

Value Addition in the Coffee Industry in Kenya: Lessons from the Cut Flower Sector

ICBE POLICY BRIEF

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EXECUTIVE SUMMARY

Coffee used to be Kenya's most valued export crop in the 1970s and 1980s. It has however suffered major setbacks, and it has since lost the title of the highest foreign exchange earner to tea, flowers and tourism. The decline of the coffee sub-sector is a complete contrast from the performance seen in Kenya's cut flower industry.

With a relatively short history of commercialisation in Kenya (beginning in the 1980s), cut flower farming has grown to make the horticulture sector stand alongside tea and tourism as the three most valued exports by the country.

Comparing the structure of value chains in coffee and cut flower sub-sectors will help policy makers identify the constraints that hamper value addition in the coffee industry. It will also inform the policy interventions necessary to improve performance of the coffee sector.

This necessitates that we map out the production, processing and marketing stages in the value chain, as well as identify the various actors in the sector(s) and how value added is distributed across the value chain.

The agricultural sector contributes about 24 percent of Gross Domestic Product and provides about 70 percent of total employment in Kenya. Yet, Kenya exports are concentrated to a narrow range of mostly semi-processed products that fetch low prices in the international market. Coffee and tea provide 45 percent of the wage employment in agriculture, underscoring the importance of these sub-sectors to the economy. Despite its importance, coffee production has been declining from 130,000 tonnes in 1987/1988 to 54,340 tonnes in 2006/2007, and indeed, coffee accounted for only about four percent of Kenya's exports in 2010 (World Bank, 2010). According to a calendar adopted by the International Coffee Organisation, a coffee year runs between October to September the following year.

To promote industrial development in Kenya, the immediate challenge is to increase value addition in

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agro-processing and mining industries. This will form the seedbed for production of machinery and high technology-based products in the long run. In a natural, resource-based production, the lowest economic value is generated if the resource is sold raw or unprocessed. It is important and economically plausible to add value close to the sites of harvest or production if a country is to gain significantly from the products it exports. The harvesting, primary and secondary processing, packaging and shipment of minerals or agricultural produce, constitute the value chain in which a country may add value. By adopting the best technologies and practices, they can reduce cost, and preserve or increase quality through further local processing of exported products.

Structurally, the cut flower sector depicts an industry that performs much better compared to other commodities, in terms of employing efficient production methods, streamlining the markets process and adopting modern technology. Comparing the structures of the value chains in coffee and cut flower sectors may highlight constraints that stifle value addition in the coffee industry. This comparison uses Kaplinsky (2000) conceptual orientation that the proportion of world price that accrues to a value chain player is related to the number of value adding activities they engage in.

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OVERVIEW OF COFFEE AND CUT FLOWER SECTORS

Most coffee in Kenya is grown on small farms (1½ hectares on average), organised into co-operatives, and large-scale estates (15 hectares). Kenya produces Arabica coffee, mostly grown in the highlands that are between 1,400-2,000 meters above sea level. The main coffee-growing regions are areas around Mt. Kenya and other few areas that include Nakuru and Machakos. Coffee processing within the country has two levels: primary processing and secondary processing (milling). The

coffee is sold through auction process in the Nairobi Coffee Exchange.

Cut flower farming in Kenya is mostly by large and medium scale growers, though there are several small-scale growers with acreage of 0.16 acres, on average. Large and medium scale growers are mainly concentrated around Lake Naivasha, Thika, Limuru/Kiambu, Athi River plains, Nakuru, Eldoret, Nanyuki/Nyahururu and fewer areas around Mt. Kenya region. The small-scale farms are located mainly in Limuru/Kiambu region, Nyandarua and pockets in Laikipia, Western and Eastern provinces.

DIFFERENCES BETWEEN COFFEE AND CUT FLOWER VALUE CHAINS

There are major differences in coffee and cut flower value chains. This is especially so in relation to the way industry players participate in value adding activities and the way this influences the distribution of value added products among the actors in the two sectors. On average, small-scale coffee farmers receive seven percent of the market value (auction price), whereas the smallholder farmers in cut flowers receive at least 42 percent.

