Regoverning Markets | Policy Brief 6

January 2008

A programme to mainstream black farmers into supply chains: An emphasis on Fresh Produce

Context

This policy brief forms part of the Recovering Markets study in Southern Africa. It has endeavored to analyse market concentration in the food processing and retail sectors, as well as to predict future dynamics in the sectors which have emerged as a result of the restructuring of the food market and the rapid changes taking place in the structure and governance of local, national and regional agri-food markets and the implications of the changes for small/medium producers in the restructuring of the food industry, together with the implications for policies and programmes within the context of the agri-food market.

Purpose of this document

The rapid changes taking place in agri-food markets in developing countries as a result of the expansion of dynamic modern retailers, wholesalers and food processing businesses, are reshaping the way that food systems are governed. In most developing countries, small scale agriculture supports the livelihoods of the majority of rural poor. However, this sector is poorly prepared for these changes. The fact that public policy makers and development partners are generally remote from changes taking place within the market as they lack evidence upon which to support policy dialogue and intervention, escalates the problem. This document intends to provide a framework and set of principles to assist government in empowering black farmers in agricultural supply chains. The programme provides a mechanism by which the infrastructure, systems and market role of agribusiness and agro-processors can be leveraged to allow the successful integration of black farmers.

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Problem statement

The problem of exclusion of small farms from commercial agricultural supply chains during much of the 20th century is especially problematic in South Africa where previous race-

based discriminatory policies contributed to the exclusion of small scale black farmers from the commercial farm sector. Fifty-eight percent of the South African population was already urbanised by 2004 (UN-HABITAT, 2005). The GDP share of primary agriculture down to 3.7% and large retail chains are responsible for 60% of food retail sales. This has meant that the food and agricultural system has had to industrialise and, as a consequence, large food and agribusiness companies and large retailers are now dominant players in the South African agricultural and food system. This is replicating the situation in the high income industrialised nations of the world.

Added to these realities are the low engagement levels of South African agribusiness and retailers with black farmers, which to some extent reflect a continuation of that process of institutionalised marginalisation. Although it has been implied that this low level of investment could be the result of continued racial prejudice, it is more likely to be the result of the perceived higher levels of transaction costs incurred by agribusinesses when they engage small scale farmers as suppliers[1]. It is against this background, and given the policy of the South African government to rid South African agriculture of its dualism and perceived exclusive nature, that it is critical to find appropriate institutional arrangements to prevent the continued marginalisation of small scale producers, ensuring their participation in commercial supply chains.

It is in this context that government may implement a series of initiatives to leverage agribusiness resources and infrastructure to expand the engagement of small scale farmers, especially black farmers and land reform beneficiaries, in commercial agriculture and supply chains.

The Argument

The basic premise here is that government should see agribusinesses as an important partner in the empowerment process by leveraging scarce resources in an optimum fashion. At the same time agribusiness firms can be persuaded and incentivised to expand procurement from smaller farming enterprises through a process where start-up and the high administrative costs of dealing with many suppliers are shared with government (Proctor 2007).

In the AgriBEE Charter, agribusiness enterprises are those individuals, groups, co-operatives or companies engaged in other agricultural activities. The argument for engaging agribusiness in this process is supported by the fact that agribusinesses are the buyers of farm produce and by definition represent the market for virtually all farmers. In addition, as agricultural market structures evolve, a larger proportion of agricultural produce is by-passing spot markets as agribusiness resort to a variety of contractual arrangements (growing programmes, production contracts, and marketing agreements) to secure supply. Often these arrangements are only done with larger commercial (mainly white) farmers. A survey by Vermeulen, *et al.*, (2006) estimated that almost 60% of total fruit and vegetable production is sourced by retailers and agro-processors by means of such arrangements. These types of contractual arrangements can be explained as an institutional response to imperfections in markets for *inter alia* credit, insurance, information, factors of production, and raw materials and could therefore be advantageous to both farmers and agribusinesses.

