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COMMITTEE ON COMMODITY PROBLEMS

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IDENTIFYING APPROPRIATE POLICY INTERVENTIONS IN SUPPORT OF SMALLHOLDER PARTICIPATION IN MARKETS

Executive Summary

Increasing the productivity of small farms is key in ensuring inclusive and broad based agricultural transformation. However, widespread adoption of productivity enhancing technology is unlikely unless greater attention and consideration are given to the incentives and constraints facing different categories of smallholder producers when deciding whether, and to what extent, to increase production for market. Smallholder participation in markets is typically characterized by constrained choice, and this choice is dependent upon their ability and willingness to participate in input and output markets and on the functionality of the markets that they are able to access. The identification of public sector interventions aimed at facilitating technology adoption must therefore be cognizant of the determinants of smallholder market participation.

Suggested action by the Committee

The Committee is invited to:

- Provide advice as regards direction for future work and support to Members in the area of policy interventions and support to smallholder participation in markets, including allocation of appropriate resources to improve the understanding of the ways in which smallholders' participation in local markets is being constrained and can be facilitated to be developed.
- Assist the Secretariat to identify opportunities for supporting work in relation to improving the evidence base on the determinants of smallholder producers' participation in agricultural markets and on the development of best practice guidance on policy approaches to facilitating greater levels of participation.
- Provide guidance to the Secretariat in the identification and delivery of activities aimed at sensitizing key stakeholders as to the merits of alternative policy approaches and developing their capacity to identify, formulate and implement appropriate policies.

I. INTRODUCTION

1. At its previous session, the Committee on Commodity Problems indicated that priority should be given to work on policies to support smallholder market integration. This paper is developed on the basis of recent work undertaken by the Secretariat in this area. It first explains the centrality of smallholder market participation in determining the extent of adoption of productivity enhancing technology. It then expands on the issue of smallholder heterogeneity in market participation, before examining the role and formulation of supportive public sector policy. In concluding, the paper suggests ways in which FAO can support improved processes of policy design, and makes several recommendations for the Committee's consideration.
2. Increasing levels of marketable surplus of food staples from small farms is key in ensuring inclusive and broad based agricultural transformation. Increased food staples production not only helps in stabilizing local market prices, providing improved incentives for investment in further market development, but can provide opportunities for smallholder households to generate cash surpluses, which when spent or reinvested within the rural economy can generate significant multiplier effects and contribute to overall economic growth.
3. Stimulating production will require the provision of appropriate productivity enhancing technology and access to finance to facilitate its adoption. However, widespread adoption is unlikely unless far greater attention is given to the incentives and constraints facing different categories of smallholder producers when deciding whether, and to what extent, to generate marketable surpluses of staple foods.
4. The extent to which smallholder producers participate in markets as sellers of staple foods is highly variable. Not only do different categories of producers face different sets of constraints in accessing markets, but due to the non-separability of their food production and consumption decisions, food security considerations can heavily influence the way in which they are willing to participate in domestic food markets. An improved understanding of the propensity of different categories of smallholder producers to generate increased marketable surpluses of staple foods and of the factors that shape their decisions is therefore imperative in identifying public sector policy interventions to enhance their participation.
5. Complicating the identification of appropriate policy interventions is that policies aligned with a longer term strategy supportive of agricultural sector development needs to take a dynamic perspective which recognizes that different categories of smallholder producers will follow, either by choice or by compulsion, different pathways during agriculture sector transformation.
6. Faced with the same set of policies aimed at encouraging increased production of staple foods, some smallholders will intensify production on existing plots through the adoption of new technologies, while others will increase the amount of land under the production of the crop in question. But many other smallholders will be constrained from benefiting from improved opportunities, due to their remoteness from these markets, lack of access to productive assets, and to specific household level constraints such as dependency structures which will affect their ability to sell a significant proportion of their production. Not all producers will therefore seek to increase production for sale in markets. Indeed, some will benefit from an increased demand for their labour from those smallholders who are increasing production and may reduce the amount of time allocated to their own land and consequently their ability to participate as sellers of food staples.
7. Smallholder participation in food markets is therefore typically characterised by *constrained choice* and this choice is critically dependent upon their ability and willingness to participate in input and output markets and on the functionality of those markets that they are able to access. Smallholder households differ significantly in the way in which they participate in markets and in the extent to which these markets are integrated with other domestic, regional and international markets. The identification of policy interventions aimed at encouraging increased smallholder participation must be cognisant of these differences.