The first major difference is that the largest proportion of cut flower processing is done within the country and farmers are involved in almost all stages of the processing. However, farmers in the coffee industry are only involved in primary production, fully missing out in the crucial processing of coffee, mainly milling and roasting. Coffee roasting is done in consumer markets outside the country. The structure of the coffee market is such that, beyond milling where farmer organisations like cooperatives are involved, other processes are dominated by a few global corporations in the final processing and retailing.

Another difference is the inability among coffee farmers to sell directly to exporters or buyers at retail level. The Coffee Act (2001) recognises the auction method as the only legalised mode of selling coffee, which must be done through a marketing agent. This significantly reduces value addition at the farmers' level with millers and marketing agents receiving more than ten times what farmers receive. Though most of cut flower produce is done through

¹ HCDA categorize small scale (under 4 hectares), medium scale (between 10-20 hectares) and large scale (more than 50 hectares).

the auction outside the country, cut flower farmers have no restriction on whom to sell to and often sell to wholesalers and supermarkets in consumer countries and in individual retailers within the country. Thus, within the coffee value chain, there is lack of a clear mechanism that can facilitate the flow of information to farmers. There is no forum for marketing agents to give feedback to small-scale farmers regarding quality and auction prices of coffee.

Comparing the two value chains, it is notable that, given supervisory powers vested in the Coffee Board of Kenya by The Coffee Act, the coffee sector in Kenya is overly regulated. For instance, the Coffee Board continues to be the only licensing agent for millers and marketing agents.

There are many players in distribution and marketing of coffee and this possibly explains the long payment cycle for smallholder farmers. Similarly, the regulatory structure has made coffee farming expensive, as there are many taxes and licensing fees that farmers pay. These statutory charges include auction commission fees, the Coffee Board levy, county council 'cess' fees and contributions to the Coffee Research Foundation. These fees have played a role in suppressing the industry's growth. This observation corresponds with findings in the World Bank (2005) report. Therefore, excessive regulations in the coffee industry stifled value addition in the sector.

Given the scope of the regulatory roles of the Horticultural Crops Development Authority (HCDA) and Kenya Plant Health Inspectorate Service (KEPHIS), the regulations in the cut flower industry are relatively less restrictive.

The history of over-regulation in the coffee industry has a correlation with the poor performance of the sector in Kenya, illustrating that the choice to use statutory agents to regulate growth of the industry has had a negative impact on the sector. This necessitates policy reforms that will address how specific regulation affects distribution of the gains and value created within the value chain. This is in contrast to associations in the cut flower sector which have played an active role in representing the interest of cut flower farmers by lobbying the government on the business environment and instituting self-regulation for compliance to

standard specifications and conduits of information feedbacks.

FACTORS THAT INFLUENCE VALUE ADDITION IN THE COFFEE SECTOR IN KENYA

There are several factors, both in Kenya and at the global level that the coffee sector can leverage to increase value addition of coffee, as well as competitiveness of the product in the global market. The country still has soils and terrain, as well as climatic conditions that favour coffee production. Since 2003, road networks in the country have improved, new information communication technologies have sprung up and the political environment is generally stable.

The existence of a well-established cooperative movement and large private investors in the coffee industry creates huge potential of improving logistical infrastructure and inter-firm subcontracting. The availability of both a skilled and

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semi-skilled workforce in Kenya is important for the coffee industry, which is largely a labour-intensive sector.

Kenya Arabica coffee is globally acknowledged as high quality coffee. Further, coffee demand in Middle East countries, as well newly industrialised countries like China, is increasing. This has increased demand for coffee in the recent years, which has in turn resulted in growth in earnings for farmers and other players along the coffee value chain. Kenya's top grade coffee was, for instance, selling at over USD 400 per 50 kilogramme bag in January 2013.

While there are a number of factors that play in favour of the industry, it still faces a number of challenges. These have to be addressed to improve value addition in the industry. Poor governance and inefficiencies in cooperatives result in delays in

supplying inputs to farmers, credit processing and payment to farmers for their produce. High costs of fertiliser and pesticides has, in some cases, forced the farmers to reduce application of these inputs, resulting in delivery of low quality cherries and substantial loss of small cherries during pulping stage in processing. The farmers get their earnings once a year, making it difficult for them to meet periodic expenses they incur both at the farm and at personal levels. In addition, there is still tight regulation in today's Kenyan coffee sector. The regulations not only all require smallholders to process their coffee through a cooperative, but prohibit direct purchase from farmers. Farmers also have limited information on the coffee market and existing member associations are structurally weak to act as feedback mechanism to farmers.