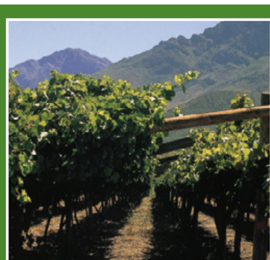
Preferential procurement and AgriBEE

The AgriBEE scorecard gives credence to preferential procurement and its role in enhancing transformation. In this regard, government recognises that agribusinesses can play a critical role in assisting the establishment of black commercial farmers and black entrepreneurs at all levels in the value chain. Since agribusiness and retailers basically represent the 'market' for all farmers, it is important to ensure that black farmers can, and are able, to

1 Some of these transaction costs are due to quality and constant supply problems







access these. But, while the AgriBEE Charter and B-BBEE codes actively promote preferential procurement, value, which is a function of quality and price in the eyes of the end consumer, will be the eventual determinant of success. As such, firms who contract with black farmers may achieve compliance points for preferential procurement as well as enterprise development and skills transfer.

Contending with high transaction costs

Several studies have concluded that high transaction costs, in either production or marketing of potentially remunerative commodities, exclude poorer farmers from participating in lucrative enterprises (Binswanger & Rozensweig, 1986, Jaffee & Morton, 1999, Delgado, 1999, Key & Runsten, 1999, Kähkönen & Leathers, 1999). Transaction costs in marketing and processing in developing countries typically arise because market prices do not fully reflect the true costs and returns to participating actors who are often unequally endowed and for whom market solutions may not be available (Delgado 1999). It is often due to the proportionally high transaction costs related to sourcing from many small scale producers that prevents agribusiness from procuring from these smaller farms.

Value chains in agriculture exhibit marked differences according to geographic region, product type and distance between processing plants and area of production. In many cases farmers are not paid fair prices due to information asymmetry regarding rules, standards and market value or minimal leverage on the farmer's part. In South Africa market forces are more effective in setting prices and price information is reasonably accessible. Sales of most agricultural products are conducted through effective market mechanisms – auctions, sales via silos or commodity buyers. Transaction costs of buyers therefore do not have a major influence on price. However, transaction costs are still important because the farmers net income is directly influenced by his transaction costs (McBain, 2007).

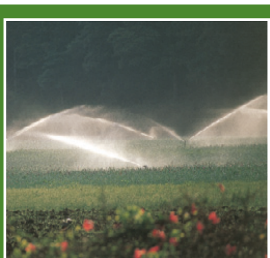
In addition to establishment-, sunk- and production costs, firms face transaction costs that induce additional business risk. Jaffee and Morton (1999) provide the following categorisation of transaction costs:

(a) *Search costs*: costs associated with identifying potential buyers and sellers.
(b) *Screening costs*: costs associated with gathering information about the reliability of a buyer/seller and the quality of goods being transacted.
(c) *Bargaining costs*: costs of gathering information on prices in other transactions, on factors that may influence the willingness to buy by the other party to the transaction, on implications of contract terms, etc.
(d) *Monitoring costs*: costs associated with monitoring contract performance. These are key in many forms of transactions.
(e) *Enforcement costs*: incurred in ensuring contract provisions are met, including the costs of default provisions.
(f) *Transfer costs*: transport, storage, processing, retailing, wholesaling, and losses. This is a major problem for small remote farmers but can be resolved through collective action in the form of effective co-operatives.

However, it should be noted that these costs exist for all farmers but in varying degrees.

Bridging economic dualism

South African agriculture continues to face the dual realities of a highly commercialised and industrialised commercial farming sector coexisting with an emerging small scale developing sector. This dualism is no different from that encountered in agriculture in virtually any country. The difference in South Africa is that large commercial farming operations are predominantly white owned and small scale farming operations are predominantly black owned. However, this can be bridged by promoting economic


integration between these two economies. This can be achieved through the initiatives discussed below.

1. **Investing in capacity building**

   Although there are no apparent barriers to market access as contracting arrangements are available for many agricultural crops, the problem is more quality standard, consistency and logistics, in terms of cost, distance and volume. Farmers should be educated and assisted in achieving international standards through both public and private initiatives and, especially through public private partnerships (PPPs) (McBain, 2007).

2. **Accelerating sustainable land reform**

   The need to accelerate the delivery of land reform is readily acknowledged. Securing market access, for example, by contracting arrangements could be a means to proactively advance production on transferred lands or to acquire land for this purpose.

