PATHWAYS TO GREATER EFFICIENCY AND GROWTH IN THE MALAWI TOBACCO INDUSTRY

A POVERTY AND SOCIAL IMPACT ANALYSIS
Fast economic growth and poverty alleviation in Malawi will not be possible without strong (6 percent p.a.) growth in the agricultural sector. Such agricultural growth has to be export-led; it cannot be based on the domestic market alone. Given that tobacco is Malawi’s principle export commodity, and will likely remain so in the short- to medium term, there is a need for sustained growth in this sector. Accelerating growth in the agricultural sector and reducing poverty will therefore require sustained growth in the tobacco sector through improvements in the efficiency of the current marketing system, pass-through to farmers of a larger share of world prices, and an increase in on-farm productivity.

During 2003/04 the Government started a process of reform in the tobacco sector. The initial steps involved implementing the first phase of levy reduction, making the membership of Tobacco Association of Malawi, and payment of its levy, voluntary, and issuing guidelines for direct exports and contract-farming (of flue cured tobacco). With the support of the World Bank, the Government also carried out a study to review tobacco institutions and marketing arrangements to: (i) assess if producers, particularly smallholders, have adequate representation in the governance of the various institutions; (ii) identify inefficiencies or overly high margins at all levels of the value chain; (iii) present recommendations on how to increase efficiency and competitiveness in the marketing chain, in order to increase growers’ return and promote strong and shared growth in the sector.

Four basic reviews of Malawi’s tobacco industry were completed in December 2004: (i) a beneficiary assessment; (ii) a review of on-farm production and productivity issues; (iii) a detailed institutional review; and (iv) a detailed value chain analysis. These studies are very consistent in their findings and recommendations. This paper presents a synthesis of the main findings and recommendations from the studies for discussion with all stakeholders at a stakeholders’ seminar on April 12-13, 2005, in Lilongwe. Based on the conclusions of the stakeholders’ consultations, the Ministry of Agriculture will present recommendations for reform to Cabinet in April 2005. Following Cabinet’s approval, the Ministry will proceed towards the implementation of a detailed operational strategy (including the drafting of the necessary legal and regulatory instruments) for restructuring the tobacco sector’s institutions and improving the efficiency of tobacco marketing in line with the studies’ recommendations.

**Main findings from Tobacco Sector Studies**

(a) *A governance structure that is not aligned with sector’s stakeholders*. The core of the sector’s current legal and regulatory framework was developed prior to liberalization in 1994. There have been deep structural changes in the sector since then. However, although there has

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1 It should be noted that the purpose of this paper is to highlight the areas that require improvement. There have also been developments in the tobacco industry which stand as success stories. Notably, the growth of the National Smallholder Farmers’ Association of Malawi (NASFAM) since 1995 has been a remarkable success story. Another success story can be found in the experimental introduction of contract farming into Malawi in the 2003/04 growing season; one of the indicators of its success is the fact that flue cured production saw a dramatic rise after the introduction of contract farming. The isolated event when Auction Holdings Limited (AHL) took on the responsibility of transportation in 1997 was also a success story. Greater detail of these success stories are not discussed in the executive summary but are embedded in the main text of the synthesis paper.
been some limited adjustment in policies and regulations, no comprehensive legal and regulatory framework review and overhaul has been undertaken. As a result, the framework is no longer in line with the sector’s current production and stakeholder structure. Small holders are in particular greatly under-represented in the sector’s main institutions (Tobacco Control Commission (TCC), Agricultural Research and Extension Trust (ARET), Auction Holdings Limited (AHL)).

- TAMA is represented on the TCC board, but National Smallholder Farmers Association of Malawi (NASFAM) (100,000 members) has only an observer status;
- TAMA has a 2.5 percent stake in AHL and NASFAM is not represented on its board;
- Smallholders’ voice in ARET is non-existent although they contribute most of the ARET levy;
- Within TAMA itself, as an organization supposed to represent the interest of both estates and smallholders, there is still a very limited participation of grass roots organizations in key decisions.

(b) **The institutional structure is fraught with conflicts of interest, mono/oligopolies and rents.** There are rents, conflicts of interests and inefficiencies all along the value chain:

- Tobacco buyers (currently 2 major companies in Malawi against 16 in Zimbabwe) operate as a cartel: they have a monopoly on processing, and Malawi does not benefit at all from the tariff preference (as much as US$0.3/kg) granted by the EU (Everything but Arms) or the US markets (AGOA). Opportunities in the EU market are now even greater with the expansion of the block to include Eastern European Countries;
- Tobacco Exporters Association of Malawi (TEAM), comprising tobacco companies — as well as AHL and TAMA— sits on the board of TCC and appears to have a major influence on policy-making, the more so as the countervailing power of Government’s representatives appears to be very limited owing to their status (middle level staff) and limited technical capacity;
- AHL has a monopoly on auctions;
- TAMA is still predominantly focused on large producers and has a firm grip on ARET’s programs which are consequently almost completely ignoring smallholders’ needs;
- While TAMA is supposed to negotiate (no competitive process) trucking rates, TAMA’s satellite depot owners are very often themselves truck owners;

(c) **Institutions lack capacity, accountability and internal efficiency.** Sector institutions suffer from a lack of technical capacity and serious internal inefficiencies:

- There is severely limited technical capacity in the Ministry of Agriculture (MOA);
- Very few of TCC’s 130 staff have relevant technical skills (most are administrative and support staff) which severely limits its capacity to lead policy formulation and enforce regulations;
- TCC’s high ratio of support/technical staff and generous employment benefits and perks contribute to its high overheads and operating costs;
- ARET has 26 higher level technical staff (research) and 31 extension agents for the entire country;
- AHL, although its activities are seasonal, maintains 730 permanent staff with very generous employment benefits and also has a centralized and bureaucratic culture fostered by its monopoly position;
• TAMA, until recent reforms, also long enjoyed a government-enforced mandatory membership (and levy) which has fostered a culture of very limited accountability to its members.

(d) **Producers bear the crushing weight of these compounded rents and inefficiencies.** Monopolies/oligopolies, rents and inefficiencies all along the value chain are passed down to producers, depressing their incomes and return on investments. Smallholders in particular are trapped in a low productivity/low income strategy. The ease with which most off-farm actors have adjusted to the recent reduction in their levies indicates that they are still high cost operators and that their cost would drop further if monopoly was removed or constrained. It is essential to do so if the sector is to be put on a sustained growth path. As an example, a 10 percent increase in sale price (through the capture of a small share of EU/US preferences and a small reduction in international marketing and processing costs) and a 10 percent reduction in domestic costs (easily absorbed by transport costs alone) would increase producers’ net return by nearly 50 percent. This would have a dramatic impact on poverty reduction where it counts most (smallholders) and boost agricultural and overall economic growth.

**MAIN RECOMMENDATIONS FROM TOBACCO SECTOR STUDIES**

The analysis above indicates that there exists considerable scope for achieving efficiency gains and promoting sustained growth in the sector. The analysis also clearly outlines the content of Government’s operational strategy and institutional reform program:

**Major Reforms for Immediate Implementation:**

a. **Undertake a comprehensive overhaul of the sector’s institutional structure:** clarify institutions’ mandates, align governance bodies with the sector’s current stakeholders, eliminate conflicts of interests;

b. **Strengthen institutions’ capacities and accountability:** undertake a detailed performance audit for each institution for (i) aligning their technical and managerial skills with their mandate; and (ii) improving their accountability and internal efficiency;

c. **Improve domestic marketing and pass-through to farmers:** Immediately implement measures for reducing marketing costs and pass-through to farmers through increased competition and/or better control of monopolies:

i. **Contract farming/direct exports:** This represents the main competition to AHL. It appears to be instrumental in AHL’s decision to decentralize its services closer to clients. Contract farming allows them to (i) have access to inputs/credit and advisory services; and (ii) manage price risk. It has other important advantages. In particular, it allows producers to have direct contact with increasingly difficult international markets and produce what the market wants. Contract farming for flue-cured seems to have the support of the overwhelming majority of small estates/smallholders who are now requesting that it be extended to burley. A pilot contract farming operation should be carried out for burley and a review of the flue-cured operation should be carried out to (i)
strengthen producers’ bargaining power (information/advice); and (ii) eliminate the requirement of going through the auction floor (it is technically feasible and would reduce the delays at AHL);

ii. *Bring efficient markets closer to farmers:* AHL has started to decentralize its auction floors. This will shift the burden of transport from the farmers to the buyers who are better equipped to negotiate with truckers and introduce economies of scale. But the AHL monopoly shouldn’t be replicated at local level. Serious consideration should be given to piloting “Local Commodity Exchanges (LCE)” at EPA level where producers and buyers would carry out direct competitive physical transactions.² One or several LCE would be opened in every EPA to focus on tobacco (or handle several crops), and would be owned/managed, under TCC guidelines/monitoring, by private entrepreneurs with adequate qualifications and providing the necessary guarantees (private ownership would have the advantage of ensuring private financing of investment costs). They would provide a physical location where licensed buyers would compete for the crop brought in by the area’s producers. LCE licenses would be auctioned by TCC and LCEs would fund their operating costs through a fee on throughput. The presence of several (20 or more) buyers would permit competition and transparent price discovery, thus protecting the producers. LCEs should be open to any “eligible” buyer, not only to the buyers active on the AHL auction floor (where there is an amount of price fixing). Buyers would be licensed by TCC according to strict criteria. Payment to the smallholders would be immediate. Transactions would be controlled by TCC. The buyers would then have a choice of either selling the crop through AHL auction floor or direct export.

Such a scheme would answer several critical existing constraints and offer other advantages: it would protect the farmers and provide an efficient mechanism for price discovery by farmers, similar to that of the AHL auction floor (prices would be set in an open, competitive environment); it would allow for immediate payment to the smallholders; it would be easily monitored by TCC; it would compete with the TAMA and NASFAM marketing channels which would both force improvement in the efficiency in the former and provide a safeguard against abuse; it would restrict the operations of illegal IBs to a limited geographical area (around the LCE); LCEs may also be used as commercial internet outlets where farmers could access market information.

iii. *Establish the Competition Commission:* Establish the Commission in line with existing law and entrust the Commission with monitoring sector’s monopolies/oligopolies on a regular basis.

**Minor Reforms for Immediate Implementation:**

d. The recommendations in the previous section suggest fundamental improvements in the existing governance and marketing systems, which would fully resolve the problems

² The organization of the LCE is analogous to the ‘mini-markets’ recommended in the Koester et al report; however, the term LCE is more commonly used and this type of marketing arrangements for agricultural commodities has been adopted successfully in several countries.
identified in the reports, and improve benefits to smallholders. On the other hand, the recommendations in this section only provide minimal adjustments to some of the specific problems identified in the current system, and are unlikely to resolve fully the problems identified in the reports:

i. TCC to design better rules for deliveries at AHL and institute penalties for non-compliance with agreed upon schedule and minimum service standards;

ii. License should be granted to anyone wanting to open a satellite depot, if they satisfy minimum qualifications. TCC to be in charge of licenses and monitoring satellite depots; depots should be accountable for deterioration and losses of tobacco.

iii. Investigate (and reduce) the high fee (2 percent) charged by banks for stop orders and transfers of money to growers’ accounts.

iv. Liberalize the distribution of Hessians (importers can set up private internal distribution network; satellite depots & NASFAM center can buy Hessians from importers and sell to farmers).

v. Abolish production quotas. The unofficial quota application should be abolished. It does not constrain overall sectoral production but it increases costs for farmers and creates illegal trade of tobacco amongst farmers and between farmers and IBs.

Medium-Term Strategies for Future Growth in Malawi’s Tobacco Industry:

e. Improving on-farm productivity: With the world-wide demand and production of burley tobacco expected to increase, it appears important that Malawi (i) develop niche markets for high quality tobacco (probably estates) and (ii) achieve substantial on-farm productivity gains for burley tobacco for remaining competitive with low cost producers. The government should launch the preparation of an operational strategy/program for establishing an efficient demand-driven technology development and advisory system. The system should be (i) demand driven (controlled by producers); (ii) open and multi-source (ARET, contract farming…). For the moment farmers pay (1 percent ARET levy) for services that very few actually receive. Contract farmers pay in fact twice: once to ARET and again under the contract farming contract. The performance audit of ARET would provide a solid basis for a complete overhaul of the sector’s research and advisory services.

e. Expanding Markets and Adding Value: Explore opportunities to increase markets and value added in the sector in the medium term:

i. Trade Preferences. Identify the mechanisms available for capturing all or part of EU and US tariff preferences;

ii. Adding Value. Undertake a detailed feasibility study for promoting competition in tobacco processing and move to greater transformation (cigarette manufacturing);
iii. *Expand Markets.* Undertake an in-depth market study to design an export penetration strategy, and review the rationale for Malawi, being a price taker, to keep production quotas, globally and by producer: (i) risk of losing market share to other low cost producers such as Mozambique; (ii) quotas currently globally not binding but binding and disregarded at individual producer level,
1. INTRODUCTION

Fast economic growth and poverty alleviation in Malawi will not be possible without strong (6 percent \( p.a. \)) growth in the agricultural sector. Such agricultural growth cannot be based on domestic market. It must be export-led. This will not happen without sustained growth in the tobacco sector, given that this is Malawi’s principle export commodity – and will likely remain so in the short-medium term. Accelerating growth in the agricultural sector and reducing poverty will require sustained growth in the tobacco sector through improvements in the efficiency of the current marketing system, to pass-through to farmers a larger share of world prices, and an increase in on-farm productivity.