II. SMALLHOLDER HETEROGENEITY IN MARKET PARTICIPATION

8. There has been a tendency to treat smallholder households as a homogenous group when attempting to identify policies to alleviate constraints to, or to provide incentives for, increased market participation. The patterns of smallholder participation in food markets are increasingly well documented¹, but the determinants of these patterns have not been adequately studied.

9. Smallholder heterogeneity with respect to market participation can be considered along three interrelated dimensions², the relative importance of which will differ across smallholder categories:

- i) The smallholder household's access to, and the productivity of, *productive assets* (natural resources, labour, capital) *vis-à-vis* their subsistence needs will determine both their ability and willingness to increase production for sale in markets in response to a positive market signal or the lifting of a critical constraint.
- ii) The *connectivity* of smallholders to different markets, which can be considered in terms of remoteness and the costs of commerce, will influence the extent to which smallholders can benefit from increasing their production.
- iii) The *functionality* of local food markets, which are often volatile due to the low volumes transacted and their limited integration with regional or international markets, can constraint the market's ability to quickly adjust to demand and/or supply side shocks. Volatility can affect the level and riskiness of returns to the producer. Where markets are not well integrated, returns to increased output can diminish quickly as prices plummet, significantly affecting incentives for market participation and consequently, for adoption of productivity enhancing technology.

10. With access to, and the ability to use assets productively; with efficient infrastructure reducing the costs of commerce; and with appropriate incentives transmitted through well integrated markets, smallholders will engage in markets as sellers of food. However, if one component is missing they cannot, or will not be, willing to participate to the same extent. The factors that dominate in determining the extent of participation in markets vary significantly both spatially across household types and locations, and temporally as agricultural transformation takes place. A key challenge for policy makers is to determine which factor(s) to target to ensure appropriate emphasis and sequencing. It is therefore essential to determine *which constraints facing which categories* of smallholders are holding back the process of productivity-led transformation in order to identify where the greatest payoffs to policy interventions lie.

11. The constraints to participation of different types of smallholders are not only multifaceted, but change during the process of sectoral development. Increasingly the opportunities available to smallholders to participate in, and benefit from, market activities are influenced by processes of value chain development that can result from stimuli that are external to the chain, such as the imposition of standards, regulations or policies, and/or internal to the chain through, for example, improved coordination of stakeholder actions. Although the focus of value chain development has often been on higher value products for trade in more lucrative markets, whether export or higher income segments of domestic markets, these developments are also significant in basic food product chains. With the formalization of staple grain value chains in East and Southern Africa, including the potential for increased use of commodity exchanges and warehouse receipt systems, the challenges to increased smallholder participation are changing.

12. For semi-subsistence producers, particularly those in remote locations, facilitating greater participation in local markets may be a first step. As producers become more commercially oriented, policy may be required to facilitate participation in processes of value chain development, requiring support to assist producers in meeting more rigorous standards or to engage in more complex contractual arrangements.

¹ See for example case study chapters in Sarris, A. and Morrison, J. (2010)

² Developed on the basis of Barrett, C. (2010)

13. Evidence from Zambia³ suggests that strategies aimed at commercializing the cassava sector need to further consider the propensity of smallholder producers to generate surpluses of what is essentially a food security crop, in the context of limited existing market opportunities. While cassava is extensively grown in some regions of the country, non-marketed production accounts for almost 90 percent of total production. This has constrained the adoption of improved varieties necessary to achieve yields required for commercially oriented production, but which are not necessarily conducive to food security needs.

