there are quite significant differences in contractual relations over time. New contractual relationships are often built on weaker foundations and ignore various contingencies. Only over time contractual relationships become more complex. In practice, contractual relationships are often built without theoretical knowledge in this area and are based on trial and error or previous experience of the parties involved. The effect of such a non-systemic approach is higher risk and uncertainty, and the associated higher potential costs. Ludwig von Mises (2013) warns against shutting down theory and practice on a more general level. Economists describe various business activities in theories, but often they do not directly realize them. Therefore, entrepreneurs who carry out these activities have a more realistic awareness of specific economic situations than theoreticians, who, however, can put these specific findings into a broader framework. Therefore, when creating theoretical models, it is important not to rely on analytical skills and desk work only, but to use knowledge from practice and cooperate widely with it.

It is common for authors to solve only one or a few selected problems using specific economic models regarding contractual relations. Such an approach can help to break into the depth of the studied phenomena, but in practice, its use is often limited. This is generally confirmed by Rutherford

(1996), with the idea of methodological holism, which is most often accentuated in sociology but has gradually found its place in economics (e.g. institutionalism) and other scientific disciplines. The holistic approach is characterized by the fact that the whole is more important than the mere sum of its parts and has a considerable influence on the behavior and functioning of its parts. Ignoring some aspects of contractual relations can affect the overall result, which can only be estimated based on a comprehensive assessment of all aspects of the contractual relationships studied. In addition, it is advisable to have a defined hierarchy of goals in the formation of contractual relations and certain rules for their creation, because the more complex the processes under consideration, the higher the need for creating a certain hierarchy. These and other issues will be further dealt with in the paper in more detail.

4. Key mechanisms of contractual relations

The main mechanisms of contractual relations are represented by issues of coordination, motivation, and transaction costs (Slangen et al, 2008). Borgen and Hegrenes (2005), based on Pihl (2000), distinguish several basic coordination mechanisms within the economic theory of organization. The first of them is called a handbook. Such coordination is based on the idea that contractual relations must adhere to established rules, guidelines, or guarantees. The disadvantage is that excessive formalism in handbook coordination can be burdensome for the other party and undermine its confidence in its contractual partner. The second type is described as the invisible hand. Here, following classical economic theory, price is the basic coordination mechanism.

Obviously, a combination of handbook and invisible hand mechanisms is also possible, depending on the relative importance of the price and the set rules, directives, etc. This is very widespread in reality. Price can also play an incentive role or fulfill the function of a certain consideration. The



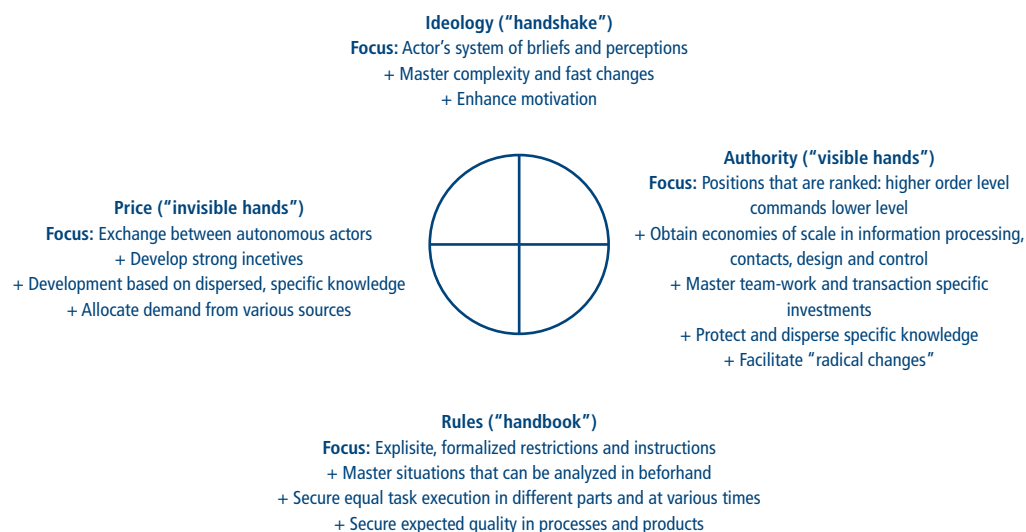
→ third type of coordination mechanism is the handshake, where mutual trust, shared values, and norms, along with the ability to find agreement, play an important role. Informal rules can lead to a reduction in transaction costs, as reported e.g. by North (1993). The last mechanism called the visible hand, is particularly widespread in companies that have a hierarchical management structure, and the individual representatives in contractual relations operate at a given hierarchical level and do so relatively independently. The disadvantage is that they are not vertically integrated. Appropriate hierarchical powers play a key role here. The original mechanism created by Pihl (2000) and first published in English by Borgen and Hegrenes (2005) is illustrated in Fig. 1.

