How can sector governance models drive sustainability performance in smallholder-dominated agricultural sectors?

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About this project

This research forms part of a project funded by the International Finance Corporation, the Dutch Ministry of Foreign Affairs, SECO and IDH the sustainable trade initiative in which Aidenvironment, NewForesight and IIED sought to develop a holistic transformation model to scale sustainability in smallholder dominated agricultural commodity sectors.

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Introduction

Governance of agricultural sectors and commodity markets can have significant influence on their performance, and good governance is key to achieving 'sector quality'. High quality sectors are resilient in the face of market volatility and climate change; have a net positive impact on natural capital and quality of life in rural communities; and have a good product reputation on world markets. High quality sectors support progress towards 'farm quality' – whereby farmers (and their workers) earn a decent living; are adaptive, resilient and innovative; produce at optimum productivity and product quality levels; and that farming has a positive social and environmental impact.

In a liberalised world economy there has been a general shift away from intervention in and governance of markets, as a reaction against the failed models that existed before liberalisation, many of which were associated with rent seeking, patronage and government mismanagement. Instead, sector management has been left to individual value chain participants. This has created 'islands of success' – limiting the scope to a smaller number of producers and a smaller proportion of the production base, and limiting the longevity of interventions. This has led to a net loss in the sector of resilience, natural capital, and quality of life in rural communities.

Despite liberalisation, however, a number of 'sector governance models' – the structures and institutions used to build and govern markets and sectors horizontally rather than vertically – have endured and have adapted well to fit new political and economic contexts. New sector governance models that have successfully delivered on aspects of sector quality have also emerged.

This paper explores the drivers and potential benefits of sector governance models in enabling the transition of smallholder-dominated agricultural sectors towards sustainability; the different forms of sector governance models and market governance mechanisms that exist; their strengths and weaknesses in relation to promoting sector quality; and key success factors that should be borne in mind when designing and implementing sector governance models in current economic and market realities.

Understanding sector governance models

Sector governance models are the structures and institutions used to build and govern markets and entire sectors. Examples of sector governance models include: state-managed or state-sanctioned commodity boards; commodity exchanges; and state-sanctioned private smallholder-owned companies that cover a large proportion of producers in the sector.

The creation of these models was triggered by a number of factors. In many cases key drivers have been crises in a sector, including:

- concerns over security of supply, for example, as a result of declining productivity
- concerns over a poor or declining reputation of national product on the world market
- social or political unrest due to lack of support for the sector
- poor labour conditions
- concerns over environmental degradation.

External factors have also been drivers. For example:

- conditions linked to international loans
- concern about or anticipation of regulatory change internationally or in competitor countries that could affect production and trade.

In some cases models have been created through inspirational leadership – one person or a group of people recognising the importance of a sector to a country's economy or the need for a change in how a sector is managed. In some producer-driven models, a key driver has been the desire to strengthen producers' representation in policy.

Though in practice varying greatly in their aims, objectives and design, sector governance models have the potential to play an important role in:

1. **Sector alignment and building a profile**
    - Developing a vision for an agricultural sector, for example, around farm quality
    - Helping to align key stakeholders around this vision
    - Setting standards to achieve this vision, for example, around quality and productivity
    - Enhancing producers' political influence and the sector's profile and international reputation

CASE STUDY: NATIONAL FEDERATION OF COFFEE GROWERS OF COLOMBIA (FNC)

Founded in 1927, the National Federation of Coffee Growers (FNC), is a non-profit organisation that has worked to raise the sector's economic and social performance. The impetus to organise came from growers themselves. FNC is farmer governed and democratic. Farmers are elected by other farmers to make decisions about the management of FNC. It has a strong social and welfare focus and ethos.

Quality and differentiation are facilitated and encouraged. Colombia is known for its speciality coffee. FNC has worked to promote this and has been able to develop a brand that associates Colombia with quality coffee. It has also obtained a trademark, which has enabled it to generate royalties to reinvest in the sector. It has also developed a strategy for facilitating the scaling up of sustainability certification.