3. **Providing post-settlement support**

   The lack of post-settlement support to beneficiaries of land reform could lead to the failure of land reform projects. This may occur because markets and the private sector do not engage with such initiatives leaving such responsibilities with the state. Contracting with the private sector to assist with access to markets, capacity building and other requisite services may be useful in this regard. This is especially necessary in terms of technical assistance for quality and standards for the small scale developing sector without access to the necessary resources.

   This is a key issue in the region. Many land reform projects have already failed due to lack of this.The AgriBEE charter lays much emphasis on this. Knowledge or technology transfer, skills development, access to mechanisation (through shared or loan of equipment or service), shared transport, collective purchasing etc. is required. Government extension services appear to be generally ineffective whereas private initiatives, e.g. the Thandi Fruit & Wine and the Thohoyandou and Giyani Spars, demonstrate marked success with emergent farmers (McBain, 2007).

4. **Incentivising markets**

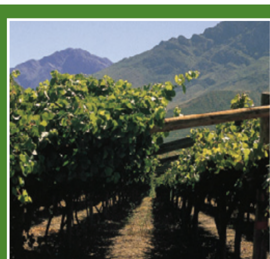
   The tendency of developmental states is to be interventionist in advancing economic development. In an economy that encompasses a mature industrialised component, it becomes equally necessary to incentivise this segment to constructively engage with the developing segment by incorporating small scale developing producers and agribusinesses into mainstream supply chains.

5. **Providing for safety nets**

   Black and emerging producers have to fend for themselves in a globalised economic environment that is less sensitive to their circumstances and can be rather harshly punitive. Such penalties could be softened through appropriate contracting arrangements and the subsequent shared risk and provision of economic safety nets that allow producers to acquire experiential learning without having mistakes render them destitute. SAFEX provides for such a mechanism for many products but, not all. However, the subsidies provided to producers in competitor countries remain a major deterrent to the markets as this is a general requirement for all farmers and a key feature of both the EU's Common Agricultural Policy CAP and the USDA programmes. South Africa has one of the most "free" markets in agricultural commodities with no intervention system for "surplus removal" even in the form of government subsidised extended storage. Pre-1995 single channel marketing reduced price fluctuation to the producer but encouraged massive inefficiencies and higher local consumer prices and inflation (McBain, 2007).







Typologies of contractual arrangements that could secure market access for black farmers

The challenges facing primary producers and their economic organisations in negotiating market access are conditioned by liberalisation and modernisation. These include technological, organisational and financial demands placed upon the small scale producer. There are several types of arrangements that agribusiness and farmers can enter into to counteract these problems as outlined below. The arrangements differ around the primary purpose of each, but are not mutually exclusive and may include more than one contract type.

Market specification/procurement contracts encompass: markets, supply schedules, quantity, pricing, price support measures, price guarantees, insurance, payment arrangements, quality, interlinked credit, financial services, product characteristics, contract duration, enforcement mechanisms, quotas, delivery conditions and other terms deemed necessary.

Resource provision contracts refer to contracts that specify the requisite resources that have to be supplied to farmers.

Production management contracts become relevant when management prerequisites necessitate that management and control is transferred gradually and concomitant with capacity enhancement. This is typical in develop-operate-transfer models or instances where new technology and scarce skills are applied. Another case where this contract might apply is in the occurrence of failure, when a second or third party can be contracted to continue managing the enterprise like a protector in a fallback position.

Mentorship contracts are relevant when skills levels are close to requisite levels but experience may be lacking. Mentors are appointed as decision-making support to farmers to limit punitive mistakes. Although the importance of this is generally underestimated by most players, including government, they are a vital requirement.

Service contracts are relevant when specified services are needed on a short term basis and often complimentary to existing contractual arrangements. They are similar to those services that companies would conventionally outsource.

