Local purchase and smallholder farmers: Revisiting the logic underpinning common assumptions

By Blake Audsley

Blake Audsley served as a Mickey Leland International Hunger Fellow with World Food Programme's Purchase for Progress (P4P) pilot from 2009 to 2011. The views expressed here are those solely of the author, and do not necessarily represent those of World Food Programme, P4P, its donors, partners, or the Congressional Hunger Center.

Executive Summary

For a number of years, humanitarian agencies have used local and regional procurement to supply their food aid operations. Recently, local purchases aiming to directly benefit smallholder farmers have gained significant support as a development tool. While a range of approaches exist, many of the commonly held assumptions that underpin the logic of smallholder-focused local purchases need to be revisited. Specifically, issues related to (1) targeting of suppliers, (2) current measures to mitigate price distortion, (3) linkages between productivity and income, (4) context-specific applicability, and (5) sustainability goals should be more critically debated. Moving forward, implementing agencies will need to develop strategies that are more inclusive of market actors throughout the value chain, that fully account for the risks associated with re-distributing marketing margins, and that manage expectations of the potential of such smallholder-focused approaches.

Introduction

The food aid sector has evolved rapidly over the past decade. Practitioners and academics alike have extensively debated the traditional paradigm of in-kind food donations, shipped to recipient countries, and monetized by non-government organizations (NGOs). While large segments of the humanitarian community have for some time advocated for a greater share of food assistance as cash donations to finance alternative response modalities such as cash transfers, vouchers, and local purchasing of food aid, support from key donors, stakeholders and emerging philanthropic organizations has not reached critical mass until recently.

World Food Programme (WFP) is the world's largest humanitarian relief organization, and has been purchasing food locally from large traders and exporters in developing countries for over 20 years. It has developed an expertise in the use of local and regional procurement (LRP) to source its humanitarian supplies in a timely and cost-efficient manner. Yet only recently has the broader international community begun looking to LRP both to better leverage increasingly scarce funding, as well as to address the underlying causes of livelihood vulnerability.

Amongst the emerging tools being tested globally is what will be referred to as smallholder LRP. Broadly, this approach targets procurement of humanitarian food aid from farmers' organizations in an attempt to catalyze development through improvements in smallholders' market access, and by effect increase their incomes. The most high-profile of smallholder LRP programs is WFP's Purchase for Progress (P4P), a 21-country pilot buying staple food commodities using a variety of tendering practices. It is not the only experiment, however. Increasingly, NGOs have entered into the fold as the range of donors ready to support smallholder LRP rapidly expands.

Despite the best efforts of numerous agencies and donors engaged in smallholder LRP, there is often considerable confusion surrounding the goals and assumptions that underpin it. This is to be expected, as the variety of approaches and actors involved represent a complex web that is nearly as convoluted as the agricultural markets that they attempt to facilitate. What follows considers some of the more common assumptions that the author has encountered when

contemplating smallholder LRP with members of the development community. It is neither an endorsement nor a condemnation of smallholder LRP, nor of the agencies that implement it. The number of actors, their roles, and their approaches are far too varied and contextualized to attempt such an exercise. Rather, this aims to outline the assumptions that are regularly made regarding smallholder LRP, and why they may not necessarily hold in all cases.

Assumption 1: The best way to help smallholder farmers is to purchase directly from them

A common fallacy is that smallholder LRP requires purchasing from smallholders. The reality is perhaps more nuanced. Smallholder LRP is about how humanitarian agencies can use their procurement resources at different entry points to the value chain in ways that help markets perform better, particularly for the most vulnerable actors. In other words, improved development outcomes *for* smallholders are the goal, though not necessarily improved development outcomes *via* smallholders. To understand this, one must appreciate the critical role that traders play in market functioning. There are numerous middlemen involved in the aggregation, cleaning, storage, transportation and processing of commodities that are necessary to link producers to consumers; the size, scale, and relative market dominance of these traders varies widely. Like smallholder farmers, many are limited by working capital and access to financing, capricious policy environments, and price volatility. While traders are often accused (sometimes fairly) of being collusive, lacking transparency, or taking advantage of smallholders, they also assume incredible amounts of risk and often operate on tight margins.