During 2003/04 the Government started a process of reform in the tobacco sector. Initial steps included the implementation of a first phase of levy reduction, making the membership of TAMA, and payment of the levy, voluntary, issuing guidelines for direct exports and contract-farming (of flue cured). The Government also undertook, with support from the World Bank, to carry out a study to review tobacco institutions and marketing arrangements to: (i) ensure that producers, in particular smallholders, have adequate voice in policy-making and adequate representation in the governance of the various institutions; (ii) identify inefficiencies or overly high margins at all levels of the value chain; (iii) present recommendations on how to increase efficiency and competitiveness in the marketing chain in order to increase growers’ return and promote strong and shared growth in the sector.

Four basic reviews were completed in December 2004: (i) a beneficiary assessment by J.M. Kadzandira, H.M. Phiri and B. Zakeyo.; (ii) an agronomic review of on-farm production and productivity issues by E.W. Tsonga; (iii) a detailed institutional review by M. Maleta; and (iv) a detailed value chain analysis by U. Koester, G. Olney, C. Mataya and T. Chidzanja. The beneficiary assessment involved a field survey to gauge views and perceptions of smallholder farmers on the roles of various players in the production and marketing of tobacco so as to provide guidance on the areas needed for reform. A total of 61 discussion sessions were held with farmers and key informants from the three tobacco-growing districts of Rumphi in the Northern region, Kasungu in the Central region and Mangochi in the Southern region. The agronomic study was an agronomic study of the tobacco sector, analyzing the performance of the sector in terms of production, profitability, quality, growth and retention/expansion of its export market outlets. The institutional review was a study of the arrangements and operations of existing institutions (mandate, structure, costs and service delivery) serving the production and marketing of tobacco to determine if they are serving the sector effectively and efficiently or need to be restructured or abolished in cases where they are a hindrance to the sector’s growth. The value chain analysis aimed to review and analyze the current structure of tobacco markets in Malawi and characterize the level of competition (and possible collusion) in the industry. Amongst other things, the study examined the differences in the marketing costs of tobacco
produced in different regions of Malawi and between estate and smallholder farmers (including the IB system and ADMARC option).

The four studies are very consistent in their findings and recommendations. One key observation which threads through them is the negative perceptions that the smallholder farmers have of institutional performance within the tobacco industry. A number of factors were cited as constraining tobacco production and marketing: prices, scarcity of farm inputs, malpractices on the auction floors, limited marketing options, levies and taxes and limited institutional and policy support. Indeed, it is the smallholders, the largest group of farmers in Malawi, who get poor representation in the negotiating process and a poor percentage share of the value chain of tobacco. While some of the specific claims of the smallholder farmers are difficult to verify, their collective sentiment is so strong as to warrant further investigation and rectification in the areas of alleged malfunction. Tobacco-farming is the main cash-earning activity for these farmers, particularly since other crops such as paprika and soya beans have relatively lower profit margins and largely unreliable markets. This merely serves to assert the position of the tobacco industry in Malawi’s economy and it thus follows that reforms have to be made in this sector to instill greater efficiencies into the industry. It is commendable that the government of Malawi is taking an active role to review and reform the industry’s institutions as it shows that strong efforts are being made to encompass these farmers and make the marketing chain more efficient.

This paper presents a synthesis of the main findings and recommendations from the studies for discussion with all stakeholders at a stakeholders’ seminar on April 12-13, 2005, in Lilongwe. Based on the conclusions of the stakeholder consultations, the Ministry of Agriculture will synthesize the agreed recommendations in a paper to be presented to Cabinet in April 2005. Following Cabinet’s approval, the Ministry will proceed to implementation of a detailed operational strategy (including the drafting of the necessary legal and regulatory instruments) for restructuring the tobacco sector’s institutions and improving the efficiency of tobacco marketing in line with recommendations of the studies.

2. DESCRIPTION OF THE MALAWI TOBACCO INDUSTRY

The tobacco industry incorporates a number of key institutions which each play an important role throughout the marketing chain process of the crop. In order to fully understand the recent developments within the industry, and thus identify areas for improvement, it is important to describe the functions of each of the pivotal institutions. This chapter serves to introduce these stakeholders but it must be noted that the Ministry of Agriculture (MOA) is not described in this chapter as its central governmental role renders its role so critical in this industry that it merits no introduction.

2.1 Stakeholders Assessment

2.1.1 Tobacco Control Commission (TCC)

The Control of Auction Floors Act Cap 65:03 is responsible for the existence of this institution; the Act establishes a Commission, the TCC, to control the tobacco auction floors. The institution’s principal mandate is to advise the government on the sale and export of tobacco,
promote and expand the sale of tobacco, collate statistics relating to tobacco, distribute market studies and information relating to tobacco and control/regulate the sale of tobacco on the auction floors in Malawi.

The TCC is the only authority that can license premises for the sale of tobacco, by auction, in Malawi and it is empowered to fix tariffs of weight, selling and commission charges after consultation with the holders of auction floor licenses and approval from MOA. There is a condition that the licensee’s charges do not exceed the tariffs and that the tariffs are published in the Gazette.

Auction floor operators are required to provide information on the quantities and prices of tobacco sold on their floors and consult with the TCC in prescribing the selling days and hours at their floors. The Act also empowers TCC to license and regulate buyers on the floor, register tobacco sellers on the auction floors, define tobacco classes and grades, license tobacco graders and commercial grading premises and make regulations to provide for forms to be used for any license, return or application, fees for any license or application, general conditions to be attached to licenses issued under the Act and prescribe penalties for breaches of regulations, amongst other duties.

2.1.2 Auction Holdings Limited (AHL)

The auctions are the interface between the farmers and their markets. AHL is a private limited company with the majority of shares held by individual farmers. However, for much of its recent history, the government held the controlling shareholding following investment through ADMARC in the late 1970s to build the main floors and headquarters at Kanengo, (Lilongwe, Central region) where nearly 60 percent of sales take place. AHL is the only licensed operator of auction floors in Malawi making it effectively a monopoly as all tobacco grown in Malawi is required to be sold through the auction floors by law. AHL operates the three auction floors situated in Limbe, Lilongwe and Mzuzu and has been the sole operator of these auction floors since 1962.

According to its memorandum of association, the objects for which the institution was established are unrestricted: the operation of auction floors, brokerage of financial instruments, planting and cultivation of any agricultural produce, transportation and so on. Through its subsidiary companies, the Agricultural Trading Company Limited (ATC) and Tobacco Investments Limited (TIL) it is also involved in the distribution of inputs and other supplies to the tobacco and tea growing industries and tobacco grading and re-handling respectively. However, the institution’s principal activity is the auctioning of tobacco.

2.1.3 Smallholders and Farmer Associations

Although farmer associations exist to promote the interests of smallholders, it has been noted that there is no consensus on the definition of a smallholder farmer across the principal agricultural and tobacco-related institutions in Malawi. For instance, the Ministry of Agriculture has a definition of customary landholding whilst TCC defines a smallholder as a farmer with a land size of less than 5 ha. As a working definition, smallholders can be identified as those
producers working on customary land with no formal title with a total landholding size of less than 10 ha (and typically less than 1) and farming as a club member, using the auction floor marketing channel. According to TCC, there were approximately 22,500 registered smallholder clubs growing tobacco in the 2003/04 season and each club has between 10 and 30 members.

The number of smallholders engaged in tobacco production has increased dramatically since the repeal of the Special Crops Act in 1994, reaching approximately 400,000 by 1998 (corresponding to 17% of total households in Malawi; this includes 183,000 poor households and 73,000 ultra-poor households cultivating tobacco, using the poverty lines developed by National Economic Council in 2000). As a result, smallholders now account for 80% of the national crop. In 1990, smallholders produced approximately 1,000 tonnes of burley but today they are producing in excess of 80,000 tonnes

\[ (a) \ \text{Tobacco Association of Malawi (TAMA)} \]

This is the oldest association for smallholder tobacco farmers in Malawi – its roots date back to 1929 when the Nyasaland Tobacco Association (NTA) was first established. TAMA was formally registered under the Trustees Incorporation Act in 1982 and its main objective is to promote and develop the tobacco industry in Malawi and to advance and protect the interests of sections and classes of producers.

Specifically, TAMA seeks to collect and disseminate information concerning the tobacco industry to its members; cooperate and work with other organizations, particularly those with similar objectives and interests; encourage, assist and subsidize research into any problems directly or indirectly affecting the industry including the growing, handling and marketing of tobacco; make representations to government on matters affecting its members and the tobacco industry; lobby for the introduction or amendments to legislation in order to advance the tobacco industry and the interests of its members and investigate, test, develop and extend markets for tobacco. As part of its role to serve tobacco farmers, TAMA is also responsible for delivering other services such as the operation of 90 satellite depots where tobacco is transported to the regional auction floors and the management of the Hessian scheme (recently taken over from AHL).

The International Tobacco Grower’s Association (ITGA) African secretariat resides within TAMA (the President of TAMA is also currently the President of ITGA) and it monitors global market trends in tobacco and anti-smoking lobbying. TAMA has thus focused some of its efforts on external issues and this external orientation has included the promotion of Malawian tobacco to international markets through promotional and informational international tours. For a period of time, TAMA was the only farmer association in the tobacco industry until policy changes led to the liberalization of tobacco production which led to the advent of a number of farmer clubs.

\[ (b) \ \text{National Smallholder Farmers’ Association of Malawi (NASFAM)} \]

NASFAM is one of the farmer-based associations in Malawi, and is generally regarded as having been very successful at promoting the interests and well-being of its members. It sprouted from a USAID-supported agri-business development program (Smallholder Agri-business Development
Project – SADP) and was established to support government’s efforts to liberalize agricultural production and marketing. SADP was launched in 1995 and established Agri-business Development Centers (ADCs) in key smallholder growing areas.

SADP staff in these ADCs assisted targeted smallholder clubs to strengthen their business skills and increase their penetration of the market through improved grading and baling practices, bulk purchase of inputs and the organization of inputs. ADC activities were focused on assisting clubs develop and implement group action responses to the challenges of the marketing system. Income of farmers in the ADC improved which led to a need to strengthen the institutional framework through which farmers could undertake their own agricultural development and diversification in a business-like setting. This then led to the formation of 14 agribusiness associations with NASFAM as their representative.

NASFAM’s objectives are to: improve the economic and social conditions of the smallholder farmers through direct interaction with and the intervention of member organizations; improve the business, financial and marketing management capability of smallholder member organizations; directly engage in business activities and services that provide linkages with public and private sector service providers; facilitate smallholder empowerment through improved information, training and advocacy; promote the participation of women in institutional development and improve the land use management practices of smallholder farmers. NASFAM also runs several different programs such as the transport program, the Hessian scheme and mixed crop marketing.

2.1.4 Agricultural Research and Extension Trust (ARET)

ARET was established in September 1995 and is incorporated under the Trustees Incorporation Act with the government and TAMA as its trustees. ARET was a merge between the previously existing Tobacco Research Institute of Malawi and the Estate Extension Services Trust. Its primary focus is tobacco but it also handles agricultural research for other high value crops.

Its objectives are to: improve the efficiency, diversity and sustainability of agricultural production on the estates; preserve the natural resources base via sound land use planning and soil and water conservation techniques and reforestation; research agricultural improvements and crop diversification; provide agricultural training advice to estate owners, their employees and tenants where appropriate and to improve the welfare of all categories of tobacco farmers.

2.1.5 The Buyers

The tobacco buyers in Malawi have been described as an ‘oligopsony’ where each of the few buyers exerts a disproportionate influence on the market. Following the announced global merger of two of the three top buyers, Dimon and Standard Commercial, in November 2004 (the merger is just about to become operational), the trend has been moving towards an even more concentrated market structure. Limbe Leaf (a subsidiary of the US parent company Universal Leaf) is the largest of the main buyers, and is allegedly the most vocal. The two principal buyers, Limbe Leaf and Dimon-Stancom, are supplemented by smaller niche market companies such as
Africa Leaf and Premier Leaf which each have negligible market shares in comparison to the top two buyers.