III. A ROLE FOR PUBLIC SECTOR SUPPORT TO SMALLHOLDER MARKET PARTICIPATION

14. Case study examples of success⁴ reveal that value chain development has often been possible only following the sequential alleviation of key constraints. In many cases where development has been short lived, or confined to a subset of stakeholders, appropriate public sector support was absent. The cases also reveal that the mechanisms through which support is delivered vary widely, and are generally chain and context specific.

15. Agriculture provides inherently risky and often relatively low return opportunities for private sector investors. A key role for public sector policy is therefore to help to offset these risks and to improve the likelihood of a decent return on investments so that the private sector becomes more involved in providing access to the required technologies and services to improve producers' ability and willingness to increase levels of marketable production.

16. The appropriate type of public sector intervention to facilitate market participation will depend in large part upon the stage of agricultural development. Where the level of commercialization is limited, provision of the basic conditions such as on farm and off farm infrastructure is likely to be a focus for the public sector. This role will require careful consideration of the relative responsibilities for funding, construction, ownership and management. Where these conditions are adequate, but input and output markets are susceptible to volatility, the public sector can play an important role in kick-starting market activity through the provision of appropriate incentives and risk sharing mechanisms. When markets are functioning adequately, the public sector needs to be aware of crowding out private sector engagement, and a reduced role focusing on market regulation, market information systems and quality assurance may become appropriate. In the absence of consideration of appropriate sequencing of interventions to lift critical constraints, there are significant risks that inappropriate policies will be implemented, particularly where formulated in situations of weak or inadequate information on domestic production and market activities. Governments may therefore need to recognize and adapt their changing role in supporting smallholder based transformation.

17. Adding to the task of identifying which constraints require alleviation, is determining how best to address them. Constraints can be addressed through policy interventions and/or institutional innovations. Institutional innovations, not considered further in this paper, may include interlinking of output purchase and input provision, contract farming, and the strengthening of producer organizations.

18. Improved trade and price policy interventions may work for farmers already operating in well integrated markets and who have the capacity to react to changing incentives. However, without also addressing the constraints inhibiting participation of other categories of smallholders, the potential beneficial impacts of such policies can be limited to the more commercially oriented farmers.

19. The need for a more active role for the public sector that goes beyond creation of basic enabling environment is increasingly acknowledged. This has allowed greater focus on the identification and design of mechanisms through which public support can be used to leverage private

³ Poole *et al* (2010, 2011)

⁴ For example, FAO (2009)

sector investment in market development. A first step is to understand the characteristics of the market failures that are preventing such investments⁵.

20. Basic infrastructure and services such as research, extension, quality assurance, and market intelligence will, because of their public good nature, be underprovided by private sector actors who are themselves making decisions on the basis of market signals or incentives. Whilst funding for establishing basic infrastructure and public goods is likely to remain a public sector responsibility, the role of the public sector in the management of chain specific infrastructure (e.g. storage, basic processing, quality assurance etc.) needs to be supportive rather than “hands-on”.

21. By contrast, inputs such as seeds, credit and fertilizers, which are provided by the private sector where markets are functioning well and producers are able and willing to pay for them, are often not available at affordable prices due to the high risks or transaction costs involved in their provision. In this context, the high degree of risk inherent in the agriculture sector provides a compelling argument for public sector risk sharing by underwriting private sector investments while the sources of low willingness to pay are addressed. Low willingness to pay, which could be due to a lack of awareness of the benefits of the good or service, can be addressed through demand stimulation, examples of which include public sector supported schemes for the delivery of appropriate levels and types of inputs such as fertilizer, seeds, or extension, for a pre-defined period of time during which the market develops.