Crowding out middlemen weakens markets

Smallholder LRP walks a fine line between temporary, small-scale displacement of traders in the hopes of gradually increasing value chain efficiency, and the full-on crowding out of key market actors. While in the short-run smallholder LRP may strengthen markets by creating demand-driven incentives for suppliers, there is a concurrent risk of establishing parallel marketing structures that can put traders out of business. Large formalized private enterprises may be able to absorb the shock of small decreases in their normal supply base, but this is less likely to be the case for smaller-scale traders. Relatively modest purchases by the standards of a large humanitarian organization can potentially represent a massive amount of lost business for local middlemen in segmented or isolated markets. With little capital and similar livelihood vulnerabilities as smallholder farmers in many cases, these traders are less likely to be able to compensate for market supply decreases. Displacing these actors can decrease the capacity of the market to aggregate, store, transport, or process commodities, leading to overall losses in efficiency and resilience.

The goal of smallholder LRP – increasing market access for farmers – thus may not necessarily be best served by purchasing from farmers themselves in some instances. Priority should be given to locating bottlenecks in the market and creating incentives and support that can alleviate these constrictions. Value chain analysis thus becomes essential when considering smallholder LRP interventions. For instance, purchasing directly from farmers has been rationalized in some cases as a solution to assumed predatory pricing by oligopolistic middlemen. If this assumption is in fact true, then the root problem is not lack of demand to incentivize production, but rather a lack of competition amongst traders. In such cases, rather than offering supply-side support to farmers in the hopes of increasing productivity, it would reason that finding ways to engage traders themselves could bring new entrants into the market, thereby increasing competition and lowering transaction costs. In Southern and Eastern Africa, P4P has experimented with purchases through nascent commodities exchanges, as well as through small-scale traders.

Unique market contexts necessitate unique entry points in the value chain

Targeting traders rather than smallholders will not hold in every instance, which is exactly the point. Unique contexts and market structures will require different LRP strategies, especially regarding the intermediate processes that link farmers to end buyers. Such interventions can take a number of forms, many of which are currently being tested. Increased use of commodity exchanges may facilitate market price discovery in the absence of sustainable or reliable market information systems; increased demand for small-scale transporters' services can incentivize geographical expansion of business and better integrate rural and urban markets; reliable demand for fortified milled cereals has potential to increase availability of nutritious foods and domestic demand for raw commodity inputs. These options represent ways in which temporary institutional demand can strengthen markets, without directly involving the smallholder. Such approaches are steeped in the logic that the most efficient markets have traders, thus market facilitation must work *through* traders, not around them.

Assumption 2: Purchasing in surplus production areas is sufficient to mitigate price risks to low-income consumers

LRP carries with it the risk that by decreasing local aggregate supply significantly, buyers can unintentionally exert upward pressure on retail commodity prices and negatively impact low-income consumers dependent upon markets to access food. Implementing agencies typically attempt to mitigate this risk by purchasing in areas of surplus production, where markets are "thick" relative to the LRP demand base. Targeting in this manner is relatively simple, as production data is often available at a devolved sub-national level in most countries. The micro-level corollary to surplus production is net buyer-seller status, i.e. whether a household produces the majority of the food it consumes, or if it is dependent primarily on the market.

Surplus tonnage metrics do not account for net household income

Targeting based upon aggregate surplus is problematic in that it ignores household expenditure or commodity value. All households are at some level dependent upon markets for at least some of their food and non-food items. Translating that dependence upon the market into value terms requires a temporal dimension of analysis. In areas with pronounced price seasonality, where low prices following the harvest gradually increase to peaks during the lean period, a given quantity of food sold by a farmer will be worth significantly less than what it will cost to buy back in the market later in the season. A household may be a net seller of food, e.g. they sell a greater volume of food than they buy. However, in translating that volume into value or expenditure, the same household could receive less from their sale then what they spend to buy food under pronounced seasonal price conditions. Volume-based assessments of 'surplus production' may run the risk of inadvertently declaring a household to be a surplus-producing potential supplier, when in fact the household could have a negative net cash flow and high dependency upon market food purchases to meet their consumption needs. Such households are vulnerable to even small changes in the local supply-demand balance of staple food commodities. This greatly complicates the targeting exercise.