The Tobacco Exporters Association of Malawi (TEAM) is the association that represents all the buyers on Malawi’s auction floors. This association was formally established in 1930 and it is involved in negotiations and dialogue with all stakeholders in the tobacco industry on behalf of the buyers. Originally, membership to TEAM was restricted to tobacco buyers and exporters but has since been extended to processing organizations and manufacturers.

TEAM’s objectives are to: represent the interests of the tobacco industry with regard to purchasing, processing and exporting; coordinate and act upon the views of all its members; cooperate with government in all matters relating to tobacco production, selling and exports; keep up to date with world market trends and all current circumstances relating thereto. In effect this means determining world market requirements in terms of types of tobacco, qualities, obtaining information on production and marketing data of competing countries throughout the world and obtaining information on new markets as well as accessibility and restrictions in all tobacco importing countries; monitor and assist with research development and cooperate with other stakeholders and interested parties in the smooth implementation of the Framework Convention on Tobacco Control (FCTC).

2.2 Current Trends and the Future for Tobacco

2.2.1 The World Market Outlook

World production of tobacco is on a visible decline. The trend of world production has remained largely positive from 1980/81 to 2004/05 but recently showed a significant structural change – world production increased until 1997/98 but has decreased by 19.1 percent (Figure 1) since then. The decline in world production reflects a decline in world consumption. Overall world consumption has been on a gradual downward trend at 2 percent since its peak in 1996/97, possibly as a response to anti-smoking campaigns in many countries. However, it is important to highlight that consumption in China has been growing steadily in recent years, and now accounts, in 2004/05, for a 40 percent share in world tobacco consumption. If overall income growth and urbanization in China continue at the same rate, tobacco consumption will continue to rise in this country and stabilize world consumption.

There is significant disparity in tobacco production across countries and regions. This is partly due to changes in comparative advantage over time but is brought upon mainly through policy differences; for instance, payments to EU tobacco producers (7800 euro per ha on average)\(^3\) have been linked to the level of production so far, but in 2006, when 40 percent of the present subsidy will be decoupled, most producers will be better off producing other crops than tobacco. It can therefore be assumed that EU tobacco production will steeply decline between 2006 and 2010 and may stabilize at a very low level.

2.2.2 Changes in the Composition of Domestic Production

Burley tobacco has taken on greater significance since the repeal of the Special Crops Act in 1994 due to increased participation of smallholders in production of the crop. In 1997, the hectarage of tobacco increased by 43 percent from 142,000 hectares to an all time high of approximately 204,000 hectares. The marked increase was largely due to a more than doubling of cultivated land under burley tobacco from 58,195 ha to 128,940 ha between 1995 and 1997. However, since 1997, the area under tobacco has declined by 20 percent due to several factors, one being the decline in profitability of the crop which will be explained in greater detail later in the paper. Another reason of the decline in cultivated area is a marginalization of other tobacco varieties: in 1984, burley accounted for 42 percent of all tobacco sold on the auction floors, while flue and dark western accounted for 35 percent and 23 percent, respectively; the share of burley in the marketed tobacco more than doubled to 91 percent within two decades, 1984 to 2003, while that of flue and dark western tobacco declined to 5 percent and 4 percent, respectively. The structural shift in tobacco production from 1984 to 2003 can be seen in the pie charts of Figure 2. The structural change in marketed tobacco is largely a result of increased participation of smallholder farmers in tobacco production following the repeal of the Special Crops Act in 1994, which had barred these farmers from producing burley tobacco.

Despite attempts by the government to encourage agricultural diversification and the inefficiencies associated with the industry, tobacco remains Malawi’s major source of export earnings. Figure 3 clearly illustrates the importance of tobacco for Malawi compared to other agricultural products, in terms of export earnings and within the tobacco bracket, burley tobacco has occupied the increasingly significant share in terms of export earnings. Simply stated, tobacco has brought in approximately US$200 million p.a. over the past three decades for Malawi which is approximately 60 percent of the country’s total export earnings. Furthermore, the average share of export earnings for tobacco rose from 56 percent in 1977-79 to approximately 60 percent during 1980-99 and to a peak of 67.9 percent during 1990-99. However, it must be noted that this share fell to approximately 54 percent during 2000-03 due to declining yields and prices, amongst other factors adversely affecting the tobacco industry’s performance. Figure 4 clearly illustrates the trend of tobacco exports by value.

3. Major Findings of the Tobacco Studies

In the four studies recently executed, it has been found that there exists much room for improvement throughout the marketing chain, from the export market, right through to the growers, and in particular, the smallholders. It is vital that Malawi concentrates its efforts towards making these improvements if it is to maximize the potential of its tobacco industry and, indeed, assert its position on the world market in this commodity.

This Section presents the key findings of all four studies, which have been grouped under five major themes: developments in the global market, developments in domestic production, marketing of tobacco, governance structure, institutional performance. It must be stressed that although this classification facilitates the analysis of the current inefficiencies throughout the entire marketing of Malawi’s tobacco industry, there remains some overlap between these subsections.

3.1 Malawi’s Position on the Tobacco World Market
Malawi has not yet exploited its full potential on the tobacco world market. Some of the constraints stem from limited growth in demand but research into trade arrangements show that Malawi has still not fully asserted itself on the world market. Malawi’s traditional markets have been the EU and the USA, which have attracted more than 70 percent of Malawi’s exports recently. These traditional markets provide the country with trade preferences. The EU, for instance, grants LDCs duty-free imports of all commodities but arms (except for some transitory restrictions for imports of rice, banana and sugar). Also, USA grants Malawi a tariff rate quota for imports (this quota amounts to roughly 12 000 MT and the import duty for this tariff rate quota is significantly lower at 12 percent than for regular imports) and also enforced the AGOA Act (African Growth and Opportunity Act) which opens its markets for duty-free imports from specific African countries, one being Malawi. Despite these trade preferences, Malawi does not exploit its export potential in tobacco even though it is in a better position than the average tobacco exporting country. As for new markets, like China, it is true that if overall income growth and urbanization, in China, continue at the same rate as before, tobacco consumption will increase further in that country. However, prospects for Malawi on the Chinese market are limited by both the failure (so far) of the major cigarette manufacturers to promote demand for American blend products, containing burley, as opposed to the flue-based cigarettes favoured by Chinese consumers, and also the complications of Malawi’s past and continued close relationship with Taiwan. It is for these reasons that the potential for Malawi lies in making improvements with its traditional markets based in the EU and the USA.

There is ample evidence that Malawi can improve its position on the world market. Given the duty-free access to the EU market, for instance, one would expect Malawi’s exporters to get a higher price than its competitors exporting a comparable quality tobacco to the same market. The evidence is to the contrary: it was found that EU import prices for tobacco from Malawi are lower than import prices from Brazil and by far lower than those from the USA as seen in Figure 5. Both countries export comparable qualities of burley tobacco to the EU and even though one has to take into account that there exists a wide range of qualities and it is not possible to compare prices for narrow qualities due to lack of data, Koester et al. took the quality argument into account in providing these findings. Figure 6 highlights that EU import unit values for tobacco (tariff line 24120) were lower for Malawi than for other African tobacco exporting countries and this information indicates that Malawi seems to have a problem producing high quality tobacco. The same comparison was taken for Germany’s unit values of imports and it was found that unit values of Germany’s imports from Brazil are higher than those from Malawi and the difference is significant at the 95 percent level. In a third comparison, Figure 7 shows that differences in unit values of imports between Malawi and Brazil for non-EU European countries are even larger than for the EU so Malawi catches higher prices in EU rather than non-EU European markets, but if it had fully benefited from its preferential agreements, it would reap more profits – at least roughly $0.26 per kg more for EU imports than for non-EU European imports.

3.2. Domestic Production: Yields, Profitability, Pricing and Quality Control

3.2.1 Low Yields, Profitability and Pricing:
There has been a trend of low yields in tobacco in Malawi and this affects the country’s competitiveness on the world market. Indeed, Figure 8 clearly illustrates the trend of declining tobacco yields; national crops estimates for the past decade show smallholder burley tobacco yield levels to lie between 800 kg per hectare and 1,000 kg per hectare. In comparison with the international cost of producing 1 kg of burley leaf, results of cost analysis by Jaffe (Table 1) show Malawi as being less competitive globally, a phenomenon which the author attributes largely to lower yields. The final impact that this has on poverty is not insignificant – wages in the major tobacco growing areas, for low- and high-input farming, range between MK45 per day and MK100 per day. However, wages will not increase unless the declining trends in productivity and prices are reversed. Unless they are supported by improvements in productivity, mandatory higher wages would effectively reduce the competitiveness of the Malawi tobacco industry, and ultimately lead to its collapse.

A major cause of low tobacco yield is the inadequate use of fertilizer but there are other factors which also contribute to the downward trend in yields. The intensity of fertilizer use in Malawi, estimated at 23 kg/ha of permanent arable land is extremely low compared with countries in Latin America (54 kg/ha), for instance. However, Malawi’s rate of application is higher than the average of other countries in the Sub-Saharan Africa (SSA) which is roughly 8 kg/ha. The importance of low fertilizer use is demonstrated by the fact that yields for all types of tobacco under the high-input production system are comparable to yield levels obtained in most tobacco-producing countries (but still lower than the USA and Zimbabwe).

Profitability of tobacco has followed a downward trend according to farm budget analysis. Estimates from ARET show that there has been a general decline in profitability of both flue-cured and burley tobacco over the past decade and this is clearly illustrated in Figure 9. Gross margins for low-input burley growers are estimated to have declined from a high of US$790 per ha in 1994/95 to a low of US$373 per ha in 2003/04; among the high-input burley production farmers, gross margins are estimated to have declined marginally from US$838 to US$791 during the same period. The low returns to investment are influenced largely by an inefficient marketing chain, which is characterized by too many deductions in the way of levies, cess, bank charges, withholding tax and other similar items, as well as other rents and inefficiencies. Although there are improvements that can be made to yields, under both low- and high-input production systems, the returns to investment can be improved through the reduction of levies and charges, imposed by service providers, and the reduction of the withholding tax rate, imposed by government. An improvement in the returns to low-input tobacco production can be made by raising productivity via increased access to credit and inputs and enhanced extension services. Increases in the profitability of tobacco must originate from improvements in yields and quality, especially leaf handling, grading and presentation.

Malawi does not influence tobacco world prices and the commodity’s prices have been on the decline. Despite Malawi’s position as the world’s 3rd largest producer of burley tobacco after USA and Brazil, Malawi’s output changes do not influence price movements. However, movements in international tobacco prices have a positive effect on domestic tobacco prices; price trends for Malawi’s tobacco are similar to global price movements falling within the range of US$0.90 per kg and US$1.20 per kg, except in countries where producers receive government price supports such as the USA and the EU. Econometric analysis in the Koester et al. report
shows that Malawi is indeed a price taker. The general price level as measured by the weighted average of four main tobacco types in Figure 10 – flue cured, burley, northern division and southern division dark fired tobacco – has been declining since the peak periods of 1990 and 1991.

*Prices are an important determinant of profitability.* Although farmers appear to have little control over the tobacco marketing process, there are still important pricing elements that need to be examined in order to improve the system of tobacco marketing because dissatisfaction and disagreements over price offers have disrupted sales and often ended up in temporary closure of markets, in spite of existing arbitration mechanisms under TAMA and TCC. One of these factors is the lack of congruence between farmers’ grading system and buyers’ classification at the point of sale and this problem makes it difficult for farmers to relate price offers to the quality characteristic of their tobacco. The interviewed farmers also claim that the arbitration by TCC or withdrawal of tobacco from sale does not solve this problem and that lack of alternative market outlets leaves growers with no option but to sell at the auction floor at prices below their expectation. The inconsistency of starters, some of whom have been accused by farmers of taking bribes from buyers, appears to be one of the sources of pricing irregularities. Price-setting under the silent auction system for tobacco grown under contract arrangements has also been challenged by farmers as being unfair on the same grounds that bales of the same quality are not offered the same prices. The problem with the silent auction arises from the absence of a neutral body to monitor and arbitrate disputes over grades and prices.