FNC has a mechanism for revenue generation and reinvestment in the sector. This is achieved through a legislated tax. This tax is managed by FNC and is reinvested in the sector to support coffee growing and the welfare of coffee growers. The revenue is invested in extension services, research and development, market development and social welfare programmes.

FNC has established additional services and institutions as required by producers. These include financial services, agricultural insurance, and dedicated research and development services.

FNC's price stabilisation fund is a critical component of the model. It allows FNC to purchase coffee and it increases farmers' capacity to invest in their own production base and to support their own livelihoods.

However, FNC has not been able to insulate Colombia's coffee sector completely from competition and the effects of exchange rate fluctuations, and recent unrest has drawn large government subsidies into the coffee sector.

2. **Market governance**
    - Carrying out marketing services and promoting export
    - Marketing and branding of products linked to their origin
    - Matching supply and demand to improve market efficiency
    - Stabilising prices
    - Rewarding and promoting quality and removing poor quality in the market
3. **Value retention**
    - Generating and collecting revenues to reinvest at the production end, for example, via levies or taxes
    - Ensuring a greater share of product value is retained by producers, for example, through minimum prices
4. **Investment in the sector to build farm quality**
    - Investing in service provision (inputs, credit, extension, and research and development) to achieve farm quality
    - Investing in social welfare programmes
    - Improving the efficiency and effectiveness of external support or interventions by offering an institutional structure through which support can be coordinated and delivered effectively
5. **Organising the production base**
    - Organising producers so that they are better able to access the service market

These features can play an important role in enabling the transition of sectors towards sustainability and in achieving sector and farm quality.

There are a number of examples of sector governance models. The different model are categorised below, and their potential to promote farm quality is analysed.

CASE STUDY: THE COCOA MARKETING BOARD (COCOBOD) OF GHANA

COCOBOD is a Ghanaian government-controlled institution responsible for every facet of Ghana's cocoa industry. COCOBOD's functions include production, research, extension, internal and external marketing, and quality control.

Production has reached record levels. Productivity at farm level has increased (though still not comparable to some other countries). Support from COCOBOD in eradicating disease and supporting good agricultural practices has helped.

Production quality is high; quality is defined, measured and incentivised. Product quality regularly exceeds the most stringent international standards. Premiums (relative to world prices) are paid for Ghanaian cocoa. Traders and producers cannot sell poor quality cocoa to government unless they have to sell it at discounted prices. Traders are incentivised to check and measure quality accurately, farmers get instant feedback on quality, and quality is checked again at point of collection for export. Bonuses are paid for quality if sales and/or prices exceed forecasts. The system uses both strict rules and incentives to ensure quality is maintained.

Farmers are supported in producing high quality cocoa. Technical assistance/inputs and spraying services are supplied by COCOBOD to support farmers.

Revenue is generated and redistributed to support the sector. COCOBOD takes a share of the FOB price (price paid at export) for 'industry costs' – technical assistance, social welfare programmes, eradicating child labour, spraying, inputs, replanting, and rehabilitation.

Share of revenue. Farmers receive a reasonable share of net FOB. The producer price is set by a Producer Price Review Committee which includes farmer representation.

The model faces a number of challenges. There have been accusations of loss of farmers' bonuses, child labour and concerns about long-term sustainability of the model (underinvestment in spraying, technical assistance, etc.). There is limited focus on environmental and social aspects of farm quality, though *some* welfare programmes are in place. The focus is rather on producer price and quality production.