It is unclear how common this situation might be; household survey data is required to investigate further, which is expensive and time-consuming to gather. All the same, targeting needs to consider the difference between net farm and net household income, their relationship with market expenditures, associated cyclical patterns, and how lagged price effects of local purchases are affecting lean season prices. Investigating production patterns is a necessary first step; however the temporal dimensions of market behavior must also be considered. This underlines the need for detailed baseline data, as well as flexible and responsive monitoring systems with rapid feedback loops that can be implemented throughout the season. Targeting and monitoring (and re-targeting, as necessary) should be prioritized, even if it comes at the expense of geographical coverage or project tonnage targets.

Aggregate supply considerations require complementary market integration analysis

Focusing solely upon surplus production also risks losing sight of how price effects are potentially transmitted between markets. While "thicker" markets are likely to exhibit smaller price effects due to local purchases, *ceteris paribus*, the level of market integration, or the flow of commodities and resulting price transmission between markets, must also be accounted for. Well-integrated markets will transmit price increases more quickly than poorly integrated markets; the degree of these price effects will be tied closely to the size of the purchase relative to local aggregate supply. At the same time, well-integrated markets, between which commodities flow freely, will be more capable of compensating for local supply decreases through trade. The risks of upward price pressure are greatest in markets that are poorly integrated, i.e. the target locations where farmers need to be connected to markets in a very literal sense. While the danger of price transmission to other markets is minimal, localized effects may be amplified as inter-regional commodity flows have less capacity to mitigate supply shortfalls. As target markets for smallholder LRP are likely to be those most sensitive to these price dynamics, understanding them is critical. Like household expenditure, market integration analysis is data-intensive and poorly understood in many of the rural markets in which humanitarian agencies are currently operating. This necessitates small, targeted purchases and regular price monitoring throughout the season. Market information systems and intelligence remain a significant bottleneck to project monitoring and re-calibration.

Assumption 3: Demand incentivizes increased productivity, and increased productivity will increase incomes

There is little debate that smallholders in developing countries by and large do not maximize productivity, but this can be viewed from two related yet distinct perspectives. From a food security standpoint, improved yields can certainly contribute to better food availability and access. This differs greatly from the premise of smallholder LRP, however, which is that increased demand from markets will incentivize productivity and by effect increase farmer incomes. To validate this assertion, net household income as a function of both farm and non-farm earnings must be considered alongside the production and processing incentives that alternative livelihood strategies create.

Increased productivity should not occur at the cost of diversified livelihood strategies

Considering profit margins, market uncertainty and increasing frequency of climatic shocks, agencies must carefully consider whether or not incentivizing increased staples production is in the best interests of a farmer's livelihood strategy. While productivity improvements can be made through more effective use of improved seeds and fertilizers, smallholder households are often land and/or labor-constrained. Staple commodities are generally low-margin, yet at the same time prone to drastic price volatility, presenting significant risks to smallholders. The unpredictability of the pricing environment is exacerbated in regions such as Southern and Eastern Africa, where the politics of food security often result in interventionist government agricultural policy, particularly in staple crop markets, more often than not leaving prices distorted and unpredictable. Recent examples can be observed from minimum pricing in Kenya and Malawi, trade restrictions in Tanzania, and extensive government food reserve purchasing in Zambia. Marginal resources may indeed best be used by risk-averse, resource-constrained farmers to enhance production of these types of crops, if the own-consumption of food-insecure households is the primary concern. However, surplus-producing, food-secure farmers aiming for increased incomes might better utilize scarce resources by diversifying into markets for food or non-food cash crops less prone to government interference, with more predictable free market pricing regimes, and higher margins. The marginal costs and risks to farming

households need to be evaluated on a case-by-case basis to assess whether smallholders should be entering a particular market segment.