### 3.2.2 Quality Control:

The high incidence of non-tobacco-related-materials (NTRM) has affected the standards of Malawi’s tobacco. In 2004, the high incidence of NTRM in the bales on the market was said to have led to a crisis in customer confidence in the quality of Malawi’s burley tobacco. There are different types of NTRM but the most common type consists of thin strips of polypropylene taken from fertilizer and grain bags which are used to tie leaves during the curing and grading processes. This form of NTRM and similar types of foreign matter are called ‘plastic’ and can pass through the factory into the export-packed product affecting the quality of tobacco. This problem had become so severe by July 2004 that the throughput on the auction floors had fallen to less than half their capacity whilst the factories searched the produce manually for NTRM following requests by customers. This process of checking for NTRM has its costs; Koester *et al.* stated that they were not able to estimate the value of this loss but they state that it is significant and is a threat to the reputation of the industry. Some solutions to this problem have been presented in the forms of raising farmers’ awareness and also the establishment of penalties.

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4 The econometric estimates indicate that for every 1 percent increase in the quantity of tobacco offered for sale, there is 0.84 percent reduction in the price offered. The effects of increased volume of tobacco on the auction floors last more than one season with an elasticity estimate of -0.93 which means that quantity demand is price inelastic – not very sensitive to prices. The results also indicate that a change in the foreign exchange regime in 1994 had a negative effect on tobacco prices and that tobacco prices are not significantly affected by changes in fertilizer prices. However, movements in international tobacco prices have a positive effect on domestic tobacco prices; indeed, price trends for Malawi’s tobacco are similar to global price movements falling within the range of US$0.90 per kg and US$1.20 per kg, except in countries where producers receive government price supports such as the USA and the EU.
3.3 Marketing of Tobacco

3.3.1 The Buyers:

*There is heavy suspicion of collusion and anti-competitive practices in the buyers’ market.* Collusion among agents is difficult to prove but there are clear indicators, employed by monopoly commissions in other countries, which have been used to identify market power of tobacco buyers. Firstly, high market shares have been held by a few buyers: the three largest buyers – Limbe Leaf, Dimon and Standard Commercial – hold nearly 95 percent of the market; as can be seen in Table 2, Limbe Leaf has more than 50 percent of the market while Dimon and Stancom combined account for a further about 45 percent. Secondly, these buyers have maintained their share over time with only minor variations in market shares. Thirdly, an econometric regression between world market prices and auction prices reveals that the coefficient of determination is only 38 percent, indicating that only 38 percent of the variation in the auction price is determined by variation in the world price. Moreover, a 1 percent change in the world market price leads to only 0.7 percent change in the auction price. Finally, there is a very strong correlation between prices paid by the few individual buyers. This market structure is in marked contrast to Zimbabwe where there are 16 buyers in the tobacco market. However, it must be noted that Zimbabwe is not as focused on one type of tobacco product as Malawi, which is focused on burley tobacco, and this can explain the greater variety of buyers in Zimbabwe.

3.3.2 Transportation:

*Transportation is a costly link on the marketing chain of tobacco and it has been reported that this is because it consists of cartels.* Table 3 gives an estimation of transport costs based on the median cost from all TAMA depots in the Central Region, plus TAMA’s depot handling fee, at various bale weights; the table outlines costs for deliveries to Lilongwe at official rates and it would seem that they are higher in the North. The cost to the farmer varies between US$0.03 per kg and US$0.12 per kg at the very least. Transport costs are inextricably linked to congestion on the auction floor – the congestion in the auction leads to queues which, in turn, leads to longer waiting times for trucks to offload tobacco. This waiting period is incorporated in the transport rates because the truck company has to continue to pay wages and allowances for the driver and the assistant as the loaded trucks lie immobile for several weeks in front of the auction hall. Transporters have been known to complain about the system but they actually gain from this market failure: they can get full compensation and even make profits from their estimations of such lag times. Transport rates are established by transporters signing contracts and agreeing on a price per bale transported at the beginning of the season (the contract may result from a tender system or may just be negotiated with individual transporters). However, at the time of the negotiations, transporters do not know the costs that they will incur, which rest largely on the lag time at the auction floor, and to cover this uncertainty and the associated risk, transporters will tend to overestimate these periods and therefore their costs. These fixed price agreements are generally quite expensive for the buyer if some cost elements cannot be estimated accurately. It must be noted that, for burley tobacco, low-input farmers face higher transport costs to the auction floors than the high-input growers. The cost of moving tobacco to the final destination is also heightened by bribes paid to transporters and handlers en route. Furthermore, the market power on both sides of the contracting parties also contributes to high transport costs.
Farmer associations play a role in the organization of transportation of tobacco; TAMA plays a pivotal part in this process but its performance has been widely criticized. The transporters have organized themselves in regional or local transport associations and negotiate the rates with TAMA or NASFAM. NASFAM arranges transport on behalf of its subsidiary district-level associations (typically grouping 15-30 clubs) by restricted tender; bales are collected, not from depots, but from roadside locations that have been selected by “group action committees” (around five clubs) as reasonably central locations for members and accessible to trucks. Although there have been isolated incidents of transportation delays for its members, NASFAM has been credited for performing its role in transportation well. According to Maleta, NASFAM has managed to reduce transport costs by half, the association’s transparent structure has eliminated the need for tips and bribes, farmers do not complain of lost or damaged bales and delivery times have been shortened by as much as 60 percent. It is, however, TAMA which plays the pivotal role, of the two entities, in the organization of transportation for the majority of small farmers and it has received complaints over its performance. TAMA’s national network of some 80 collection points and its role in negotiating and managing transport contracts is critical in the existing system of delivery of tobacco onto the auction floors. Some TAMA members complain that the association does not always act in their best interests when in negotiations transportation rates with farmers. Other members directly cite an issue of conflict of interest as councilors governing TAMA benefit from current transportation arrangements through the use of their own vehicles in brokerage arrangements. TAMA members also complain that they have to pay for two sets of transport costs, unlike NASFAM members, because they have to pay for the transportation of tobacco from the farm gate to satellite depots and pay TAMA to transport the tobacco to the auction floors. The transportation system is inefficiently organized but in order for any real improvements to be seen in this area, the congestion on the auction floors needs to be addressed.

There has been one recorded event where the transportation system was believed to have worked well. This event occurred in 1997 when, for a brief period, AHL ran the whole delivery set-up, from the point of receipt, through directly contracted trucks, to the satellite depots, which were controlled by the auctions themselves at the time. This did not last long and militant small/medium haulers brought the system to a halt, blockading routes and protesting that they were being excluded in favor of a small number of large-scale haulage contractors. Since then, trucking has been placed in the control of these operators and the bigger firms have largely got out of domestic tobacco deliveries, concentrating on imports of green tobacco and other commodities.

3.3.3 Satellite Depots:

Interviews with farmers have revealed a marked dissatisfaction with the management of satellite depots. Overall, it has been reported that monopolistic/oligopolistic structures are prevalent in the satellite depots on regional markets and that the system does not work efficiently. Stockpiling at the satellite depots is neither based on accurate cost calculations nor on the dictation of market forces which means that the quality of depot conditions do not correspond with their fees. For instance, at the time of investigation, the farmer had to pay a flat fee of MK60 per bale which is irrespective of the quality of depot conditions as well as the duration of storage. This means that
TAMA councilors, as owners of numerous depots, can charge high prices for warehouses even if the conditions of these warehouses do not actually justify the fees. There have also been reports of the existence of a conflict of interest for councilors who own depots and are also members of TAMA and complaints about corruption, with the “first in, first out” rule not being observed. Other farmer complaints, in this area, consist of incidents of tobacco rotting in the depots.

3.3.4 Hessians:

*Farmers have expressed dissatisfaction over the management of the Hessian system.* In 2004, the responsibility of the Hessian system was transferred from AHL to TAMA. TAMA is now supposed to buy Hessians from a few importing companies, store them centrally and distribute them to satellite depots (farmers supposed to get Hessians in accordance with their production quota). However, the system is so ineffective that farmers actually purchase Hessians on the market forcing them to pay twice, as they also get charged for Hessians on the auction floor by AHL on behalf of TAMA (US$0.063 per kg or MK500 per bale (of approximately 80 kg)), regardless. Systematic flaws contribute to the malfunctioning of the Hessian system: firstly, registered growers are not charged for Hessians until the tobacco is eventually sold at the auction; secondly, farmers who produce in excess of their quota are officially banned from getting Hessians. The general flaw in the system is that the farmer does not pay for Hessians at the time of delivery. Furthermore, TAMA may not be the right organization to handle the Hessian scheme: firstly, TAMA is renowned for having amassed great inefficiencies within its operations and structure; secondly, TAMA members’ conflicts of interest have affected the organization’s performance as it has an incentive to serve its members better than NASFAM members, in order to retain its membership.

3.3.5 There are large inefficiencies and rents all along the value chain of Tobacco:

*The value chain diagram for small estate farmers (baseline, Case 1, representative of typical smallholders) highlights that only a very small share of the value of the tobacco crop stays with the smallholders (Figure 11).* This reflects the large rents and inefficiencies in the marketing chain of the tobacco industry. Table 4, extracted from Koester et al., gives a breakdown of the value allocations to tobacco as it passes through the marketing chain for a baseline case (Case 1) of a small estate with no formal credit and CR transport costs. The net return to the family is US$0.34 per kg, after the tobacco is marketed, which is approximately 30 percent of the value of the tobacco at the auction level (US$1.18 per kg) and a mere 12 percent the value of the tobacco at the European market level (US$2.90 per kg). This illustrates that smallholders reap a very small reward from tobacco production and sale, significant though they may be in the production of the tobacco crop.

*The baseline Case 1 shows that the greatest percentage of value from the marketing chain goes to the buyers.* Figure 11 and Table 5 illustrates the percentage shares that go to the various links in the marketing chain and the domestic buyers take an astounding amount of half the value of this chain whilst the small estate (and smallholders) takes a mere 12 percent of the value. Bank charges take up the least with less than 1 percent whilst taxes and levies consume approximately 5 percent of the value of the marketing chain. This simple table of results serves to illustrate how
the monopolistic/oligopolistic practices, cited in the buyers’ market, extract the most value from
the tobacco industry.

Case 2 (NASFAM club members) shows a 1/3 improvement in smallholder net returns (as compared to the baseline case). In comparing the baseline Case 1 with Case 2, which involves a NASFAM smallholder club, one can see that there is 1/3 improvement in the net return to the family as the return rises from US$0.34 per kg to US$0.45. The biggest difference between the two cases contributing to the difference in net returns arises from clubs’ exemption from withholding tax, accounting for some US$0.08 per kg or 2/3 of the difference. Apart from tax, net returns to farm families (in these two models) are different largely because of assumptions made on inputs and labor use (the empirical basis for these assumptions is weak, however). In the NASFAM club case, an arbitrary 25 percent of the MRFC package (for additional inputs) and 60 work days (weeding and reaping *ganyu*) at MK45 are used as assumptions based on team members’ experience. Although there are certainly some efficiency gains to be made by tackling congestion and the other manifestations of market power that have been noted in the marketing chain, greater gains in farm incomes are to be made, by far, from improved technology (with the access to finance that this entails) and management (with the access to knowledge that this entails).

There are some assumptions and reservations taken in the comparison between the baseline case and Case 2 which should be taken into account. Firstly, NASFAM represents a minority of smallholders, and arguably an elite group of farmers, mostly in high potential areas only. Secondly, under Case 2, transport costs to AHL are assumed to be somewhat higher than under Case 1, simply because the authors used Northern Region costs (said to be higher) to make the point that transport costs vary for *any* grower, depending on location. In any given location, however, NASFAM members are expected to have lower transportation costs overall. This is because the roadside GAC collection system saves on both depot charges and local ‘shunting’ costs. Thirdly, it was also assumed that the typical NASFAM club gets input credit from MRFC but, in reality, not all of them do; nor does it seem that MRFC is able to meet demand from all creditworthy clubs and has, perforce, to ration funds. The cost of TCC registration is shown as slightly higher for a club, to reflect the internal dues and local association levies which are said to be the norm; formal registration, itself, is exactly the same, for a given weight, to a club or an estate.

Case 3 (Estate) shows nearly 80 percent improvement in smallholder net returns from baseline case (from US$0.34 per kg to US$0.60 per kg) and there are a host of assumptions and reservations taken into this comparative analysis. Jaffee (2003) stated that there has been very little recent empirical work done on estates, it is believed that the shift beyond dualism has left most production in the hands of farmers who occupy the grey area on either side of the boundary between leasehold and customary land title. The distinction may be rather more theoretical than signifying real differences in the mode of production, though there should be distinctions in scale, per family, between a club of 20 smallholders, compared to the same licensed weight as an estate with a single owner. Whatever the detail and scale of these changes, some estates still follow the tenant system. It has been assumed that all marketing costs beyond the farm gate are the same for the baseline case and Case 3 and that estate owners use the same level (ARET low) of purchased inputs. Also, estate farmers generally deduct input costs as well as other advances (food and cash) but these deductions have not been factored into the table. The authors did not
execute this comparison to form accurate models of tenant farming. This comparison was performed to show, amongst other things, that if the scale of implied profit (however exaggerated in this simple model) approximates the truth, it would justify the view that the system is fundamentally exploitative and wrong.