Amidst these challenges, coffee production has gone down in recent years as farmers divest from the industry and eye what are perceived to be more lucrative industries. For instance, coffee growing in the periphery of major towns like Nairobi and Nyeri has slowly been transformed into real estate development, with the sector losing substantial acreage to high-rise apartments and residential homes.

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CONCLUSIONS AND RECOMMENDATIONS

The cut flower industry in Kenya is characterised by a number of features which result in the relatively large proportion of value added accruing to farmers. The vertically integrated value chain enables the sector to adjust and respond quickly to changing consumer preferences and international competition. The sector has invested heavily in new technologies (e.g. in greenhouses, machinery, irrigation systems and robust cold storage facilities), which enhances

value addition in the sector. The regulatory system plays a facilitative and largely supportive role, with the HCDA playing a very limited interventionist role in the value chain. The associations in cut flowers are not only strong lobbies but have developed self-regulating mechanisms like an industry 'Codes of Practice' that are benchmarked to international codes. The Fresh Produce Exporters Association and the Kenya Flower Council work closely with government in promoting an enabling environment conducive for development of the sector.

These developments in the cut flower sector contrast sharply with features that characterise the coffee value chain. The coffee sector in Kenya is excessively regulated, limiting the participation of small-scale farmers to just the farm level. Restrictive regulation has, over time, allowed opportunistic licensed marketing agents and the regulatory authority to take advantage of the smallholder farmer and maximise legally imposed fees that stagnate the industry. Inefficient operations by cooperatives have also played an essential role in the diminishing returns for farmers.

Consequently, value additions along the coffee value chain have been dismally low and skewed against the farmer who gets seven percent of the market value, which is hardly a tenth of what accrues at the milling and marketing stage in the value chain. In addition, the bulk of value added accrues at the roasting stage of the value chain.

Producer associations in the cut flower sector have played a key role in self-regulation, information dissemination and lobbying for a better business environment. This is unlike the associations in the coffee sector that lack ownership among small-scale farmers and have been ineffective in addressing the challenges facing the coffee industry.

² The value added at retail end of value chain may be possibly higher but comparison data was not available.

To improve value addition in the coffee sub-sector, the study recommends:

1. Implementation of new governance structures in cooperatives, millers and the Coffee Board of Kenya

There is need to restructure the cooperatives and coffee marketing institutions. The coffee sector can borrow the vertical coordinated networks model from the cut flower chain where farmers are involved throughout the commodity value chain, from the input stage to the farm level, and then to processing and marketing. This may involve transforming cooperatives to cooperate bodies with ownership remaining with farmers but management hired on a performance basis.

2. Regulation reforms to increase private sector participation

There is still tight regulation of coffee processing and marketing in Kenya. The Coffee Board of Kenya continues to be the only licensing agent for millers and marketing agents. The relevance of the Coffee Board should be revisited to allow greater dynamic role of the private sector in the coffee value chain. Specifically, individual farmers should be allowed to sell directly to consumer markets.

3. Networks and alliances formation among coffee farmers

The government should support formation of effective membership organisations that

self-regulate the coffee farmers in areas of compliance to standard specifications, environment preservation and integrity with respect to all stakeholders. This helps to improve levels of productivity, efficient use of inputs, uniform application of labour laws and enhanced quality of coffee.

4. Encourage coffee branding

Coffee branding through the Geographical Indication (GI) for single-origin coffee is a relatively new concept that could improve value addition along the supply chain. Coffee branding according to the zones of origin widens the market through segmentation. The farmers could use coffee branding to strategically position themselves, through partnerships, and reduce price spread between producer and retail level. This may be achieved through joint ventures in investment that allows local roasting and packaging of the product before exportation. Further, the partnership can take the form of contract farming. Contract farming has ancillary benefits in the form of credit arrangement for critical inputs and may also embrace insurance schemes. For such developments to be useful to farmers, the government may need to play a role in mediating and establishing the ground rules for these arrangements. The government also should pursue aggressive marketing of Kenyan coffee and offer fiscal incentives to encourage foreign investors to engage in contract partnership with coffee farmers.

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³ Starbucks to Sell Exclusive Rwanda Coffee In Europe,' PLANET ARK, 10 March 2008