MODEL TYPE AND DESCRIPTION	EXAMPLES	STRENGTHS/ OPPORTUNITIES IN TERMS OF PROMOTING SECTOR QUALITY	WEAKNESSES/CHALLENGES IN TERMS OF PROMOTING SECTOR QUALITY
Marketing boards State-controlled or state-sanctioned entities legally granted control over the purchase or sale of agricultural commodities.	**Ghana's Cocoa Marketing Board** (COCOBOD)	If managed and designed effectively: Can improve the quality and reputation of a national product on the global market. Can improve bargaining power, leading to increased prices, bulk buying for reduced costs of inputs etc., price stabilisation through guaranteed purchasing. This can improve the ability of farmers to invest in their own farms. Can help to organise the sector more widely and generate and manage revenues for reinvestment in the sector to support farmers (e.g. via levies that raise funds for extension, crop-spraying services, research and development etc.). Can set a vision for sector quality and work towards that vision through a system of hard and soft incentives and compel others in the sector to buy into that vision.	If state controlled and the state is corrupt, the model can offer opportunities for rent-seeking, political bias/influence to the detriment of producers and consumers, and sector quality. Can be challenging to meet current market demands for traceability and quality/ sustainability-based differentiation.
State-sanctioned private smallholder-owned agencies, companies or federations Private companies, agencies or federations that are made up of and are governed by producers as a way to improve support to farmers in a particular sector.	**Kenya Tea Development Agency** (KTDA) **Federation of National Coffee Producers,** Colombia (FNC)	Opportunities for greater value share/retention by smallholders e.g. through better bargaining position or ownership of processing Opportunities for sector- wide service delivery and quality management. Limits government involvement/intervention in contexts where this may lead to rent seeking, though governments often may play a vital role in initiating, supporting/sanctioning these organisations e.g. sanctioning collection and allocation of levies.	Needs significant capacity/skills for effective management and for the organisation to be designed in a way that allows for participation of all producers rather than elite capture (e.g. leaders are elected by members/producers). May focus on certain aspects of farm/sector quality and ignore others. For example focus on yield and productivity rather than environmental protection (private gains rather than public goods). Model can be weakened where industry decides to buy direct from producers rather than via the model. This can lead to financial difficulties for the model where producers receive services but do not contribute to revenue generation through sales (AllAfrica, 2014).

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Commodity Exchanges Marketplace where buyers and sellers come together to trade, and are assured of quality, delivery and payment.	**Ethiopia Commodity Exchange**	Can help reduce inefficiencies in a market by better matching supply and demand, enforcing contracts, and making timely payments. Can improve price discovery and transmission (even for those not trading on the exchange), by publishing prices that are easily accessible country-wide, leading to improved negotiating capacity and higher prices. Can raise the quality and reputation of commodities on the world market. Can offer opportunities for accessing credit through warehouse receipt financing.	Many exchanges have struggled to establish traceability to allow for the sale of commodities that are certified or speciality products. Can risk excluding smallholders if minimum limits on trading volumes are too high or costs/requirements to hold a trading seat are too high. Again, success is often dependent on the state and implementation of legislation to support sales. In the ECX example, the Government of Ethiopia made it mandatory to sell certain commodities through the Exchange (e.g. coffee). This change in legislation undoubtedly contributed to the Exchange's success in terms of volume of sales.

CASE STUDY EXAMPLE: THE KENYA TEA DEVELOPMENT AGENCY (KTDA)

The KTDA is private agency owned by smallholders, whose aim is to support the smallholder tea sector, increase producers' share of value, drive quality production and support producers via extension and other services. Over 400,000 farmers are part of the KTDA (the majority of smallholders in Kenya) and they produce over 60 per cent of the country's tea (Nzuma, 2011).

KTDA emerged as a result of privatisation of the Kenya Tea Development Authority – a government authority responsible for supporting small-scale tea production.

Quality is a core part of KTDA's model. This is prioritised as part of the KTDA's vision, and is achieved by offering training in good agricultural practices, access to inputs and quality processing (processing is smallholder owned). KTDA staff train farmers to improve the productivity and quality of tea yields through techniques such as planting, weeding, and fine-plucking.[2] Producers are incentivised to produce better quality tea through increased price. The average net return to a KTDA farmer is 75-80 per cent; KTDA tea fetches prices of 12 per cent above the average price of tea.[3] Increasingly, sustainability (through Rainforest Alliance certification) has also become a key part of the model, though this has been driven by Unilever and a number of donors. The KTDA model offers an infrastructure that facilitates certification. For example, producers are organised around factories for group certification and auditing, and the delivery of technical assistance.

Marketing. KTDA buys tea from smallholders for processing in its factories. Farmers deliver tea to KTDA buying centres where it is weighed, graded, and valued. A mobile application-based IT system is used to transmit data on tea deliveries to factories and the information is used to pay farmers. Tea is transported from buying centres to factories where it is processed, packaged, and transported for sale in both domestic and export markets.