3.3.6 Traditional “silent” auctions of the AHL vs. Contract Farming:

AHL has received widespread criticism for the management of the auction floors. Malawi, Zimbabwe and Canada are the only three countries that still market their tobacco crop under the auction system. AHL operates the three auction floors situated in Limbe, Lilongwe and Mzuzu and complaints surrounding its operations focus on the central issue of congestion with a host of other associated problems such as long waiting times, inefficient transport and delivery system, the prioritization of sales from contract farming and corrupt and collusive practices on the auction floors. Congestion has many causes. As a result of liberalization, the increase in farmers has resulted in an increase in the number of stakeholders and a rise in the diversity of their various needs, arise in the volume of sales transactions that need to be processed, congestion on the floors and so on. In compliance with the law and also to ensure that total sales are adequately recorded for purposes of computing levies and recording production statistics, tobacco produced by contract farmers is required to pass through the auction floors for “silent” auctioning and other stakeholders have stated that this contributes to the congestion. Another contributor to the congestion is the presence of NTRM as they significantly reduce the throughput on the auction floors and reduce the purchasing capacity of companies.

Contract farming has been presented as an alternative to the traditional inefficient auction system in Malawi. Contract farming consists of an agreement between farmers and buyers for the production and supply of agricultural products under forward agreements (frequently at determined prices). This type of production and marketing arrangement is quickly becoming a global norm in tobacco production. Figure 12 compares the marketing chain in Brazil and Malawi. Brazil engages in contract farming and has a shorter and more efficient marketing chain where exporters get lower costs and farmers get more money for their crop. In Malawi contract growers still have to go through the silent auction with a whole series of marketing costs and sales deductions. As can be seen in Figure 12, Brazil incurs less costs by virtue of having a more efficient marketing chain: Brazil incurs costs of US$1.55 per kg whilst Malawi has costs of US$1.67 per kg. It must be noted, however, that there are problems with comparing tobacco types strictly between Brazil and Malawi because the tobacco types are only similar to each other and not exactly the same (Malawi's burley is a filler, non-aromatic tobacco. Its prices cannot be directly compared with those of Brazil as the burley there is a different product, used in a different way for cigarette production. The value of Malawi's tobacco is precisely because it is a low cost filler, for blending purposes); furthermore, there is difficulty with comparing ‘headline’ prices.

Contract farming would serve to increase investment and productivity. The argument in favour of contract farming argument is not only about better pricing for the farmer. It is mainly about increasing investment, commitments, and forms of partnerships between growers and buyers that have long been absent in the sector. One of the aims of contract farming should be to increase the buyers’ involvement in the promotion of productivity and in the management of commercial and
other risks faced by growers. It is only through some type of contractual arrangements, interlinking input supplies, advice, and product sales, that the trend of productivity decline be reversed. Better productivity is the essential element in the long-term sustainability of the industry, and any sustained profitability for growers. As long as Malawi's productivity remains around 1/3 that of its main competitors and complementary suppliers, there is little prospect for faster growth in the industry.

However, international experience shows that it requires an efficient legal and regulatory framework in order to be successful. A relevant and efficient legal and regulatory framework are essential preconditions for contract farming because it can lead to the exploitation of smallholders by large companies, for example. This is why government has to play an important role in this venture, such as in an arbitration or dispute resolution position, but it should resist the tendency to overregulate the system. For instance, in Canada, thousands of potato farmers under contract with a single buyer negotiate prices and contract terms through the offices of the New Brunswick Potato Agency which has compulsory membership. In most countries, there is no legislation that specifically regulates contract farming. If legislation is introduced, it should ideally be based on the industry’s ability to regulate itself.

The experiments involving contract farming in Malawi have been successful so far. In a bid to rescue the flue cured crop, which had dropped from a peak of 28 million kg to 8 million kg by 2001, tobacco leaf merchants offered finance packages to growers prepared to produce the crop. In 2002, it was resolved by the annual tobacco seminar that TCC should seek permission from government on formalizing contract farming in this type of tobacco. The result has been impressive – flue cured production has doubled since the 1st experiments in 2001/02. A number of multiplier effects are believed to have contributed to this outcome, even though they have not yet been quantified: growth in fertilizer and other input sales; a doubling in sales of tractors, farm machinery and employment; an increase in incomes and consumption. Moreover, in spite of some dissatisfaction amongst flue-growers at their lack of relative bargaining power with merchants, there is no evidence of farmers trying to exit their contracts or even switch merchants which is surely a sign of the success of this experiment. However, the present status of contract farming in flue cured tobacco in Malawi remains tentative – government may terminate the arrangement.

3.4 Governance Structure Misaligned with Industry’s Developments

3.4.1 Legal Framework:

There is widespread evidence of anti-competitive practices in the tobacco industry. The analysis of the marketing chain (see Section 3 above) has highlighted that monopolistic/ oligopolistic structures dominate the tobacco industry: exporters, manufacturers, buyers on the auction floor, the AHL, TCC, transporters, providers of the Hessian, banks and satellite depots on the regional markets. For instance, stakeholders have expressed concerns that the buyers operating through their association, TEAM, operate very much as a cartel and collude to fix prices offered for tobacco on the floors, quantities purchased by each buyer and engage in other anti-competitive practices. Although there has been no empirical evidence to prove this point, the opposition
raised against such activity has been so strong that there is a definite case to study and deal with this area accordingly.

*The Control of Tobacco Auction Floors Act Cap 65:03 is markedly weak in handling industrial complaints.* This Act is one of the two key pieces of legislation governing the operations of the tobacco sector (the other one being *The Tobacco Act Cap 65:02*), and it provides for the establishment of a Commission, TCC, to control tobacco auction floors. It does not confer powers on TCC to investigate the practices of buyers in the industry and deal with complaints effectively. It has been noted that efforts have been made to rectify the situation – the Competition and Fair Trading Act, No. 43 of 1998 was to provide a legal framework through which monopolistic/oligopolistic practices, mergers and unfair trading practices by associations, among others, would be controlled. However, the Competition Commission which was to be established under this Act is yet to be established.

### 3.4.2 Regulatory Framework

*The current regulatory framework is weak, reactionary and outdated.* The regulatory framework is outdated, as it has not been reviewed for a long time, thus it has failed to keep pace with changes in policy and its environment. Any changes in this framework have been in the form of reactions to changes in the environment and has only been able to make piecemeal changes to deal with specific changes as they are introduced. Also, it is unable to set transparent, clear rules to govern operations of the sector especially as new initiatives and developments are introduced. Contract farming is a good example of this latter point: although there has been much discussion about the extension of contract farming to smallholder burley growers, there still remains uncertainty and indecision over its commencement and its regulation.

*The experience of the IB scheme is a good example of how the current state of the regulatory framework hinders progress in the tobacco industry.* After being introduced in 1994, the IB scheme was not accompanied by a proper regulatory scheme to govern its operations. This resulted in the scheme contributing to the collapse of the agricultural credit schemes, increase in thefts of burley crop from the estates sector and a decline in quality of the crop brought to the floors among other issues. Another example, applicable to more recent times, involves the confusion surrounding the regulation of contract farming, including the marketing arrangements for tobacco produced under contract farming and whether or not it should be extended to smallholder burley growers.

*The core of the current legal and regulatory framework covering the production and marketing of tobacco in Malawi was designed for a policy framework that existed prior to liberalization.* Some significant changes, brought upon by liberalization which render aspects of the law outdated, include: changes in the policy environment affecting both the production and marketing side; the diminishing role and influence of ADMARC, (which had interests entrenched in some of the existing legislation and in the production and marketing of tobacco); political pluralism and the enactment of a new constitution providing for freedom of association and advent of other farmer associations and groupings for smallholder farmers operating in the sector.
A comprehensive review of the legal and regulatory framework has not been done to match the pace of the dramatic changes. There is only evidence of some revisions to certain sections of the legislation and regulatory framework which have either been reactionary or not rigorous in the consideration of the impact on the overall sector. One related finding is that in spite of the undeniable changes, the TCC still distinguishes between “estate” and “club” in the licensing procedure and the AHL database captures the distinction in the sales data. The licensing procedure and consequent market information is subject to a confusing set of overlaps between estates and clubs and this has probably been made worse by the distorting effect of relief on withholding tax for clubs.

3.4.3 Stakeholders: Conflicts of Interests:

Serious conflicts of interest exist in the policymaking and policy deliberation arena. Some senior personnel in institutions, such as TCC and MOA, are also tobacco growers who have benefited from the contract farming schemes financed by TEAM. There is a concern that such inter-relationships may compromise the ability to formulate policy in an independent manner; some stakeholders have expressed fear that the nature of the relationship itself may only help TEAM to obtain an upper hand and push for its agenda in policy negotiations. Similar concerns are also expressed with regard to arrangements for the delivery of tobacco to the floors for sale; smallholders hold the view that growers who are able to influence policy at AHL are able to deliver their tobacco earlier, and with fewer problems, than smallholders. There has also been evidence of conflicts of interest in the issue of transportation; TAMA has proven unwilling to coordinate, or improve, the process because some TAMA members are also truck owners and benefit from the transport charge of 3 percent. Indeed, this issue exists in the discussion on satellite depots: there are some TAMA councilors who own depots and may benefit directly from charging high fees on their depots even though farmers may support a reduction in these rates.

3.4.4 Smallholder representation:

Smallholders represent the largest group of tobacco farmers and yet they do not receive as much representation as they should in the policy deliberation process. This is detrimental for policymaking prospects because the concerns of the majority of the farmers are not taken into account. Indeed, according to Maleta, TAMA has developed a cadre of members – medium-size estate owners who are said to have become very loyal to the association. Even though TAMA was designed to be a local farmer-led initiative with grassroots groups forming secondary and tertiary institutions, it has not achieved the desired level of grassroots participation. It is characterized by a limited level member participation (the councilors) taking key decisions and an even smaller number of members taking key management and financial decisions. However, according to Maleta, NASFAM has a governance structure that adheres to the principles of grassroots participation; the association was built from the bottom up, starting with clubs comprising of, on average, fifteen farmers (the clubs are organized into action groups of 5-10 clubs each governed by a democratically elected Group Action Committee (GAC). Overall, the mechanisms for institutionalizing and promoting broad-based and representative decision-making within the associations still await development. Capacity constraints within the farmer associations limit the ability of these associations to properly analyze policy options and
articulate positions that would benefit their members. Also, there is low operational openness in the management of member associations.

3.5. Institutional Performance: Recurring Themes

3.5.1 Inefficiencies in the institutional system:

There is evidence of widespread anti-competitive practices all along the marketing chain. Individuals interviewed in these studies pointed to excessive remunerations and benefits for some of the monopolistic stakeholders as evidence of the existence of these anticompetitive practices. As mentioned earlier, there are currently only two buyers dominating the industry – Limbe Leaf and Dimon-Stancom – with Limbe Leaf, accounting for over 50 percent of all purchases. Table 2 clearly shows the large market shares that Limbe Leaf, Dimon and Stancom enjoyed just before Dimon and Stancom merged in 2004. The massive turnovers by these firms provide even more evidence of their dominance: before the merger, Dimon had a net income of US$28 million. There have been reports of the existence of cartels in the transportation sector, AHL is a practicing monopoly on the auction floors, and the management of the satellite depots is characterized by anti-competitive practices of the warehouse owners. These are all just some examples of widespread anti-competitive practices in the tobacco industry.

The inefficiencies associated with monopolistic/oligopolistic practices encourage illegal behaviour. The studies abound with examples of inefficiencies that plague the marketing chain, which result from the monopolistic/oligopolistic practices: the anti-competitive practices associated with AHL have resulted in congestion on the auction floors, cartels in transportation and the congestion on the auction floors have contributed to high transportation rates, the anti-competitive practices found in the management of satellite depots have meant that there is no alignment between the quality of depots and their corresponding fees. The inefficiencies are by no means minor. For instance, customer dissatisfaction with the performance of AHL and the auction floors system has led to tobacco being diverted to alternative markets outside Malawi (so called ‘cross-border’ trade), which is illegal, but has become an increasing practice by smallholders in recent years. In response to this customer reaction, AHL has decided to open one satellite floor, in the 2005 selling season in Kasungu, and it has invested heavily in specialized infrastructure on its three floors. However, AHL needs to adopt far more radical solutions if the problem of congestion and long waiting times is to be resolved properly. Related anti-competitive practices that induce inefficiency into the entire system are schemes such as quota licenses which restrict individual farm growth. The inefficiency of most legal channels and the mal-functioning of the credit market may induce farmers to resort to illegal marketing channels; for instance, selling to IBs and/or across border to neighboring countries is forbidden but may be attractive to some growers because they need funds early in the season if they have no access to credit (high interest rates allow IBs to offer low prices early in the season). Congestion, another inefficiency, makes IB prices more appealing.