Possible opportunities for contractual arrangements

- Agricultural co-operatives/agribusinesses contracting with black farmers
- Sugar mills contracting with small scale farmers
- Grain traders and co-operatives contracting with black farmers
- Feedlots, abattoirs or traders contracting black livestock owners
- Exporting firms/agents procuring from black producers
- Processing companies procuring from black suppliers
- Cotton mills and ginneries out-contracting to black farmers
- Wine cellars issuing delivery rights to black farmers
- Market agents contract selling produce of black farmers
- Supermarkets procuring from black farmers, especially in rural areas
- Centre-satellite outgrower schemes in primary agriculture.

In virtually all these areas contracts are already operational but the issue of effectively including black farmers more effectively into the supply chain is a more complex problem. Solutions need to be found for knowledge/skills transfer (mentorship, effective extension services) leading to enhanced yields and quality, reducing transaction costs (co-operatives to lower cost to market), mechanisation (through shared implements, tractors or arrangements with commercial farmers), appropriate and relevant R&D (at the ARC a special section exists).





Types of incentive schemes to support contracting

Despite the potential of these types of arrangements to assist the process of black economic empowerment in agriculture, the reality is that due to the extra effort and additional costs involved in managing a large number of suppliers, many agribusiness firms will not engage in these types of ventures – often because of the effect on the 'bottom line' and the resultant concerns about return on capital, equity and growth in share holder value. Agribusinesses operate in a very competitive environment and it is difficult to be the first to move in a direction that has yet to be assessed and its risks defined. The reluctance of agribusiness firms to engage in these types of ventures are therefore explained by the high levels of smallholder start-up cost, administration cost and high levels of asset specificity. These factors tend to make agribusinesses wary of opportunistic behaviour by the contracted farmers. Other factors include the fact that farmers often see the agribusiness as a source of free inputs and skills which bring about unnecessary costs and losses to the agribusiness. Farmers are also wary of these ventures because they are sceptical of the intentions of large agribusinesses.

Adding to this reality are the high levels of unequal power in most supply chains where the farmers have no association, exercise little autonomy and the supply chains are tightly managed. Although farmers' organisations, such as NAFU, do exist and more can be formed, the solution lies more in creating co-operatives focused either on product type or geographic location or both, but not in market intervention by the state, except in extreme circumstances. Limited trust between the contracted partners and perceived opportunistic behaviour on both sides also prevents more of these types of arrangements and there is a need for the development of contractual regulatory mechanisms. This lack of trust is expected due to our historical legacy. Market oriented collective action initiative can sustain benefits for small scale farmers. Market orientation is driver, and at the same time, a key to inclusion. The challenge however is to turn this around by considering the social return of a vibrant and growing rural economy with farmers being incentivised to produce to a secure and non-exploitative market. The incentive should be to produce the right product at the right cost, deliver value to the consumer and be adequately rewarded. Therefore, the answer lies in improved productivity through higher yields, lower transaction costs and superior quality. The challenge for government is to design a programme of incentives for agribusiness to engage in contractual arrangements with black farmers. This can be done in the following ways:

1. **Transaction cost offset scheme**
   Firms are expected to record all realised transaction costs for which the state can compensate them should they transact with black firms. This may occur through tax concessions or compensatory rebates.

2. **Revolving fund attrition scheme**
   An industry or large firm is allocated a revolving fund that can be used to finance transactions with black farmers and returned to the fund at the end of a business cycle (e.g. a season).

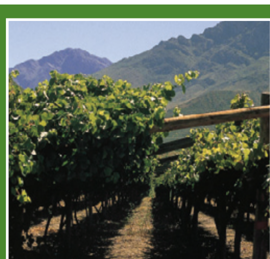
3. **Contract and equity acquisition scheme**
   Black farmers, who gain contracts with other firms, can access matching grant finance from a central fund to acquire equity in the companies they are contracting with.

4. **Price support scheme**
   Firms or industries may choose to provide some form of price stability to new entrants to limit the effects of volatile markets. These may include minimum price guarantees, floor prices, advance payments, and risk premiums, etc. The funds can be accessed when market prices do not reach the minimum required levels.

5. **Market access quota scheme**
   Farmers can be allocated a quota of a certain market.







This quota (e.g. percentage of exports, percentage of off-take, etc) can be financed through a central fund against a guaranteed market with some matching finance by the private sector. This is to be addressed as part of the Land Bank mandate.

