Chapter 10

Emerging Tiers of Suppliers and Implications for Upgrading in the High-Value Agriculture Supply Chains

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Abstract[2]

Trade preferences in the European market have historically provided a strong incentive to diversify away from commodity dependency and enable a shift towards other forms of high-value agriculture. Within this context, this chapter reflects on the participation by the incumbent Kenya, and the more recent entrant Ethiopia, in the high-value agriculture value chain and the subsector of cut flowers. The emergence of tiers of suppliers is clearly apparent in the case of Kenya, with lead firms emerging as intermediaries, controlling production and supply to retailers. Some Kenyan lead firms are also active in Ethiopia, which pursued global value-chain (GVC) engagement led primarily by foreign direct investment. The evolution of the cut-flower GVC suggests that some Kenyan lead firms have extended their range of services undertaken within the sector across countries, including Ethiopia. This is essentially a form of intra-sectoral upgrading, which has occurred even though functional upgrading in the conventional sense, into international services such as sales and marketing, has not been achieved. These trends have implications for conventional upgrading processes within GVCs. In view of the emergence of tiers of suppliers and powerful intermediaries within GVCs, these findings underscore the importance of analysing conventional learning by exporting processes with due consideration to the type of value chain governance structure in operation. Policy makers have to better understand and distinguish between tacit and non-tacit knowledge flows and their translation into developing producers' capabilities. Close linkages between the public and private sectors are required in order to enable dual processes of economic and social upgrading.

10.1 Introduction

In recent years, through the provision of tariff rents, the international trading system has provided certain groups of countries with incentives to induce movement into the modern export sector. In view of this history, this chapter reflects on the evolution of the cut-flower global value chain (GVC) in Kenya. The horticulture value chain in Kenya first rose to prominence during the 1990s, as retailers began to develop backward vertical integration strategies. At that time, concerns were raised regarding the exclusion of smaller-scale producers, in view of the drive towards economies of scale and scope in production and marketing structures (Dolan *et al.* 1999; Dolan and Humphrey 2000). More recent but less well-known aspects of contemporary value-chain participation includes how some of Kenya's lead firms have now subsequently become powerful intermediaries, both sourcing from and producing in Ethiopia, the new East African entrant into the global cut-flower value chain.

The emergence of powerful intermediaries in their own right has only recently been acknowledged by the GVC literature and most notably in relation to the light manufacturing sector. However, the emergence of tiers of suppliers within the high-value agriculture GVC, and the resultant effects on upgrading processes and governance structures, are less well understood. Contract farming is a form of vertical integration between producers and buyers. The major difference between contract farming and contract manufacturing is that the former is resource-seeking while the latter is efficiency-seeking (UNCTAD 2011). However, both types of trade typically occur within similar types of GVCs in terms of their associated governance structures, driven by large retailers. Contracting arrangements are non-equity modes of production.

In this chapter, first, the evolution of the cut-flower subsector in East African countries, such as Kenya and more recently Ethiopia, is reviewed. We then describe the emergence of tiers of suppliers within the cut-flower GVC in Kenya and summarise the identifiable upgrading processes. These experiences are then contrasted with those identified in Ethiopia. Finally, this chapter concludes with reference to the implications of these findings for conventional GVC governance structures and upgrading processes.

10.2 Evolution of the high-value agriculture and cut-flower global value chain

In recent years, exports in new sectors have been encouraged by the creation of economic (tariff) rents created by the global trading system. The 1970s marked a major turning point in international trade policy, as industrial economies were persuaded to enter into the Generalised System of Preferences (GSP).[3] This period essentially marked the beginning of trade preferences for development. Although the GSP was initially agreed under the auspices of the United Nations Conference on Trade and Development (UNCTAD), the mandate was subsequently incorporated into the General Agreement on Tariffs and Trade (GATT), the predecessor of the World Trade Organization (WTO). Principles of special and differential treatment (S&DT) have subsequently been incorporated into the WTO. This means that all WTO members recognise that developing countries have specific trade needs.