3.5.2 Internal operational inefficiencies:

There is evidence of a poor allocation of funds within some of the institutions. For instance, he 2000 Public Expenditure Review showed that the highest share of the MOA’s budget was
actually spent on administrative issues, with headquarters receiving a significant proportion which is partly due to the ministry’s centralized structure. The TCC is a good example of misallocation of resources. In November 2004, it employed 132 personnel across its operations in three regions. The institution employs a large number of administrative and support staff relative to technical staff; up to 60 percent of staff are in support functions and a substantial number of those in core technical functions effectively support the grower registration process. This is inconsistent with good practice institutions which would normally seek to have no more than 1/3 of their total staff in support functions and could very well be one of the contributory factors to the high overheads. The TCC has a benefit structure that emphasizes employee welfare, provision of employment benefits and perks at the expense of efficiency. Staff benefits and perks are almost as high as 90 percent of the Commission’s total staff salaries and wages costs and despite the adverse changes in the economic climate, TCC has continued with its provision of very generous employment terms. Furthermore, the high level of staff costs, travel and office expenses indicates that TCC is operating beyond its capacity. Its operating revenues are unable to cover these costs and it is the interest income from investments which masks the inefficiencies. Office expenses, at 41 percent of operating revenues, are high and rising. It has been found that the biggest components of these costs include meals and breakfast, which is actually higher than costs of tobacco analysis, postage and telephones, printing and stationery, depreciation, insurance and repairs and renewals. It would seem that there are areas where improvements can be made quickly. For instance, Maleta has reported that high stationery costs probably arise from computer stationery costs, which can be reduced immediately.

The performance of the key industry’s institutions in service delivery is weak, as reported by the beneficiaries. The grower registration process is reported to be long and cumbersome, and appears to be poorly managed by TCC. MRFC is often late in providing authorization of loans for growers, sometimes as late as 3-5 months into the season. There are allegations of corrupt practices involving AHL staff and tobacco re-graders at the floors – it has been alleged that some farmers give ‘tips’ to their staff at the receiving bays to enable a faster offload of tobacco and a higher vending price. ARET is known to fail to meet farmer expectations because of its infrequent contact with farmers – meetings are held only once or twice in a farming year. SACCO sets a limit of four bags of fertilizer per farmer which is considered too little for a good farming effort; also, its members get no access to extension services from their loan supplier. NASFAM members generally have a positive view of their association, but have nevertheless complained of incidents of transportation delays which lead to a loss in tobacco value and subsequent low prices on the auction floors.

3.5.3 Capacity Issues:

The dearth of different forms of capacity makes a significant feature in the studies. For instance, the TCC indicates that inadequate decentralization and an inefficient information technology system (that is, capacity limitations) limit its ability to streamline the current grower registration process. Also, the big increase in the number of growers, since the liberalization of tobacco production, has stretched the TCC’s capacity to monitor operations of the market and the auction floors. Consequently, TCC has been unable to effectively police alleged instances of illegal exports of green leaf by some farmers, and it has also been unable to adequately regulate and monitors IBs when they were operating on the market, and so on. In some instances of alleged
poor capacity, it can be stated that the actual issue is one of prioritization of resources and objectives. The MOA is such a case where there has been an alleged lack of office space, vehicles, computers, basic office supplies and sector-specific items such as extension aids but would actually make better use of its existing capacity if it streamlined its mandate.

Further on capacity issues, ARET is known to fail to meet farmer expectations. The main cause of this is infrequent contact with farmers brought upon by the factor of distance: meetings are held only once or twice in a farming year. For instance, survey participants in Rumphi stated that ARET offices were reported to be in Mzuzu only, a distance of more than 60 km, which means that contact between ARET staff and farmers is minimal and sporadic. This outcome is capacity-related because ARET offices have been reported to be understaffed making them incapable of providing extension support to farmers throughout the farming year. These institutional capacity constraints clearly hinder the services that can be provided.

3.5.4 “Accessibility” of Institutional Services:

Access to credit is severely restricted. MRFC members, for instance, complained that the institution demanded high collateral, which, not less than MK15,000 per club, gets raised depending on the value of inputs and equipment that is borrowed. Although the collateral is reported to earn interest, the farmers believe that the interest is usually very little. Furthermore, MRFC members have complained about the high interest rate (over 45 percent) on input loans. MRFC has been noted to grant a grace period of six months from the time the loan is approved before charging interest, (>45 percent) every month, until the club makes a full repayment; with any partial payments being met with interest being charged on the balance. The unsustainable debt levels that this has brought to some clubs has led to their demise. The high charges can be particularly disconcerting to the farmers because payment delays sometimes arise from delays on the auction floors, which is not their fault. Accompanying this complaint is the alleged harsh credit recovery mechanisms which include confiscation of property. Indeed, this complaint is widespread: Commercial banks are also a source of input loans for the smallholders but the survey revealed that farmers do not borrow from these banks because these institutions were too slow in authorizing loans, charged very high interest (in excess of 45 percent) and required a lot of collateral (in excess of MK25,000 or property that would fetch that amount or more when liquidated). For SACCO members, the fact that they were not assured of the safety of their tobacco on the way to the auction market, that the institution had a limit of 4 bags of fertilizer per farmer and that its members got no access to extension services from their loan supplier were reasons for complaint.

The issue of “accessibility” of services has also been raised with levies. For instance, TAMA members considered their levies to be too high. Participants believed that the ARET levy was not justified because contact with farmers was so sporadic. In the case of AHL, it was stated that tobacco prices, on the auction floors, were better compared to those that could be obtained from IBs although AHL prices were too low to allow for profit-making. Since AHL makes bulk purchases of tobacco (unlike intermediate buyers who buy loose and small quantities), farmers make more money at a time and they can budget properly. Some participants also said that selling tobacco through the auction floors was good for the government because it was easier to monitor the sales and get the required taxes.
3.5.5 Effectiveness and Accountability:

There are some institutions that have largely been effective in executing their mandates. For instance, the majority of stakeholders have reported satisfaction with the TCC. There are, however, some concerns about its willingness and ability to deal with some problems relating to the auction system. For example, it has not been strong enough in enforcing the delivery quotas and schedules assigned to various groups of farmers and this has added to the levels of congestion, especially on the Lilongwe floors, which have come to a head in the 2004 selling season. Also, the TCC has not enforced discipline and transparency on the floors. Reports of corrupt practices at off loading bays, and on the floors themselves, are on the rise. Furthermore, there are also concerns of other malpractices in the transportation system from the satellite depots, often perpetuated by TAMA, that the TCC should have addressed as part of a larger strategy to remove inefficiencies in the whole auctioning system and ensure transparency. As far as price-fixing and other collusive activities, among the buyers on the floor go, TCC is reportedly ineffective. NASFAM is another example of an institution that has been praised for executing its mandate well; for instance, it has facilitated credit for its members and it has negotiated improvements on transport contracts for its members well despite isolated incidents of transportation delays.

There are other institutions that have received reports of being very ineffective in executing their mandates. TAMA is an example of an institution which falls into this category; according to Maleta, a significant proportion of TAMA’s group of members is dissatisfied with the quality and levels of services that they receive from their association. Specific complaints include lack of transparency and accountability in the manner in which services such as transportation and satellite depots are managed. AHL has also been the recipient of many complaints and these have revolved around the issues of congestion and widespread allegations of corrupt practices on the auction floors.

3.5.6 Financing of the Institutions:

It would seem that the institutions encounter issues revolving around insufficient funding. The MOA is one such example: Officials from the MOA report that the lack of office space, vehicles, computers, basic office supplies, and sector-specific items such as extension aids, severely inhibits the MOA’s ability to carry out its designated roles. Furthermore, they highlight that over the past decade, typically only about 50 percent of the amounts of budget requests have been approved, and on average, less than 60 percent of approved budgets have actually been funded. Such large discrepancies, however, highlight the existence of a degree of confusion as to what constitutes the MOA’s core activities and functions, and suggests the existence of substantial inefficiencies in resource use.

The institutions in the study also tend to be heavily reliant on particular sources. The MOA, for instance, is constrained by its high dependence on donor aid and inflows: grants and foreign loans form a large, but unstable, source of funding for its budget, typically accounting for 2/5 of total expenditures and in recent years rising to over ½ of total expenditures. TCC’s income has been found to be heavily dependent on license, permits and cess income. Out of these, the main
source of income comes from cess on all sales of tobacco, whether over the auction floors or by private treaty, at the rate of US$ 0.01 per kg (the rate having been reduced from US$0.013 per kg in the current season). Cess contributions are made by TAMA, NASFAM and TEAM.
Figure 1: World Tobacco Production

Source: Foreign Agricultural Service, Official USDA
Figure 2: Structure of Tobacco Production: 1984-2003

Figure 3: Malawi Export Share by crop from 1977-2003

Figure 4: Tobacco Exports by Value (US$)

![Graph showing trend in tobacco exports by value from 1990 to 2003.](image)


Figure 5: EU Unit Values of Tobacco Imports from Selected Origins

![Graph showing unit values of tobacco imports from 1999 to 2003.](image)

Source: Koester et al. (2004), pp.26
Figure 6: Unit Value of EU Imports of Tobacco (Tariff Line 240120)


Figure 7: Comparison of differences in unit values of tobacco import from Malawi and Brazil for EU and Non-EU European countries - Quality 3

Source: Koester et al. (2004), pp.30
Figure 8: Yield of Burley Tobacco 1986/87 – 2002/03 (Kg/ha)

Figure 9: Trend in Low and High input Tobacco Gross Margins: 1994-2004

Figure 10: Trends in Tobacco Auction Prices in Malawi (US Cents/kg)

Figure 11: Tobacco Value Chain Analysis in Malawi (Burley, Small Estate)

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>US$ cents/kg</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CIF Europe</td>
<td>290</td>
</tr>
<tr>
<td>2</td>
<td>Sea + Insurance</td>
<td>12.5</td>
</tr>
<tr>
<td>3</td>
<td>Road haulage</td>
<td>27.0</td>
</tr>
<tr>
<td>4.1</td>
<td>Buyer</td>
<td>15</td>
</tr>
<tr>
<td>4.2</td>
<td>Interest on Working Capital (CV)</td>
<td>1.02</td>
</tr>
<tr>
<td>4.3</td>
<td>Processing &amp; Packing</td>
<td>44.00</td>
</tr>
<tr>
<td>4.4</td>
<td>Green weight Conversion (Yield)</td>
<td>122.0</td>
</tr>
<tr>
<td>4.5</td>
<td>Buyer</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>International transport</td>
<td>29.0</td>
</tr>
<tr>
<td>6</td>
<td>FOT, LL</td>
<td>280</td>
</tr>
<tr>
<td>7</td>
<td>Price at Auction</td>
<td>117.66</td>
</tr>
<tr>
<td>8.1</td>
<td>TCC Case</td>
<td>105.50</td>
</tr>
<tr>
<td>8.2</td>
<td>TCC Classification</td>
<td>105.00</td>
</tr>
<tr>
<td>9</td>
<td>ARET levy</td>
<td>103.58</td>
</tr>
<tr>
<td>9.1</td>
<td>Associations (TAMA, NASFAM et al.)</td>
<td>103.28</td>
</tr>
<tr>
<td>11</td>
<td>Fission</td>
<td>103.28</td>
</tr>
<tr>
<td>12</td>
<td>Transport to AHL</td>
<td>4.85</td>
</tr>
<tr>
<td>13</td>
<td>Credit recovered</td>
<td>0.00</td>
</tr>
<tr>
<td>14.1</td>
<td>AHL Stop-order(s)</td>
<td>0.15</td>
</tr>
<tr>
<td>14.2</td>
<td>Sidler's Sheet Charge</td>
<td>0.05</td>
</tr>
<tr>
<td>15.1</td>
<td>Bank Exchange</td>
<td>1.95</td>
</tr>
<tr>
<td>15.2</td>
<td>Bank Fees</td>
<td>0.00</td>
</tr>
<tr>
<td>16</td>
<td>Cash at Withdrawal Costs</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Transport to satellite (shunting)</td>
<td>95.88</td>
</tr>
<tr>
<td>18</td>
<td>Cash Purchased Inputs</td>
<td>94.00</td>
</tr>
<tr>
<td>19</td>
<td>Hired Labour + other</td>
<td>33.6</td>
</tr>
<tr>
<td>20</td>
<td>Net return to family land, labour &amp; capital</td>
<td>33.9</td>
</tr>
</tbody>
</table>

Note: The chart shown is for a notional ‘modal’ grower, a small estate registered as such but using a mode of production similar to the smallholders. The chart starts in the main export market and deducts the cost of each link, or transaction, in the value chain, and showing the balance left at each stage, ending with net returns to farm families.