6. Infrastructure development fund

This fund can be accessed to finance or match the cost of infrastructure (including sunk costs) needed for marketing or contracting.

7. Training and capacity building

Funds for specialised training in aspects related to contracting should be supported. This includes legal assistance with contract formulations, introduction to contracting, intellectual property rights, contracting models, finance, management, post harvest handling, food safety, etc. There is need to professionalise the civil service to provide market based services (or support their provision by third parties) as public policy can effect outcomes positively or negatively, intended or unintended. This is probably the most important issue of all, not just in the area of contracting, but in all the technical and management aspects of farming.

Farmers generally have problems of ineffective application of available technology, poor management and low productivity, cash flow, adverse weather and associated risk, over or underinvestment in infrastructure (including equipment, etc). Experience in SA suggests that some of the proposals in this section can be abused and might not deliver what is intended. Again, the need for government enforcement and support should be emphasised.

Recommendations

- The DoA and the NAMC consider the proposals for implementation
- Some pilot schemes (5) be engaged within the next year or two to enable learning
- More emphasis on quality extension services and mentoring to ensure technology and knowledge transfer and ongoing support
- The development of national capacity at centres of excellence with a focus on value chain analysis, market research, market information services
- Alignment with government programmes should be sought e.g. Land Redistribution for Agricultural Development (LRAD), Comprehensive Agricultural Support Programme (CASP), proactive land acquisitions, Micro Agricultural Finance in South Africa (MAFISA), etc
- The Marketing Act be considered to cater for the legal provision in the establishment of contracting schemes
- Provision within AgriBEE be considered
- The proposed AgriBEE Fund be utilised to start some of these schemes
- SA to grow its agricultural based exports for significant job creation. It can occur in the sector through development of new techniques and exploring new opportunities including Farmer to Pharma value chain – nutraceuticals, natural flavours, fragrances and bio-pesticides
- Opportunities for matching funds from industries be sought (e.g. industry trusts, development finance institutions - Land Bank, Industrial Development Corporation (IDC) - levies, commercial banks, etc.)
- Engender infrastructure and appropriate logistics at local level, human capacity building, market information, support services
- Creation of a conducive environment for investment through sound business practices
- Establishment of producer organisations, marketing organisations, co-operatives and Private-Public Partnerships (PPPs) and emphasis on PPPs across the farming agri-processing divide
- Address issues regarding contract enforcement and informal contracts - develop strategies to protect different stakeholders in contracts and informal arrangements
- Improve levels of trust between stakeholders
- Address financing at different levels by revisiting the Land Bank's role in transformation and assigning the IDC (part of AgriBEE fund) more responsibilities

- A greater level of international understanding and collaboration be sought, including finance and capacity building
- Encourage supply chain involvement by black producers
- Alternative employment opportunities at rural level
- Government needs to take account of deficiencies at macro and micro level (including rural) and must establish a structured consultation process
- Policy reform at both local, national and international level
- A more integrated involvement of DFIs in rural development.

Authors

Dr. Mohammad Karaan (Stellenbosch University)
Prof. Johann Kirsten (University of Pretoria)

With input from

Dr Kurt Sartorius (University of Witwatersrand)
Dr Tobias Doyer (Agri-Business Chamber)
Prof André Louw (University of Pretoria)

Reviewer

Hammish McBain (formerly of Tiger Brands)

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For further information contact

Prof. André Louw
Department of Agricultural Economics, Extension and Rural Development - University of Pretoria
PRETORIA, 0002, South Africa

Office Room 2.23, Agricultural Annex
Phone +27 12 420 5772
Fax +27 12 420 4958
e-mail andre.louw@up.ac.za

This publication is an output of the 'Regoverning Markets' programme, which is a multi-partner collaborative programme funded by the UK Department for International Development (DFID), the International Development Research Centre (IRDC), ICCO, Cordaid, the Canadian International Development agency (CIDA), and the US Agency for International Development (USAID). The programme analyses the growing concentration in the processing and retail sectors of national and regional agri-food systems and its impacts on rural livelihoods and communities in middle- and low income countries. The views expressed are not necessarily those of the funding agencies.

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