As subgroups of developing countries such as the least developed countries (LDCs) were identified in 1971 and principles of S&DT adopted, so too were limits placed on market access for some traders. For example, quotas were applied on specific product lines destined for developed country markets, most notably textiles and clothing, from the emerging Asian economies. Regional trade policy developments also excluded important competitors from markets. For example, Stevens (2001) describes how EU trade policy effectively excluded many of the most important global agricultural suppliers from the UK market. However, more recently, because of the proliferation of regional and bilateral trade agreements in recent years, there has been a dramatic preference erosion of conventional tariff rents.

For countries in sub-Saharan Africa in particular, because of a failure to negotiate a successor to the trade-related protocol the Cotonou Partnership Agreement (CPA), which expired in 2007, revised dates were set for the removal of autonomous preferences by the European Commission (EC) in 2014. By that time, African, Caribbean and Pacific (ACP) countries that had not agreed and taken the necessary steps towards the ratification of an economic partnership agreement (EPA) – the intended trade-related successor to the CPA – with the EU would be downgraded to the EC's standard GSP. For many ACP countries plugged into GVCs driven by EU retailers, the standard GSP offered by the

EU is less favourable than the previous non-reciprocal regime under the CPA, in terms of both the available tariff rents and the applicable rules of origin.

A comparison between the cut-flower GVCs in Kenya and in Ethiopia is interesting in many respects, but particularly in view of how the trade preference rent made available to Ethiopia was perceived as more secure compared to Kenya over the period 2007 and 2014 (because Ethiopia is an LDC, whereas Kenya is not). As described in the following sections, this perceived security (along with other concerns regarding exchange rate volatility) prompted the relocation of some firms from Kenya to Ethiopia during that period.

10.3 Evolution of the cut-flower industry and trade policy developments[4]

There are two main marketing channels into the European market for cut flowers: through auction houses, which act as intermediaries, or direct to retail. Over time, the number of cut-flower auction houses has been on the decline in the European market. There were around ten in 2011. The merger of the two largest Dutch co-operative flower auction houses in 2007 resulted in the world's largest flower marketplace: FloraHolland (Hortiwise 2012). This auction house was originally a co-operative among Dutch growers, before they began to expand their operations overseas, driven by efficiency as well as resource-seeking motivations. It remains a co-operative, although the geographical reach has expanded; members pay fees to sell their produce within the auction house. The auction house remains a members' club run by the major suppliers. However, a direct sales route also exists, as some members of FloraHolland have begun to establish operations overseas, including in Ethiopia and, to a lesser extent, Kenya.

Unlike the direct sales route, where prices and quantities are agreed in advance, the auction house operates an 'auction clock', whereby the price starts high and is lowered until a buyer is willing to accept the figure; if the minimum price is not achieved, the grower must cover the loss as well as disposal fees (Wishaw 2013). One of the perceived benefits of the auction house route is how it provides for rapid payment; in addition, it enables suppliers to sidestep some of the certification processes typically demanded by large retailers.

More than 75 per cent of the UK's grocery spend is accounted for by the 'big four supermarkets', which exhibit considerable market power.[5] There are significant differences, however, among these retailers in terms of their sourcing strategies, reliance on intermediaries and direct purchasing methods.[6] While some backward vertical integration by retailers has taken place in terms of dealing directly with producers, some Kenyan lead firms have also vertically integrated to control logistics and become preferred suppliers for retailers.[7] Gaining control of particular stages of production, particularly transport and logistics, means capturing greater value. More recently, large retailers in the UK such as Tesco have expressed interest in entering the wholesale market, with a recent merger under scrutiny by the UK Competition and Markets Authority.

10.4 Emergence of tiers of suppliers

Around six UK retailers account for the direct sales route in the case of Kenya and in recent years around half of these have been supplied directly by one major firm, a subsidiary of a major transnational corporation (founded in 1750, originally as a trader and manufacturer of cotton). In recent years, because of continued growth in the sector, other Kenyan lead firms have emerged. One of these recent entrants now ranks as one of the largest producers and exporters of fresh produce from Kenya and is among Kenya's top five flower exporters. Subsequently, the company has become part of a group that has expanded production into neighbours such as Ethiopia, as well as into Ghana. The operations undertaken overseas have grown from production to packaging and exporting, as well as logistics, energy and general trading This process of upgrading has also begun to be replicated by other lead firms in the sector.

10.5 Country capabilities

The available evidence suggests that Kenya is favoured as a preferred supplier, mainly because of its compliance infrastructure (Table 10.1). In comparison, Ethiopia is viewed favourably for cost.