Reinvestment and retention of value. This is achieved through smallholder ownership of factories, and high quality production (facilitated by access to services). A levy is applied by KTDA at the point of processing, which funds its extension services, inputs and credit for producers. Farmers get a higher share of value compared to tea producers in other east African countries, which allows them to reinvest in production.

Each of these specific sector governance models may utilise different market governance mechanisms to achieve their aims and objectives. Even where sector-wide governance models are lacking, market governance mechanisms can play a central role in driving the transition towards sustainability. These can be used in isolation or in combination with other mechanisms. These mechanisms can include:

- **National standards on sustainability** (voluntary or mandatory)**:** for example, Indonesia's national palm oil standard (ISPO), which is mandatory to all producers and uses third-party audits to ensure that palm oil producers comply with national laws and regulations, including provisions on managing environmental and social impacts. ISPO summarises regulations that apply to the palm oil industry and makes use of a certification scheme to improve monitoring and enforcement. While the potential of ISPO to improve governance in the Indonesian palm oil sector is high, there is still room to improve its provisions and a need to allow multi-stakeholder participation. National sustainability standards, such as ISPO, can offer an important platform or catalyst for sector alignment. Sector governance models may be able to build on, or learn from, these standard-setting platforms or roundtables in terms of how to develop a vision for an agricultural sector, aligning multiple stakeholders around that vision and setting standards to achieve that vision, for example around quality and productivity.
- **National or international quality standards.** Vietnam's coffee production has typically been of poor quality – with robusta being the dominant coffee type grown – with a large number of defects and moisture found. The government replaced its old quality standard in September 2002 when the Ministry of Agriculture and Rural Development launched an initiative to improve and stabilise quality with new grades based on international standards. This new standard limits the number of defects that can be found and identifies normative references and five grades, with clear guidelines for defects and grading (Giovannucci *et al*., 2004). After years of unsuccessful investments by the private sector and NGOs to raise the quality of cocoa in Côte d'Ivoire, in 2012 the government introduced stricter regulation and control on quality. Since then quality has increased considerably.
- **Minimum price mechanisms**. In Indonesia, prices for fresh fruit bunches (feedstock for palm oil production) are set monthly at the regional level, by a price formula based on the world market price for palm oil (CPO and PKO) and an index (K-index) specifying the proportion of the price transferred to farmers. While in theory a fair share of the value can be allocated to farmers through the price formula, in practice the announced prices have become ceiling prices rather than floor prices. The price formula is criticised for its complexity as well as lack of transparency in calculating the K-index and does only apply to farmers who are part of company outgrower schemes.
- **Purchase guarantee schemes.** For example, Colombia's FNC guarantees the buying of harvests from its members at a transparent price (based on international market prices for Colombian coffee on the day of the transaction), paid in cash and at centres close to their farms.
- **Levies or taxes on production or export to fund service delivery** (research and development, inputs, credit or extension). For example, the National Institute for Agricultural Research (INIA) of Uruguay is funded by farmer financing at the national level. INIA was established in 1989 as an autonomous public agency, co-managed by the private sector and the state. It is tasked to carry out research, manage scientific knowledge and link with technology transfer bodies. INIA is funded through a levy of 0.4 per cent on traded agricultural products matched by law with an equal contribution from the government of Uruguay. In South Africa, sugar cane farmers pay a levy of about 1.0 per cent of the value of the crop to finance research and development, training and extension. The sugar growers themselves decide on the amount of the levy applied.
- **Branding of products** (e.g. geographical indications, where products have particular quality attributes linked to a place). In India, for example, the Tea Board was able to obtain an intellectual property right – in the form of a geographical indication – for Darjeeling tea (in 2003). Darjeeling tea has a good reputation in national and international markets, is known for its distinct flavour and aroma and its specific growing region in the Eastern Himalayas, and attracts a premium because of its distinctive quality characteristics. The GI legally protects the Darjeeling name and logo from being misused, though the Board has had to work to monitor the use of the logo and name of Darjeeling to prevent unauthorised use.

Recommendations

What are the key success factors for sector governance models to survive and prosper in current economic and market realities?