22. Another set of decisions concerns policies to facilitate the participation of low income groups, often remote from markets. For example, the extension of credit to remote areas, where the risks and transaction costs of investment are too high for private sector financial institutions to make a sufficient return. Mechanisms to leverage this involvement might include matching grants to share the cost or risk at a critical stage of investment, or guarantee funds to allow development of new financial products or the extension of existing products to new groups by the private sector.

23. In designing such public-private partnerships, the public sector is harnessing the capacity of the private sector to deliver. However, whilst contracting the private sector operators may work in some situations, the low levels of development and competition within the private sector in many contexts may make this problematic and can provide particularly difficult design issues. Careful contract design and monitoring and the choice of appropriate partners should serve to mitigate these difficulties, but will need improved public sector capacity to identify, design, implement and monitor such contracts.

IV. FAO'S ROLE IN SUPPORTING MEMBER COUNTRIES

24. Analyses undertaken by the Secretariat support the contention that broader based smallholder participation will necessitate a more active role for the public sector. FAO can assist Members in identifying appropriate policy in support of increased market participation by (i) improving understanding of smallholder market participation, (ii) sensitizing stakeholders to alternative interventions, and (iii) building their capacity to identify, formulate and implement appropriate interventions.

25. FAO has already started to play a key role in further *enhancing the understanding* of how smallholders participate in markets, the functionality of those markets, and how these combine to determine the pathways open to smallholders. In Zambia, FAO has supported the design and implementation of the cassava sector strategy under the EU-funded *All ACP Agricultural Commodities Programme* by mapping producer characteristics against potential market opportunities and seeking to identify interventions through which to alleviate constraints to marketable production. In Kenya, under a Multidisciplinary Funded project, surveys have been undertaken to improve understanding of the determinants of smallholder participation in alternative maize marketing channels.

26. The type of policy appropriate in a given context depends upon the objectives sought, the constraints to be addressed and nature of these constraints. FAO is well placed to play the urgently

⁵ A typology of these characteristics is proposed in Poulton (2009)

needed role of *sensitizing stakeholders* as to the most appropriate interventions in specific contexts and to equip them with the knowledge and ability to make informed choices about where, when and how to support smallholder market participation. In East Africa, FAO is promoting public-private dialogue to assist countries in reducing the use of ad hoc trade policy interventions, seen as a critical precursor to encouraging the level of private sector investment in market related infrastructure required to facilitate increased participation by smallholders in more formalised grain markets.

27. Improved identification and design of policies will require the *development of the capacity* of stakeholders to collect relevant data and to analyze the impact of alternative policies in a given context. In the Pacific region, FAO is supporting a process aimed at building the capacity of governments to collect and use information on the structure and functionality of domestic food markets in informing evidence-based policy design and implementation.

28. The development of appropriate policy support needs to be based on a comprehensive understanding of the different conditions and constraints that influence the pathways open to the various categories of smallholders. Under Strategic Objective G, FAO is building that understanding and translating it, through advocacy and capacity building activities, into more informed interventions to assist governments in overcoming the constraints to market participation and to smallholder agricultural development more broadly.

V. RECOMMENDATIONS

29. In light of the issues addressed in this paper, the following recommendations are tabled for the Committee's consideration:

- i) In *improving the evidence base*, Members could consider allocating resources to improved data collection and use, to allow improved understanding of the ways in which smallholder producers' participation in domestic markets is being constrained and can be facilitated to be developed.
- ii) In *sensitizing key stakeholders*, Members could be assisted, through the sharing of case study analyses, to raise awareness of the potential implications of alternative policy interventions on the pathways that different categories of smallholders will follow during sectoral transformation.
- iii) In developing capacity in policy analysis and design, Members could be assisted in creating fora for sharing experience of best practice to allow for improved dialogue between public and private sector stakeholders aimed at ensuring that the key constraints to the ability and willingness of smallholders to increase their participation in markets are identified and addressed through the identification and formulation of appropriate policy interventions.