Different coordination mechanisms play a role in different approaches to contractual relations. In the classical approach, the mechanisms of the invisible hand and handbook appear. However, the key role here is played by the price and therefore the invisible hand mechanism, which was intro-

duced first, prevails. In the neoclassical approach, the role of the price as a coordination mechanism is somewhat weakened, and therefore the coordination mechanism can be described by a combination of the handbook in the first place and the invisible hand in the second place. Elements of the handshake mechanism may also appear here. In the relational concept, the role of price is limited, and the other factors already mentioned predominate. Therefore, the handshake coordination mechanism prevails here, while invisible hand mechanisms or even a handbook may partially appear.

Another important issue in the mechanisms of contractual relations is the motivation, which is given by the different interests of the individuals involved in the formation of contractual relations. We distinguish between internal motivation, which is associated with the feelings of the individual (well-done work, achieved goal, precise processing, etc.), and external motivation, which includes all other motivational factors that affect the

Figure 1 » Scheme of coordination mechanisms within the economic theory of an organization



Source: Borgen and Hegrenes (2005)

individual from the outside (remuneration, benefits, career advancement, but also the threat of punishment). The role of individual motivation factors can change as they coexist. For example, in formalized hierarchical management structures, external motivating factors (e.g. execution of orders according to established rules and guidelines, performance tables, and remuneration system) can undermine internal motivation, which is often neglected in market behavior models. An individual's actual motivation is usually a combination of internal and external motivating factors. Many contractual relationships provide governance mechanisms that set performance criteria that are then reflected in remuneration. Again, the forms of motivation diverge in different approaches to contractual relations. In the classical approach, motivation based on performance evaluation is considered, which is less pronounced in the neoclassical approach, and the relational approach is then based on completely different forms of motivation. These include, for example, reliability, credibility, professional and career growth, or building a good reputation.

The third important issue in the mechanisms of contractual relations is transaction costs. This term comes from Coase (1937) and was developed mainly by Williamson (1971, 1981) and later in collaboration with Masten (Masten, Williamson, 1999). Of course, a large number of other leading economists have studied it. Despite this, and perhaps because of this, there is no single universally accepted definition of this term. We can still say that these costs represent the time, labour, and other resources that need to be spent to conclude contracts, manage companies, and so on. They are associated with the use of a price mechanism, which, however, is not functional on its own. It is necessary to identify prices on the market, compare them, negotiate prices, formulate contracts correctly, monitor them, and establish dispute resolution mechanisms and the level of possible penalties for non-compliance. They therefore present additional costs associated with contractual rela-

tions. Transaction costs appear in market transactions, but also in other specific areas such as motivation, coordination activities in companies, or contractual relationships. Matthews (1986) divides transaction costs into costs for securing contractual relations (ex-ante) and costs for monitoring and enforcement (ex-post). Contract-related transaction costs and other similar costs fundamentally affect the allocation of resources. Other institutionalists also draw attention to the considerable importance of property rights concerning the costs associated with contractual relations.

The importance of issues of coordination, motivation, and transaction costs may change in real situations in contractual relations, therefore it is necessary to approach the analysis of contractual relations with caution and to adapt the formation of contracts to specific conditions concerning, for example, production technology, existing market structure or ownership rights. This is the only way to avoid fatal failures caused by the erroneous assumption that if contractual relationships work well in one model situation, they will work equally well in another. Several contradictory goals appear in contractual relations, which change adaptively in different situations. Therefore, it is appropriate to work with ten key rules for the formation of contractual relationships, e.g. according to Bogetoft and Olesen (2004). The rules for the formation of contractual relations are as follows:

- production coordination,
- balancing the pros and cons of decentralization,
- minimizing costs related to risk and uncertainty,
- reducing the costs of post-contractual opportunism,
- decrease in the cost of pre-contractual opportunism,
- maintaining cooperation,
- motivation concerning long-term interests,
- settlement of pros and cons for re-negotiation,
- reduction of direct contracting costs
- use of transparent contracts.