Table 10.1 Country capabilities

Capabilities	Kenya	Ethiopia
Resource endowment and available hectares in 2010	3,400	1,600
Main products	Range of products available: roses; other decorative flowers High-value rose products (geographical factor)	Roses
Main destinations	66% UK; 17% Netherlands; 5% Germany; 12% other	84% Netherlands; 8% Germany; 8% other
Strengths	Certification and trust in compliance infrastructure: business to business and retailer specific Pool of skilled labour force 10-year corporate income tax holiday Exemption from value-added tax and customs import duty on inputs Business support services, including industry associations	Cost-competitive; incentives provided to investors Cheap labour force Ease of doing business Tax holiday for 5 years; duty-free import of input materials Credit and finance available
Weaknesses	Perceptions regarding pesticide residue issues in the past Perceptions regarding labour standard and rights issues, e.g. minimum wage legislation Difficult to start a business and register property; complex land management and administration Taxes are a problem, with poor co-ordination among government agencies Labour is no longer low cost	Weak compliance infrastructure Weak post-harvest technologies Issues with labour standards and rights, e.g. minimum wage legislation Air freight dictated by government Lack of trade promotion support
Trade policy	Uncertainty regarding the EU-EPA negotiations was a problem Costs resulted from a failure to conclude negotiations by the deadline set by the EC, though more recently EU market et access has been secured	LDC status and security of tariff rent available in EU market Willingness to work with buyers and industry representatives, e.g. Centre for the Promotion of Imports from developing countries (CBI), Netherlands

Source: Adapted from Rikken (2011, 2012), and key informant interviews

10.6 Upgrading opportunities

The range of upgrading opportunities for producers in the modern agricultural sector is similar to those available to new entrants into the textiles and clothing GVC. A form of functional upgrading could entail sales on the domestic market. Gaining control of logistics and supplying retailers with a flower product may be considered broadly comparable to movement from basic 'cut, make and trim' tasks within the garment industry towards movement of supplying a full package and final product, direct. A form of upgrading entails moving from supplying fresh cut flowers towards the supply of complete bouquets and flower 'products'.

There is evidence of Kenyan cut-flower firms moving towards the position of a full package supplier, with responsibility for sourcing all inputs, as in the case of a more relational type of GVC governance (Keane 2014). In comparison, Ethiopia supplies fresh-cut flowers (roses) predominantly to the Dutch auction houses; some supply is destined for UK retailers.

10.6.1 Upgrading in Kenya

In the case of Kenya, the available evidence suggests that the internal governance structures between firms have become complex in view of two major marketing channels: UK retailers and the Dutch auction houses. A new wave of consolidation is under way within the sector. This process is occurring among different types of firms, as described in Table 10.2. For example, Type 3 firms are developing new relationships with Type 2 firms: those firms that deal with intermediaries in the same country, as well as directly with retailers or auction houses based overseas.

It could be assumed that sales to auction houses would be – in terms of a hierarchy of GVC governance (Gereffi *et al.* 2005) – a case of market governance. However, in practice, given overlapping ownership structures between important actors involved in Dutch auction houses and some of the Dutch-owned flower producers based in Kenya, the situation is more complex. As new lead firms have emerged, some retailers have increased purchases direct from growers under long-term contracts. There is evidence to suggest that there is a more relational type of governance between Kenyan vertically integrated lead firms and UK retailers. Firm age is found to exert a significant influence on the likelihood that Kenyan firms supply the direct sales route.[8] This type of value-chain governance structure, identified by Gereffi *et al.* (2005) implies far fewer asymmetric trading relations in view of capabilities than, for example, the hierarchical type of governance.

However, the interaction between different types of knowledge, including codified forms, with producers' capabilities is somewhat problematic with reference to the Gereffi *et al.* (2005) framework. For example, both hierarchical and relational governance structures are characterised by a high complexity of transactions, with a low ability to codify transactions. Within relational structures, producers' capabilities are high in view of tacit knowledge acquisition, while within the hierarchical structure the opposite is supposed. Whose capabilities improve in the supply base (or firm) and how in relation to the acquisition of both tacit and codified forms of knowledge acquisition are aspects which require further elaboration.