Source: Koester et al. (2004),
**Figure 12: Comparative cost of unprocessed flue cured tobacco in factories**

![Bar chart showing comparative cost of unprocessed Flue cured tobacco in factories.](chart)

Source: Dimon (Malawi) Ltd.

**Table 1: Comparative Production Costs for Burley Tobacco**

<table>
<thead>
<tr>
<th>Country</th>
<th>Cost/ ha (US$)</th>
<th>Cost/kg (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>749</td>
<td>0.60</td>
</tr>
<tr>
<td>Brazil</td>
<td>1282</td>
<td>0.70</td>
</tr>
<tr>
<td>Malawi</td>
<td>1756</td>
<td>0.86</td>
</tr>
<tr>
<td>Smallholder (00/01)</td>
<td>1080</td>
<td>0.72</td>
</tr>
<tr>
<td>Large Estate (99/00)</td>
<td>2062</td>
<td>1.29</td>
</tr>
<tr>
<td>United States</td>
<td>8850</td>
<td>4.14</td>
</tr>
</tbody>
</table>

Source: Jaffe (2003).

**Table 2: The market share of buyers (%)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Limbe</td>
<td>47.9</td>
<td>45.4</td>
<td>47.0</td>
<td>51.2</td>
<td>52.9</td>
</tr>
<tr>
<td>Dimon</td>
<td>23.1</td>
<td>22.5</td>
<td>22.6</td>
<td>21.6</td>
<td>21.6</td>
</tr>
<tr>
<td>Stancom</td>
<td>23.7</td>
<td>24.5</td>
<td>24.0</td>
<td>22.1</td>
<td>20.4</td>
</tr>
<tr>
<td>Africa</td>
<td>7.4</td>
<td>6.1</td>
<td>6.1</td>
<td>4.7</td>
<td>4.2</td>
</tr>
<tr>
<td>Wallace</td>
<td>0.2</td>
<td>0.8</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Tobacco</td>
<td>0.0</td>
<td>0.7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Premier</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: Koester *et al.* (2004), pp.80
Table 3: Estimation of transport costs:

<table>
<thead>
<tr>
<th></th>
<th>Haulage, ex-depot (MK/bale)</th>
<th>+ TAMA fee (MK60)</th>
<th>100 kg/bale</th>
<th>80</th>
<th>40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>363</td>
<td>423</td>
<td>3.9</td>
<td>4.9</td>
<td>9.8</td>
</tr>
<tr>
<td>Median</td>
<td>360</td>
<td>420</td>
<td>3.9</td>
<td>4.86</td>
<td>9.7</td>
</tr>
<tr>
<td>Mode</td>
<td>350</td>
<td>410</td>
<td>3.8</td>
<td>4.7</td>
<td>9.5</td>
</tr>
<tr>
<td>Max</td>
<td>450</td>
<td>510</td>
<td>4.7</td>
<td>5.9</td>
<td>11.8</td>
</tr>
<tr>
<td>Min</td>
<td>270</td>
<td>330</td>
<td>3.1</td>
<td>3.8</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: TAMA transport rates; consultants’ calculations. Exchange $1=MK108.00. Note that TAMA takes a brokerage fee from the hauler, in addition to depot management fee.

Table 4: Summary of results: Value Chain Analysis (US cents/kg)

<table>
<thead>
<tr>
<th>Link</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Auction Price</td>
<td>118</td>
<td>118</td>
<td>118</td>
</tr>
<tr>
<td>6 Withholding Tax</td>
<td>-8.26</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>7 AHL Commission</td>
<td>-4.13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.1 TCC Cess</td>
<td>-0.10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.2 TCC Classification</td>
<td>-0.35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 ARET levy</td>
<td>-1.18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Associations</td>
<td>-0.70</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Hessian Scheme</td>
<td>-0.39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 Transport to AHL</td>
<td>-4.86</td>
<td>-5.21</td>
<td></td>
</tr>
<tr>
<td>13 Credit Recovered</td>
<td>0.00</td>
<td>-30.72</td>
<td></td>
</tr>
<tr>
<td>14.1 AHL stop order(s)</td>
<td>-0.15</td>
<td>-1.07</td>
<td></td>
</tr>
<tr>
<td>14.2 Sellers’ sheet</td>
<td>-0.05</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15.1 Bank exchange</td>
<td>-1.96</td>
<td>-1.48</td>
<td></td>
</tr>
<tr>
<td>15.2 Bank fees</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>16 Cash at bank</td>
<td>96.0</td>
<td>73.0</td>
<td>96.0</td>
</tr>
<tr>
<td>15.3 Withdrawal costs</td>
<td>0.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17 Transport to satellite</td>
<td>-1.74</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>8.3 TCC registration</td>
<td>-0.40</td>
<td>-0.50</td>
<td></td>
</tr>
<tr>
<td>Σ marketing transaction costs</td>
<td>23.87</td>
<td>14.77</td>
<td>23.87</td>
</tr>
<tr>
<td>18 Cash purchased inputs</td>
<td>-16.0</td>
<td>-27.5</td>
<td></td>
</tr>
<tr>
<td>19 Labour &amp; other costs/tenant</td>
<td>-44.0</td>
<td>-0.05</td>
<td>-18.1</td>
</tr>
<tr>
<td>20 Net Return to Family</td>
<td>33.9</td>
<td>45.0</td>
<td>59.6</td>
</tr>
<tr>
<td>Change on case 1</td>
<td>33%</td>
<td>77%</td>
<td></td>
</tr>
</tbody>
</table>

Case 1: Small estate, no formal credit, Cr transport costs
Case 2: NASFAM smallholder, MRFC package +25%, NR transport costs
Case 3: Estate, tenant, med. ARET, low, TAMA prices
Source: Koester et al. (2004) pp.151
Table 5: Percentage shares of the Value Chain of Tobacco: Baseline case

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (US cents/kg)</th>
<th>Percentage share of US 290 cents/kg (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>International transport</td>
<td>29.90</td>
<td>10.31</td>
</tr>
<tr>
<td>Domestic buyers</td>
<td>142.44</td>
<td>49.12</td>
</tr>
<tr>
<td>Levies</td>
<td>15.51</td>
<td>5.35</td>
</tr>
<tr>
<td>Domestic transport</td>
<td>6.60</td>
<td>2.28</td>
</tr>
<tr>
<td>Bank charges</td>
<td>2.16</td>
<td>0.74</td>
</tr>
<tr>
<td>Cash purchased inputs</td>
<td>16.00</td>
<td>5.52</td>
</tr>
<tr>
<td>Hired labour and other</td>
<td>44.00</td>
<td>15.17</td>
</tr>
<tr>
<td>Small estate return (Net Returns to Family Land, Labour &amp; Capital)</td>
<td>33.90</td>
<td>11.69</td>
</tr>
</tbody>
</table>

Note: The shares in the table refer to revenues and are not necessarily indicative of profit margins.
Source: Based on Chart 6.1 in Koester et al. (2004) pp128-129
4. MAJOR RECOMMENDATIONS ARISING FROM THE TOBACCO STUDIES

The analysis from the studies indicates that there exists considerable scope for achieving efficiency gains and promoting sustained growth in the tobacco industry throughout its marketing chain. The analysis also clearly outlines the recommendations for a marketing and institutional reform program to improve the efficiency and performance of the tobacco sector. The main recommendations are summarized in this section and provide a number of proposals for future reforms.

Major Reforms for Immediate Implementation:

Undertake a comprehensive overhaul of sector’s general legal, regulatory and institutional structure

- MOA and the TCC should initiate a comprehensive review of the legal and regulatory framework governing the sector in order to ensure that it is updated and transparent. The review should use the outcomes of the ongoing tobacco sector studies and stakeholder consultations as a foundation.
- Government should expedite policy-making and formulation. This can probably be improved through adoption of a medium to long-term policy formulation for the sector, which would in turn improve certainty and transparency.

Strengthen institutions’ capacities and accountability:

- Government should undertake detailed performance audit for each institution for (i) aligning their technical and managerial skills with their mandate; and (ii) improving their accountability and internal efficiency;

  a) The Ministry of Agriculture (MOA):

  - Government should address capacity constraints in MOA: clearly defining its role and the services that it is intended to provide with regard to tobacco industry. In particular, MOA should clearly articulate its policy towards the provision of extension services to the tobacco sector and negotiate incentives that the sector would require from the government in order to finance the provision of extension services.
  - MOA should strengthen its capacity for policy analysis and formulation for the tobacco sector. Consultations among relevant Government departments (MOF, EP&D, Ministry of Commerce and so on) should be expedited and policy decisions communicated timely to the industry.

  b) Tobacco Control Commission (TCC):

  - Within the context of sector-wide review of the regulatory environment, TCC should develop a medium-term strategic plan that responds to medium- to long-term sector policy.
• Elements of conflicts of interest in TCC’s governance structure should be removed: TEAM, AHL, farmer associations and any other institution whose operations are regulated by TCC should not be represented on its Board of Directors. The composition of the Board should be de-politicized through the appointment of independent professionals.

• TCC should review the whole tobacco delivery system to the floors in order to remove the current inefficiencies. Additionally, TCC should work with AHL to ensure that the whole auctioning system is transparent and void of corrupt activities; the introduction of penalties should be considered as a possibility. TCC should commission an activity-based analysis to determine the appropriate commission to be charged by AHL.

• TCC should undertake a detailed performance audit of its operations and systems in order to remove inefficiencies.
  ▪ This exercise should include a detailed review of human resources and skills of staff in order to determine an optimal number and distribution of its staff. (TCC should also ensure that technical staff are multi-skilled in order to undertake some of the secretarial work themselves.)
  ▪ The audit should also include the IT and grower registration systems in order to identify and develop strategies for overcoming the deficiencies. Enhancements to the registration system should contribute to a reduction in the number of clerical staff.
  ▪ As part of the review TCC should revise its remuneration structure and the level of benefits provided for its staff, and it should also identify ways to reduce its operating costs in order to manage its overall costs.
  ▪ In the context of the review, TCC should also explore the possible synergies that can be developed between TCC’s registration system and AHL sellers’ data and investigate the possibility of using modern technology such as the Malswitch system. The registration system should also include credit rating components.

• TCC should determine an appropriate level of levies and fees in the tobacco industry, through periodic performance audits (it must be noted that there is no compelling case for TCC’s levies and fees to be raised). Any surpluses made by TCC should be paid back to the industry through support of services such as extension, research, studies and so on.

• TCC could become more involved in market intelligence and could provide necessary information to the future Competition Commission.

c) Auction Holdings Limited (AHL):

• Government and TCC should review the role of AHL in the tobacco marketing chain, as part of the regulatory review. Government should consider separating the operational and financial autonomy of the three floors as a first stage in the process of setting them up as independent companies.

• AHL must become a client-focused institution and design strategies that will immediately address stakeholder concerns: congestion on Lilongwe floors, reducing the selling cycle, eliminating corruption on its auction floors, agreeing to the marketing mechanisms for tobacco produced under contract farming and so on.