→ The first three rules (coordination of production, balancing of pros and cons of decentralization, minimization of costs related to risk and uncertainty) concern coordination to ensure that a product can be produced in the right place and at the right time. Coordination should lead to the optimization of production within the entire commodity vertical, where production, processing, storage, and distribution should be properly synchronized, which is crucial in agribusiness because the produced commodity or products from them can be perishable, e.g. Trienekens, Petersen, Wognum, and Brinkmann (2009). The issue of (de) centralization of decision-making in contractual relations addressed in the second rule is also essential. In centralized contractual relationships, the preponderance of decision-making is on the part of processors, in decentralized relationships, the decision-making power is on the part of manufacturers. Centralized decision-making in agribusiness allows for a reduction in the cost of information but can lead to an opportunistic approach by processors with fatal consequences for producers. Decentralized decision-making has many advantages, reducing the risk of missing important information, and reducing communication costs, but on the other hand, it can also lead to serious coordination and synchronization problems between producers and processors, as well as motivational problems. The contracting parties should therefore make optimal efforts to ensure that decision-making is made by the best informed contracting party, as the acquisition and processing of information is very costly and a well-formulated contractual relationship can significantly reduce these costs. The third rule focuses on minimizing costs related to risk and uncertainty, which in agribusiness is significantly influenced by biological characteristics of production, and weather, but other common price risks, risks in payments, etc. may also appear.

The other five rules (reducing the costs of post- and pre-contractual opportunism, maintaining cooperation, motivation concerning long-term interests, and balancing pros and cons in renegotiation)

are related to motivation, which creates desired incentives for socially beneficial decisions. Regarding the post-contractual opportunism of producers, Bogetoft and Olesen (2004) state that their behaviour can be effectively influenced through strong incentives, when the producer is aware that, with additional effort, he can achieve higher added value or through reducing the costs associated with risk, which can also serve as a means of motivation. According to Slangen et al (2008), producers with opportunistic characteristics tend to not comply with some less favorable terms of the contractual relationship, which can result in a moral hazard problem. In preventing such situations, it is necessary to maintain the producer's motivation at the right level. Another topic is the question of the costs of opportunism on the part of the manufacturer, even before entering into the contractual relationship (pre-contractual opportunism). The manufacturer can influence the future contractual relationship in his favor at the expense of the processor, if he knows thorough information about his production activity, cost structure, etc. According to Bogetoft and Olesen (2004), it is possible to minimize the impacts related to the emerging adverse selection in several ways. The processor can reduce the manufacturer's informational advantage by securing the necessary information before concluding the contractual relationship or by making this information available directly to the manufacturer. The processor can also limit its cooperation only to certain manufacturers where he has sufficient information or offer the manufacturer different variants of the contractual relationship and based on the manufacturer's response, he can get the necessary information.

The sixth rule concerning the maintenance of cooperation between producers or between producers and processors will enable the resolution of situations that go beyond the scope of the given contractual relationship and can prevent potential conflicts, see e.g. Lyons and Metha (1997). Bogetoft and Olesen (2004) further state that maintaining cooperation reduces the costs that firms would

otherwise spend on influencing the decisions of contractual partners to set their intentions. The seventh rule emphasizes the need to be motivated by long-term interests in contractual relationships. If the contracting parties are not sure of the long-term nature of the contractual relationship, they will not be willing to invest in specific assets, and cooperation may be suspended for various, often unforeseen reasons. Therefore, it is advisable to set the long-term nature of the contractual relationship in advance, where informal factors such as the good reputation of the contractual partner can also play a positive role. The eighth rule deals with the need to consider the pros and cons of renegotiation, which according to Slangen et al (2008) brings the possibility of adapting the parameters of contractual relationships to changing conditions over time, and which can lead to the elimination of inefficiencies in the contractual relationship. On the other hand, if the contracting parties calculate with renegotiation, they can adopt a strategic behavior where they do not rely on the incentives in the original contractual relationship, but on the expected incentives in the anticipated renegotiation, which will avoid inefficiency in the contractual relationship. An example can be strict contractual penalties for non-fulfillment of obligations by one of the parties. If the contracting parties are aware that monitoring and implementing such strict rules would be extremely costly, they will try to avoid those situations or modify the rules. However, if they expect future negotiations in this area, it will weaken the motivational nature of these agreed rules, in this case, the risk of a possible contractual penalty.