The evolution of the cut-flower GVC suggests that some Kenyan lead firms have extended their range of services undertaken within the sector across countries, including Ethiopia. This is essentially a form of intra-sectoral upgrading, which is not currently conceptualised within the GVC governance structures identified by Gereffi *et al.* (2005). Intra-sectoral upgrading has occurred, even though functional upgrading in the conventional sense, into international services such as sales and marketing, has not been achieved.

Table 10.2 Cut-flower subsector in Kenya and tiers of suppliers

Functional capabilities	Description of activities
Type 1: subcontractor/ assembler Product: foliage/summer flowers/roses Supplier tier: marginal supplier	Small and medium-sized firms are integrated into the cut-flower GVC by acting as subcontractors to larger firms (Type 2) or intermediaries. This is a form of subcontracting, in which the Type 1 firm is responsible for the supply of the product up to its final destination, Type 2 firms or intermediaries. In some cases, inputs may be supplied by Type 2 firms to Type 1 firms, depending on the subcontracts and end product specified. These farms tend to be relatively small scale and specialise in a limited number of cut-flower types, including summer flowers.
Type 2: package contractor/assembler Product: roses and/or foliage/summer flowers (bouquets) Supplier tier: preferred supplier and may subcontract, or niche supplier	Type 2 firms tend to be medium-scale firms that have greater functional capabilities than Type 1 firms, both growing and packaging to specification. They may also have their own nurseries and use these to supply other firms. These firms tend to have set annual contracts with their buyers for specific volumes and prices. They may, however, also develop more informal linkages with Type 3 firms and supply them; similarly, they may in turn subcontract Type 1 firms to fulfil their buyers' requirements. For example, Dutch auction houses typically require a steady supply of high-volume and high-quality roses. In comparison, retailers may require specific products, such as bouquets, which require both roses and other summer flowers/foliage. Generally, Type 2 firms are responsible for the supply of the product up to its final destination. Because of the differences in end markets and product supplier, we distinguish between Type 2a firms, which are preferred suppliers to their buyers, and Type 2b firms, which tend to be niche suppliers to auction houses. Both types of firm may make use of an intermediary based in Kenya, but do not rely solely on them, as they have established their own direct links with end markets.
Type 3: package contractor/full package provider Product: roses Supplier tier: strategic supplier or niche supplier	Large multinational enterprises typically not only have their own nurseries integrated within their supply chains, but also tend to be vertically integrated, taking care of production, packaging and logistics. This means that the price invoiced or quoted by Type 3 firms includes insurance and all other charges up to the named port of destination, or named place in the country of destination such as a warehouse. A full package supplier carries out all steps involved in production. This includes the selection, purchasing and production of materials; the completion of production; and delivery of the finished product to the buyer: Dutch auction houses or supermarkets/retailers. Type 3 firms may subcontract Type 2 firms to fulfil their buyers' requirements.

Source: Field work and key informant interviews

Despite these apparent upgrading experiences within the cut-flower GVC in Kenya, outcomes in terms of an improvement in producers' capabilities are less obvious. Because of major data limitations, for example, it is not possible to confirm the anticipated dual process of social and economic upgrading. This includes higher wages and remuneration, which one would expect with increasing demand for skilled labour.

It is difficult to assess clearly how pay rates in cut-flower production compare with those in other sources of employment, although it is clear that collective bargaining agreements within the sector have increased rates. This means it is very difficult to confirm, as others such as Bernhardt and Milberg (2011) conclude, that social upgrading has occurred in tandem with economic upgrading.[9] Recently has a Vocational Training Act been implemented (Government of Republic of Kenya 2013); although around 30 vocational training institutes are operational, linkages with the private sector are still being developed (Lacave and Vullings 2014). Other policies have been introduced to facilitate the entry of small and medium-sized enterprise (SME) exporters across the following sectors: horticultural, commercial crafts and textile/apparel. The Export Business Accelerator programme is an initiative to nurture SME exporters to become medium-sized or large exporting enterprises, including by providing tax incentives and business development services. It seems premature to assess their effectiveness, however, these initiatives do reflect the need for specific measures to promote SMEs effective engagement with GVCs, not just in high-value agriculture, but across other sectors.