They should have a strong sector vision based on sector and farm quality (as defined in the introduction). This vision should be co-created through balanced representation and participation of all major stakeholders in the sector. There should be clearly defined objectives and key performance indicators which are meaningful and measurable, and a clear division of roles and responsibilities for achieving the vision:

- **Industry is central in defining and demanding quality.** Industry needs to buy into the vision for a sector by seeing the business case for the model. It plays a central role in committing to making purchasing decisions on the basis of farm quality and discriminating against worst practices.
- **Government is very important in driving and establishing sector governance models.** In many successful sector governance models, government is often the catalyst for defining 'quality' and putting structures in place that support quality production. Even if government is not the catalyst in establishing a sector governance model or setting a vision, government buy-in is vital in order to ensure ownership and action. Legislation is significant in either establishing the models or in helping to ensure they work in practice and to ensure that there is consistency across policies. For example, designing legislation to ensure effective financial markets are in place, which in turn will determine the model's access to finance and credit for farmers.
- **Strong producer involvement and representation is most likely to deliver a successful sector governance model.** Producer buy-in and representation are vital for long-term viability and success of the model in delivering on sustainability. Sector governance models should improve negotiating positions of producers. Fair market access is needed for small-scale producers and SMEs. Where models are producer-led, building and organising the model requires considerable management skills.

Effective, accountable management is needed, at arm's length from government. Though the role of government is important, sector governance models are best managed at arm's length from government, for example, by non-profit private institutions with a mandate from the state.

Systems of checks and balances are needed to prevent corruption *within* the model. This is linked to the point above about the need to ensure appropriate institutional design that specifically seeks to avoid nepotism and political influence, but is also about developing a system of incentives, rules and enforcement of rules within the model to ensure effective revenue spending and distribution, rewarding producers for quality, and transparent and honest pricing etc.

Models must be able to function in liberalised markets. Models established in an era of heavy state intervention in commodity markets can be adapted to suit a post-liberalisation world, for example, through total or partial privatisation, without losing the original spirit of the model. This can lead to benefits for producers where they become shareholders in a company and they may get a greater share of the revenues through ownership of processing. Any transition needs to be governed effectively. Ineffective models can be made more effective without radical overhauls. In general, there has been a shift from state-controlled models to state-sanctioned (but producer-owned/controlled) models over time and a concurrent shift in 'management and operation that are more akin to successful corporations than operations of government' (Veeman, 2002).

The model needs to allow room for product differentiation and price transmission. Models should allow for differentiated products, especially for products like coffee, for example, by having the infrastructure in place to allow for physical segregation and traceability. Sector governance models need to ensure markets function in a way that allows for quality to be rewarded, for example, through differentiated pricing and payments at auctions and/or market information/transparency/infrastructure that allows supply to respond to demand and for demand to reward producers. They also need to ensure that they don't act as a blocking institution between producers and the market, or at least incorporate competition into domestic trade.

Tools for revenue collection to facilitate investment in the sector is a key component of any effective sector governance model. Such tools could include a tax or levy which is redirected back to the sector and opportunities for increased value share through shareholder involvement or ownership of processing.

Reinvestment in the sector is needed in order to drive improvements in farm and sector quality. This might take the form of extension services, access to inputs (planting stock, fertilisers etc.), credit, land rehabilitation, programmes to encourage young people to become farmers. Over time, as the sector thrives, producers will be able to complement or replace these services by paying for their own, tailored services directly. Farmers need to see the value of revenue collection, and spending needs to be transparent. Decisions made on reinvestment should be accountable to producers.

Notes

1 For more information see: http://www.federaciondecafeteros.org/static/files/Informe_de_Sostenibilidad_2011_Ingles.pdf

2 See: http://www.ifc.org/wps/wcm/connect/f097d4004ff4df23a8c0ff23ff966f85/FT-Award-Shortlist_KTDA.pdf?MOD=AJPERES

3 See: http://www.ifc.org/wps/wcm/connect/f097d4004ff4df23a8c0ff23ff966f85/FT-Award-Shortlist_KTDA.pdf?MOD=AJPERES

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