The last two rules (reduction of direct costs of contracting and the use of transparent contracts) are then focused on transaction costs to ensure that coordination and motivation entail the lowest possible costs. Direct costs related to the contractual relationship include the costs of gathering the necessary information, the negotiation itself, monitoring, and resolving conflict situations related to the contractual relationship, and it is advisable to

minimize them. As for the last rule (the use of transparent contracts), according to Bogetoft and Olesen (2004), it is an effort to make contractual relations as simple as possible, as they are aware of the limited rationality of the contracting parties, where the perception of incentives does not always fully correspond to reality. On the other hand, the risks of excessive simplification of the contractual relationship, which may lead to its incompleteness and the resulting potential problems, must also be taken into account. Setting specific characteristics of contractual relations is of considerable importance for agricultural enterprises and the development of agribusiness as a whole, including its competitiveness.

5. Conclusions

Described approaches to the issue of contractual relations and the extension of knowledge and information can lead to a useful enrichment of the practice of contractual relations in agribusiness. However, real contractual relations can only reach the current level of the theory of contractual relations, and therefore it is necessary to strive for a correct understanding and rationalization of real contractual relations in everyday practice. There are also relatively significant differences in contractual relationships over time. New contractual relationships are often built on weaker foundations neglect various eventualities and only become more complex with the passage of time. In practice, contractual relations are often built even without theoretical knowledge in this area and are based on the trial and error method or previous experiences of the parties involved. The impact of such a non-systematic approach is higher risk and uncertainty and associated higher potential costs. Efforts towards a holistic approach are characterized by the fact that the whole is more important than the mere sum of its parts and has a significant influence on the behavior and functioning of its parts. Ignoring some aspects of contractual relations can affect the overall result, which can only





The holistic approach is characterized by the fact that the whole is more important than the mere sum of its parts and has a considerable influence on the behavior and functioning of its parts. Ignoring some aspects of contractual relations can affect the overall result, which can only be estimated on the basis of a comprehensive assessment of all aspects of the contractual relationships studied. In addition, it is advisable to have a defined hierarchy of goals in the formation of contractual relations and certain rules for their creation, because the more complex are the processes under consideration, the higher is the need for creating a certain hierarchy. These and other issues will be further dealt in the paper in more detail.

be estimated based on a comprehensive assessment of all aspects of the studied contractual relations. In addition, it is advisable to have a defined hierarchy of goals when creating contractual relationships and certain rules for their creation, because the more complex the assessed processes are, the greater the need to create a certain hierarchy.

The main mechanisms for creating contractual relationships are issues of coordination, motivation, and transaction costs. Several basic coordination mechanisms are distinguished within the economic theory of organization. The first of them is called a handbook. Such coordination is based on the idea that in contractual relations it is necessary to adhere to established rules, guidelines, or protective measures. The disadvantage is that excessive formalism in handbook-type coordination can be burdensome for the other contracting party and undermine its confidence in its contracting partner. The second type is referred to as the invisible hand. Here, following classical economic theory, the basic coordination mechanism is price. A combination of handbook and invisible hand mechanisms is also possible, depending on the relative importance of the price and established rules, guidelines, etc. and it is very widespread in reality. The price can also play an incentive role or fulfill the function of a certain consideration. The third type of coordination mechanism is the handshake,

where mutual trust, shared values, and norms with the ability to find consensus play an important role. Informal rules can reduce transaction costs. The last mechanism called the visible hand, is especially widespread in companies that have a hierarchical management structure, and individual representatives in contractual relationships operate at a given hierarchical level and relatively independently. The disadvantage is that there is no vertical integration of them. The key role here is played by the competency corresponding to the hierarchical level.