• Government should encourage the appointment of at least two directors who would represent the interests of smallholder farmers. TAMA should only remain on the Board if it increases its shareholding to the requisite level as provided in the Company’s memorandum and articles of association.
AHL must undertake a comprehensive performance audit of all its operations and systems:
- AHL should reduce its operating costs in order to operate profitably despite the implementation of contemplated deductions to the selling commission.
- AHL must review its management structure in order to reduce staff and administrative overheads and therefore reduce the flow of costs passed on to the farmers.
- AHL should apportion its head office costs to its three auction floors and two subsidiary companies.
- A separate audit of its current IT system should be undertaken to assess its operational and cost effectiveness and also investigate if some synergies can be obtained by interfacing it with TCC’s registration system. Opportunities for partial mechanization of some processes at the floor should be investigated and, in partnership with TCC and other stakeholders, the whole logistics for transportation and delivery of tobacco to the floors should be reviewed and streamlined.

d) Farmer Associations:

- Government should encourage associations to operate as voluntary membership organizations. As such, the government should limit its role in strengthening the capacity of the associations, encouraging transparency in their operations and interfering with their management. Member associations should collect membership fees directly from their members who should in turn hold their association accountable for the management of the fees collected and services provided.
- TCC and MOA should strengthen their dialogue with the farmer associations. Where possible, the associations should be supported to develop capacity for the provision of training. AHL, TCC, MOA should work with the associations to see how improvements in AHL/TCC’s IT capacity can assist with the development of a credit rating scheme for tobacco growers that would be acceptable to financial institutions.
- Farmer associations should ensure transparency and accountability in management processes and systems and in the contracting of services provided to their members. All situations that arise as matters of conflict of interest should be declared.
- Associations should strengthen their member recruitment campaigns and provide the desired level of services to justify membership fees paid by their members. In addition, they should intensify efforts to identify alternative and additional sources of revenues and review their own cost structures to improve their operational costs.
- Associations should empower their members and improve the flow of financial and other key operational information to members.
- TAMA should review its operations and structure, and immediately restructure itself both operationally as well as financially. It does not appear to be equitable for TAMA to expect its current members to repay loans from which they have derived no benefit.

e) Agricultural Research and Extension Trust (ARET):

- ARET should narrow its mandate and focus solely on the tobacco sector; ARET should review its trust deed to ensure that it adequately responds to changes that have taken place in the tobacco industry since its establishment.
- ARET should maintain levy at the current level.
• ARET must increase the number of its extension agents by 16, at least, in order to cover the whole country and invest in the necessary supporting structure; extension programs and their delivery mechanisms should be redesigned to ensure that the specific needs of the less educated smallholder growers are met. Farmers who elect to obtain their extension services from other sources – contract farming, private sector – should pay a reduced amount of levy.

• ARET should implement changes in its governance structure. Notably: ADMARC should no longer be represented on ARET’s Board; ARET should raise the representation of smallholder farmers; ARET should be independent of TAMA – it should not be perceived as a subsidiary of TAMA; TAMA’s position as a trustee should be revisited since farmers are no longer obliged to belong to any farmer association.

• ARET should identify resources for improving its laboratory capacity and services provided as well as obtain international accreditation. This exercise should be supported by government.

• ARET and other stakeholders should evaluate research programs in order to identify reasons for slow uptake of research findings and strategies. As part of its strategic planning process, ARET should identify the resources that it needs to improve its capability to anticipate industry’s demands and to design research programs that are able to meet those needs in a timely manner.

• ARET should undertake a detailed performance audit and review the composition of its operational costs and identify areas in which savings can be achieved:
  ▪ As part of this exercise, the Trust should review its remuneration policy and strategy in order to control employment costs and also to rationalize and prioritize experimental programs, trial sites and farming operations.
  ▪ Also, ARET should discontinue running and subsidizing the Institute; an industry-wide management committee should be established to take over the management of the Institute.

**Implement measures to reduce marketing costs and improve pass-through to farmers.**

• *Expand contract farming and direct exports:* Contract farming allows farmers to have access to inputs/credit and advisory services as well as to manage price risk. Other advantages include allowing producers to have direct contact with increasingly difficult international markets and enabling the market to dictate production. Contract farming for flue-cured seems to have the support of the overwhelming majority of small estates/smallholders who are now requesting that it be extended to burley. A pilot contract farming operation should be carried out for burley and a review of the flue-cured operation should be carried out to strengthen producers’ bargaining power (information/advice) and eliminate requirement of going through the auction floor (it is technically feasible and would reduce delays at the AHL); in this light, contract farming represents the main competition to AHL. It must be stressed that government needs to play an important role in order for contract farming to be successful as this venture needs a relevant and efficient legal and regulatory framework in order to work effectively.

• *Bring efficient markets closer to farmers:* AHL has started to decentralize its auction floors. This will shift the burden of transport from the farmers to the buyers who are better equipped to negotiate with truckers and introduce economies of scale. But the AHL monopoly should
not be replicated at local level. Serious consideration should be given to piloting “Local Commodity Exchanges (LCE)” at EPA level where producers and buyers would carry out direct competitive physical transactions.\(^5\)

One or several LCE would be opened in every EPA to focus on tobacco (or handle several crops), and would be owned/managed, under TCC guidelines/monitoring, by private entrepreneurs with adequate qualifications and providing the necessary guarantees (private ownership would have the advantage of ensuring private financing of investment costs). They would provide a physical location where licensed buyers would compete for the crop brought in by the area’s producers. LCE licenses would be auctioned by TCC and LCEs would fund their operating costs through a fee on throughput. The presence of several (20 or more) buyers would permit competition and transparent price discovery, thus protecting the producers. LCEs should be open to any “eligible” buyer, not only to the buyers active on the AHL auction floor (where there is an amount of price fixing). Buyers would be licensed by TCC according to strict criteria. Payment to the smallholders would be immediate. Transactions would be controlled by TCC. The buyers would then have a choice of either selling the crop through AHL auction floor or direct export.

It should be emphasized, however, that the LCE does not mitigate the cartel problems found on the auction floors. The LCE would answer several critical existing constraints and bring other advantages: it would protect the farmers and provide an efficient mechanism for price discovery by farmers, similar to that of the AHL auction floor (prices would be set in an open, competitive environment); it would allow for immediate payment to the smallholders; it would be easily monitored by TCC; it has the potential to ease the congestion witnessed on the auction floors; it would compete with the TAMA and NASFAM marketing channels which would both force improvement in the efficiency in the former and provide a safeguard against abuse; it would restrict the operations of illegal IBs to a limited geographical area (around the LCE); LCEs may also be used as commercial internet outlets where farmers could access market information. Also, the transparency and close interaction between buyers and sellers will raise the negotiating power of the farmers. It also has the potential to reduce other understated, yet notable problems, such as the spread of HIV/AIDS since the reduction in congestion will reduce waiting times and leave the trucking company employees less idle time to indulge in prostitution.

• **Create the Competition Commission.** Establish the Competition Commission (in line with existing law) and entrust the Commission with monitoring sector’s monopolies/oligopolies on a regular basis: Monopolistic/oligopolistic structures are dominant and pervasive in Malawi’s tobacco industry: exporters, manufacturers, buyers on the auction floor, AHL, TCC, transporters, providers of Hessian, banks, and satellite depots on regional markets. All the distortionary effects that accompany such market structures would seem to apply to the Malawi case. For instance, salaries and benefits in such institutions are considered too high, the pricing of products and services are brought to question and the market power held by

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\(^5\) The organization of the LCE is analogous to the ‘mini-markets’ recommended in the Koester et al report; the term LCE is more commonly used than ‘mini markets’. An LCE is essentially a decentralised auction with mobile teams of auctioneers and buyers working exactly as they would on the main auction floors, but mobile. This type of marketing arrangements for agricultural commodities has been adopted successfully in several countries.
these institutions lead to mass distrust amongst the stakeholders. Stakeholders are well advised to make their cost and pricing structure transparent. The Competition Commission should investigate the behaviour of the monopolists on a regular basis. Hence, we recommend that the Commission be set in operation as soon as possible and start to act on the tobacco market with priority.

- The Competition Commission should control the setting of fees and prices by monopolistic entities and should approve any changes in fees. The Government should abstain from setting fees, levies or prices.
- There is a strong suspicion that collusion exists among banks, which charge a fee of 2 percent for transferring money to growers’ accounts. The Competition Commission is the right institution to investigate this issue. As it is not working yet, the government should take action.
- Deductions for stop-orders seem too high. The same holds for deductions for TCC services. If the Competition Commission cannot investigate these issues, the Government should set up a specific commission for this task.
- The deduction for ARET implies that tobacco growers contribute to the financing of extension services to non-tobacco growers. Also this deduction implies a cross-subsidization of large growers by small growers as small farmers gain less from extension services than estate farmers. ARET’s generation of revenues and use of funds need to be revised.
- The Competition Commission should monitor the behavior of importing companies with respect to collusion.

- Maximising preferential access to the EU and US: Explore opportunities to increase markets and value added in the sector in the medium term by pursuing trade preferences: Malawi should be able to make better use of its preferential access to certain markets and thus capture higher prices in the EU and the USA than Brazil due to its preferential access to these regions. However, the analysis of the effects of trade preferences revealed that Malawi was not yet able to benefit at all or fully from these agreements. Assuming that findings are correct, the Government should negotiate a procedure to allow Malawian exporters to capture rents with the preference-granting countries, the EU and the USA. There are two possible systems:
  - A simple way would be for the EU to transfer to the Government the revenue collected from the import duty on imports from Malawi. The money could be used either to diversify agricultural production in Malawi or to improve the efficiency of the agricultural sector. As this study shows there is a wide scope to improve the efficiency of the sector.
  - An alternative procedure would be to copy Botswana’s method. Exports to the EU and the US could be taxed, siphoning the import duty foregone. However, it might be necessary to set the tax below the tariff forgone. Otherwise, Malawi exporters might not be competitive on EU and USA markets.

**Minor Reforms for Immediate Implementation:**

- Satellite Depots: A license should be granted to anyone wanting to open a satellite depot, if they satisfy the minimum requirements befitting knowledge, reputation and financial
background. The manager of a depot should be liable for observing the rule ‘first in, first out’ and any loss or deterioration in quality of the tobacco stored. TCC should be in charge of the licenses and monitoring satellite depots and the depots should be accountable for deterioration and losses of tobacco. The TCC should deal with complaints and should have the authority to set penalties and compensation for those who report of any form of mismanagement.

- **Hessians:** Liberalize the distribution of Hessians (importers can set up private internal distribution network; satellite depots & NASFAM center can buy Hessians from importers and sell to farmers). There is no need to regulate the distribution of Hessians. The following options could apply:
  - Importers could set up an internal distribution scheme, with the depots and the NASFAM centers acting as middlemen, buy Hessians from importers and sell them to farmers. It has been suggested that this system would be more efficient.
  - The responsibility for management of the scheme should be transferred to each of the member associations who will administer the scheme for their members and the collected levies paid to the individual associations. Those growers who belong to neither of the associations should either chose one association to manage their Hessian requirements or purchase their requirements directly from the private sector. The Hessian levy should be adjusted as proposed by the industry.

- **Transportation.** There have been recommendations for transport costs to be broken into two parts: one for moving the tobacco from the depot or any other place to the auction floor and the other for waiting time. The first element can be agreed upon *a priori*. The second should only fix the per unit cost of waiting time. Costs will vary among transporters: modern trucks would be cheaper on the road but more expensive per unit of waiting time. Contractors of transport could opt for a truck which is cheap on the road, but expensive in waiting or vice versa. Sellers of tobacco would want to minimize their waiting time, thus avoiding shipping tobacco to the floor if there is a long queue. Transporters would be neutral as they would be remunerated accordingly:
  - Collusion among bidders should be forbidden and penalized and this presents another role for the Competition Commission. Free markets will only lead to efficiency in the economy if there is sufficient competition. Competition is lacking on the market for transport and conflicts of interests seem to worsen the market failure.
  - As a principle, no one with vested interest – as a truck owner – should get involved in negotiations on transport rates on behalf of his fellow farmers. Moreover, TAMA should not get a commission which is related to the value of the transport service. Instead, it should be a flat rate as is the case with NASFAM.

- **Production quotas:** The unofficial quota application should be abolished. It does not constrain overall sectoral production but it increases costs for farmers and creates illegal trade of tobacco amongst farmers and between farmers and IBs.

**Medium-Term Strategies for Future Growth in Malawi’s Tobacco Industry**
• **Improving on-farm productivity:** With the worldwide demand but also most importantly production (Mozambique, Brazil) of burley tobacco expected to stay constant or increase, it appears important for Malawi to develop niche markets for high quality tobacco (probably estates) and to achieve substantial on-farm productivity gains for burley tobacco in order to remain competitive with low-cost producers. The government should launch the preparation of an operational strategy/program for establishing an efficient demand-driven technology development and advisory system. The system should be demand-driven (controlled by producers), open and multi-source (ARET, contract farming). At the moment, farmers pay (1 percent ARET levy) for services that very few receive whilst contract farmers actually pay twice – once to ARET and, again, under the contract farming agreement. The performance audit of ARET would provide a solid basis for a complete overhaul of the sector’s research and advisory services.

• **Adding Value:** Explore opportunities to expand value added by undertaking a detailed feasibility study for promoting competition in tobacco processing and move to greater transformation (cigarette manufacturing)

• **Expand Markets:** Undertake an in-depth market study to design an export penetration strategy and review the rationale for Malawi, being a price taker, to keep production quotas, globally and by producer: (i) risk of losing market share to other low cost producers such as Mozambique, (ii) quotas currently globally not binding but binding and disregarded at individual producer level. Also, Malawian exporters of tobacco should develop a more efficient export marketing strategy. Enlargement of the EU and policy changes in the EU and the US should allow redirection of export flows and improvement of export revenues. It must also be stated that direct exports can facilitate the diversification of products from the country.