10.6.2 Upgrading in Ethiopia

The available evidence suggests that Ethiopia has pursued foreign direct investment (FDI)-led GVC engagement, although some conditions on the investment have been put in place. Strong interactions exist between the CBI – the Dutch Centre for the Promotion of Imports from developing countries – and the Ethiopian Horticulture Producer Exporters Association (EHPEA). Although there are some apparent weaknesses in the strategy – for example, as discussed by Gebreeyesus and Iizuka (2010), so far there are no links with the Ethiopian Agricultural Research Organization (EARO) – a form of innovation system was established in Ethiopia when it engaged with the GVC, through close government co-operation with private investors.

It is not possible to clearly identify tiers of suppliers in Ethiopia (as it was in Kenya). However, it is clear that a few large producers exist in terms of land area (and one of these is a lead firm that relocated from Kenya, with multiple operations across the two countries). The available econometric evidence at the firm-level suggests that foreign ownership exerts a strong influence on supplying the direct sales (Keane 2016).

The limited development of more medium-sized firms may reflect the relatively short period during which the industry has been in operation. Although functional upgrading processes within the sector have been described as limited as well as challenging to identify, intersectoral upgrading processes, including movement into other forms of light manufacturing, deserve further attention. This includes in relation to the specific policy measures that may have made this route more amenable in Ethiopia.

10.7 Concluding remarks

This comparison of GVC engagement in the cut-flower GVC in Kenya and Ethiopia provides some evidence of a type of East African 'flying geese' in action. This is taking place as investors in Kenya begin activities in Ethiopia, which is a lower-cost producer. Ethiopia has been inserted into the cut-flower GVC through a strong FDI-led process, with a specific focus on the supply of cut flowers to Dutch auction houses. It has exhibited an impressive performance to date in relation to the volume of cut flowers exported. There is evidence of some functions, notably logistics, being handled by Kenyan firms.

The evolution of the cut-flower GVC suggests that some Kenyan lead firms have extended their range of services undertaken within the sector across countries, including Ethiopia. This is essentially a form of intra-sectoral upgrading, which is not currently conceptualised within the GVC governance structures identified by Gereffi *et al.* (2005). Intra-sectoral upgrading has occurred, even though functional upgrading in the conventional sense, into international services such as sales and marketing, has not been achieved.

Finally, while some upgrading processes have clearly occurred, their translation into greater value addition and capture deserves further attention. Moreover, further analysis is required to reveal the specific mechanisms which translate the tacit knowledge obtained from engagement with this GVC information into knowledge stock, over time. These processes may become more apparent upon the complete implementation of Kenya's National Innovation System.

Notes

1 Economic Adviser, Commonwealth Secretariat. The views expressed in this chapter are the author's own and do not reflect those of the Secretariat.
2 This chapter is adapted from Keane (2016).
3 See Page (1994).
4 This section draws on Keane (2014).
5 These are Tesco (31 per cent), Asda (18 per cent, Sainsbury's (17 per cent) and Morrisons (12 per cent). See Wishaw (2013) for further discussion.
6 Because Asda has a commitment to be 10 per cent cheaper than its supermarket rivals, it is reputedly an aggressive price negotiator (Wishaw 2013).
7 Some UK retailers have begun to establish direct sale arms in supplier countries such as Kenya. This includes IPL, a subsidiary of Asda – the UK's second-largest retailer – whose parent company is Walmart. IPL was created as a direct sales arm of Asda in 2004 and in 2009 it subsequently became a wholly owned subsidiary.
8 Based on the firm-level data obtained by Ksoll *et al.* (2013).
9 Despite this, the direct benefits of formal employment opportunities are not to be downplayed. For workers on permanent contracts, they could include sickness pay, maternity leave and subsidised accommodation. It is also notable that entry-level positions such as harvesters and graders are filled by women as well as by men, either immediately after high school or after having obtained other relevant experience. The barriers to entry to such positions would therefore appear to be low.
10 The land rights system in Ethiopia is singled out as being a particularly problem and potentially stifling to employment growth in the sector, because families that are perceived not to be using land allocated to them may thus lose that land. This means that families with surplus labour in their households can be reluctant to take up formal employment opportunities elsewhere. Women are more likely to be able to take up the opportunities for formal employment in cut-flower firms for these reasons.

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