The prevailing patterns in value addition may already reflect comparative advantage

Diversification as a means of minimizing risk applies not only to optimal utilization of land resources and inputs, but also of labor and time. To produce the quality specifications required by institutional buyers, smallholders must make additional investments in drying, sorting, cleaning, and/or processing to reach buyer quality specifications. A fundamental question however is why farmers do not already occupy this downstream market space in the value chain. If it is due to a lack of resources, then supply-side support may be effective in helping smallholders capture margins up the value chain. If it is due to the farmer's own evaluation of their comparative advantage in the market, then new answers must be sought. Smallholders may run the risk of failing to recover additional processing costs in volatile markets (increasing revenue while *decreasing* profitability), or may displace time that could have been devoted to casual labor as part of a calculated risk reduction strategy. Farmers may be engaging in value chains only to a certain level because they see more risk and less sustainable profit potential in the downstream processes that institutional buyers require. For instance, the generalized lack of sustainability that characterizes many producers' organizations across the developing world may be attributed to the high social and time costs associated with group marketing. For some farmers, the additional benefit of group aggregation may be outweighed by the time that could have been devoted to off-farm income-generating activities. This is not to suggest that markets are performing Pareto optimally; there may very well be slack where value addition by smallholders can be profitable without cutting into traders' margins. What is critical, however, is that smallholders are only encouraged to engage in value addition up to that point.

Value-added production must occur only where markets for quality can be sustained

Incentivizing production of higher quality commodities only makes sense if demand for higher quality is already present, or is likely to develop in the future. Smallholder farmers generally do not produce to national, institutional, or *Codex Alimentarius* standards for their traditional buyers. Producing at the grade required by humanitarian agency buyers can have profit potential if resources are utilized efficiently and value-added costs are compensated by the prevailing market price. However, such improvements come at the cost of time, resources, and risk to smallholders. If that new, improved grade cannot be marketed after the humanitarian agency buyer exits the market, then these quality improvements represent one-off revenue gains that have not improved market access or efficiency. Furthermore, the incentives for and capacity of smallholders to cost-efficiently maintain those higher quality standards is compromised as a greater share of the associated costs are subsidized by third parties for longer periods of time.

Assumption 4: Smallholder local purchase is applicable to all contexts

International organizations must respect cost-efficiency

The logic that market development goals should conform to basic market principles is too often lost in conversations regarding local purchase. Smallholder LRP programs should pay only up to the market price for the like-quality commodities; paying development "premiums" to farmers, a repackaging of the infant industry argument, can have a number of potentially distorting effects on markets. First, it can displace local buyers, providing the procuring agency an unfair advantage relative to the private sector in buying goods: by using 'free' donor money, humanitarian agencies isolate themselves from the true costs incurred in purchasing commodity. Second, it is likely to be inflationary: artificially high prices inject more liquidity into markets, which can encourage retailers to increase their prices to low-income consumers

already subject to tight budget constraints. This is especially likely in collusive, low-competition contexts that typify the rural retail environment in which LRP is likely to occur. Third, paying above the market price engenders dependency amongst beneficiaries, who are not incentivized to make efficiency and competitiveness upgrades that will allow them to operate sustainably in the free market when the institutional buyer exits. Finally, it is an inefficient use of resources by the humanitarian agency itself. Being both purchasers and distributors of food aid, the effective subsidy that is being paid by agencies to surplus-producing, relatively better-off farmers comes at the expense of more vulnerable beneficiaries that receive the food. Each dollar spent paying above the market price is one dollar less that could potentially be spent to purchase additional rations for food aid program recipients.

Smallholder LRP should build upon traditional LRP

These pitfalls can be avoided by purchasing where traditional LRP has already been shown to be cost-efficient. WFP has substantial experience in local purchases informed by import parity analysis, in addition to considering the timeliness and appropriateness of the food it purchases and distributes. As it is a more intensive iteration of the traditional LRP paradigm, smallholder LRP should be reserved for those countries and commodities that have already demonstrated capacity to supply cost-efficiently. The purchase of commodities at prices above the prevailing import parity price is distortive, inefficient, and rationalized by flawed development logic. West African rice markets have experienced significant difficulty in competing with modernized, efficient Southeast Asian rice suppliers, even after including transoceanic shipping costs. Degraded infrastructure and low aggregate supply in some post-conflict and early recovery situations has led to similar pricing difficulties. Yet pressure to utilize smallholder LRP as a response tool to address both chronic and acute poverty in complex situations continues, rather than leveraging it as a procurement modality that, when implemented cautiously, can contribute to development gains by priming existing institutions that can make markets more accessible and efficient for farmers.