Different coordination mechanisms play a role in different approaches to contractual relations. In the classic approach, invisible hand and handbook mechanisms appear. However, the price plays a key role here, and therefore the invisible hand mechanism, which was mentioned first, prevails. In the neoclassical approach, the role of the price as a coordination mechanism is somewhat weakened, and therefore the coordination mechanism can be described by a combination of the handbook in the first place and the invisible hand in the second place. Elements of the handshake mechanism may also appear here. In the relational concept, the role of price is limited and the other factors already mentioned prevail. The handshake coordination mechanism prevails here, while the invisible hand and handbook mechanisms may also appear in part. Another important question in

the mechanisms of creating contractual relations is motivation, which is given by the different interests of individuals participating in the formation of contractual relations. We distinguish between internal motivation, which is linked to the individual's feelings (work well done, goal achieved, precise processing, etc.), and external motivation, which includes all other motivational factors that affect the individual from the outside (remuneration, benefits, career advancement, but also penalty threat). The role of individual factors of motivation can change depending on how these factors coexist with each other. For example, in formalized hierarchical management structures, external motivational factors (e.g. fulfilling orders according to established rules and guidelines, performance tables, and a reward system) can undermine internal motivation, which is often neglected in market behavior models. The real motivation of an individual is usually a certain combination of internal and external motivational factors. In many contractual relationships, there are management mechanisms that set performance criteria, which are then reflected in remuneration. The forms of motivation diverge again in different approaches to contractual relations. In the classical approach, motivation based on performance evaluation comes into consideration, which is less evident in the neoclassical approach, and the relational approach is then based on completely different forms of motivation. These are, for example, reliability,

trustworthiness, professional and career growth, or building goodwill.

The third important issue in the mechanisms of contractual relations is transaction costs, representing the time, labour, and other resources that must be spent to conclude contracts, manage firms, and so on. These are associated with the use of a price mechanism, which, however, is not functional on its own. It is necessary to identify prices on the market, compare them, negotiate prices, formulate contracts correctly, monitor them, and establish dispute resolution mechanisms and the level of possible penalties for non-compliance. They therefore present additional costs associated with contractual relations. Transaction costs appear in market transactions, but also in other specific areas such as motivation, coordination activities in companies, or contractual relationships. The importance of issues of coordination, motivation, and transaction costs may change in real situations in contractual relations, therefore it is necessary to approach the analysis of contractual relations with caution and to adapt the construction of contracts to specific conditions concerning, for example, production technology, existing market structure or ownership rights. This is the only way to avoid fatal failures caused by the erroneous assumption that if contractual relationships function well in one model situation, they will be functioning equally well in another.

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ABSTRACT

Contractual relations play an important role in agribusiness, and therefore a thorough understanding of the creation and management of these relations at all levels, from primary production to the final consumer, is essential. This article aims to evaluate the functional mechanisms of creating contractual relations in the theory and practice of agribusiness. The theoretical approach helps to clarify and understand the basic processes that occur when concluding contracts, the practical approach is based on improving contracts based on emerging shortcomings, which can have a relatively high risk and cost due to its random nature. Therefore, it is useful to use both approaches at the same time, where existing theoretical knowledge leads to better empirical outcomes, and these then become a source of newly generalized theoretical knowledge. The main mechanisms for creating contractual relationships are issues of coordination, motivation, and transaction costs. There are several basic coordination mechanisms within the economic theory of the organization. In the classical approach, invisible hand and handbook mechanisms appear. Price plays a key role here and the invisible hand mechanism prevails. In the neoclassical approach, the role of price as a coordination mechanism is somewhat weaker, and therefore the coordination mechanism can be described by a combination of a handbook in the first place and an invisible hand in the second place. Elements of the handshake mechanism may also appear in this approach. In the relational concept, the role of price is limited and the other factors already mentioned prevail. Thus, the handshake coordination mechanism predominates here, and invisible hand mechanisms or even handbooks may also partially appear. Motivation, which is given by the different interests of individuals involved in the formation of contractual relations, also represents an important issue in the mechanisms of creating contractual relations.

KEYWORDS

Contractual relations; microeconomic theory; coordination; agribusiness

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