Assumption 5: Smallholder local purchase programs should aim for sustainability

The goal of local purchase is to incentivize sustained market access for smallholders, not sustained program implementation and scale-up

A common question posed to proponents of smallholder LRP is whether or not it is sustainable. The answer lies in differentiating between smallholders' ability to sustainably supply markets and the ability of humanitarian agencies to sustainably procure from them. There is little to suggest that smallholders cannot sustainably engage in markets. Indeed the smallholder is the origin of most industrial agricultural systems in the developed world. In many countries, smallholders constitute the majority of domestic production. Barriers exist to efficient and profitable local, national and regional trade, but they are not insurmountable.

In contrast, smallholder LRP by humanitarian agencies is not sustainable, by nature of being a top-down activity; the objective is to be temporary and targeted, so as to catalyze improved market performance that benefits all stakeholders. From a cost perspective, repetitive purchases from smallholders will never be a competitive alternative to traditional LRP for humanitarian operations. This is due primarily to the higher administrative costs of having to buy more of the smaller lots supplied by smallholders. Smallholders may be competitive on the basis of per unit costs and decentralized uplift locations nearby end delivery points, making them attractive suppliers to the existing domestic or regional buyers. However for humanitarian agencies subject to bureaucratic procedures that must move large tonnages repeatedly, and quickly, traditional LRP via large traders and processors has economies of scale that out-compete smallholders. Donor funding has thus far subsidized the increased costs associated with smallholder LRP, though at a certain point those subsidies must be removed, and their full

market costs accounted for in evaluating what represents the most cost-effective and cost-efficient procurement strategy.

Recommendations

Smallholder LRP has the potential to positively impact agricultural markets for the world's small farmers, yet various risks lie along this path. To maximize the chances of success, implementers and donors should consider the following:

Encourage markets, don't work around them. The logic that only purchases directly from smallholders will ultimately achieve core goals runs the risk of undervaluing the critical role that traders play in efficient markets. It assumes that all markets face the same problems, which can be addressed with overarching, generalized solutions. Markets are invariably complex, and the most effective way to leverage the humanitarian community's procurement footprint in some cases may not involve smallholders at all.

Be cognizant that smallholders face sizeable risks in shifting production to higher quality commodities. Just because the farmer sells his/ her commodity for more, does not mean he/she is earning more profit or is better off. Where farmers have a comparative advantage in producing a product with sustainable demand, they should be assisted in finding reliable buyers. Where these conditions are not met, humanitarian agencies should not try and force them. Failing to fully understand smallholders' risks and how best to mitigate them amounts to playing with the livelihoods of the poor.

Revisit assumptions, regularly. Markets change. Conditions evolve. Opportunities come and go. Regular macro-, meso-, and particularly micro-level analyses are needed to constantly update the assumptions that underpin smallholder LRP. In some cases this may go beyond simply re-evaluating whether the target participants or selected approaches of the program make sense. Practitioners must carefully consider the economic rationale behind their engagement in a given commodity, as well as in countries and regions. Agencies need to be flexible to make these calls, and donors need to be ready to support such decisions. This is particularly relevant now when smallholder LRP is in a pilot phase, a time at which learning should be prioritized, rather than attempting to re-affirm or validate initial, possibly flawed, assumptions.

Manage expectations. Smallholder LRP is still in its infancy; too little is known at this point to gauge its net aggregate effect on smallholder farmers' welfare, nor that of the broader market. In addition to potential positive impacts, there are significant risks associated with highly invasive approaches, and not all farmers or participants will benefit from this approach. The humanitarian community will do well to be mindful of the many ways in which market interventions can lead to unanticipated and harmful effects on the very segment of the population they seek to assist. A measure of humility and caution will serve practitioners well, as they seek to replicate successes and learn from failures.