Discussion Paper:

Smart Subsidies in Market Facilitation

With a Focus on Agricultural Knowledge and Information Systems (AKIS)

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Table of Contents

Introduction

The Market Facilitation Initiative (MaFI), a working group of the Small Enterprise and Education Promotion (SEEP) Network, promotes learning and peer support amongst practitioners for facilitation of pro-poor market development programs that aim to achieve sustainability and impact at scale. It also assists practitioners in moving from design to implementation by advancing principles, techniques, and tools.

In 2008, MaFI developed three sub-groups to focus on specific topics within market facilitation: horizontal and vertical linkages, capacity-building, and subsidies. The Subsidies Working Group aims to share and distil experience and advance practical principles, techniques and tools on whether, when and how subsidies can be used to improve the livelihoods of poor people. As an initial step, the group agreed to focus on the use of subsidies for the promotion of sustainable agricultural knowledge and information services. and their relevance to pro-poor market development within the agricultural sector This reflects the rural focus of many of SEEP's member agency and the weakness of many agricultural markets. The application of subsidies is particularly relevant to agriculture as traditional practice has been heavily subsidy-dependent. Agricultural Knowledge and Information Systems (AKIS) is used throughout the paper as the area of focus. AKIS is any type of knowledge or information (such as skills. techniques, prices, principles, suppliers.

pest control and markets) that is useful to enhance agricultural enterprises (and thus the livelihoods of those people who depend upon them).

This document is a synthesis of discussions between Subsidies Working Group members around a draft document circulated on October 15th, 2009. It presents a definition of subsidies, touches on key principles of subsidy use, tips for implementation, central questions and challenges, and issues specific to AKIS.

The objective of this document is to spur discussion, reflection, and the contribution of case studies to illustrate the application of subsidies in the field amongst MaFI members and more broadly amongst other development agents and researchers. We anticipate that this will in turn contribute to a more effective use of subsidies in pro-poor market development. AKIS is used as a reference point in the paper given the widespread use of subsidies and unique characteristics (in terms of public investment policies) within this sector.

Towards a Definition of Subsidy

Defining a subsidy is made difficult by the diversity of terms used by practitioners. These include: *incentives*, *buying down risk*, *investments*, *smart subsidies*, *risk capital*, *grants*, and *start-up capital*.

Subsidies are a mechanism for reducing the cost for a market actor, through *cost-sharing* with a development agency, in order to achieve a particular development objective. Subsidies promoted or provided by development agencies are therefore considered to be *investments* to bring about a desirable result – whether or not they lead to *systemic changes* that permit their eventual discontinuation. That "desirable" result could be political (e.g. to get votes, increase national food security) or developmental (e.g. to level the playing field, reduce exclusion, inequality and discrimination).

Experience has shown that well-placed "investments" that stimulate innovation, access to essential services and improved business practices are often necessary to catalyze systemic change. They may be provided anywhere in the system, be time-bound and intended to bring a sustainable desired change.

In contrast to such time-bound interventions, which are used to kick-start a change, are the provision of on-going cost-sharing services to cover recurrent costs of market actors. These are commonly called "subsidies". Examples include publicly-funded extension services, grants to farmers, and discounted charges for vulnerable consumers. Such interventions tend to be very costly and distort markets to achieve a desired political or social result. For those working to promote pro-poor market development, the capacity of such subsidies to promote greater inclusion of the most vulnerable is appealing. But there is an awareness that the high recurrent costs of such subsidies limits their widespread and recurring use except in wealthier economies. This raises the question: How can subsidies aimed at addressing socio-economic inequalities, or promoting greater inclusion, be made "smarter" – i.e. be time-bound and contribute to systemic change?

Key Principles for Subsidy Use

The following statement, made with reference to working with lead firms, provides a good reminder that there are no principles that are always effective:

> *In general, there are no cost-sharing mechanisms that are always good, under all circumstances. Some, however, will generally be more attractive, and carry within them less potential for problems. Judgment, prudence, transparency and negotiation are always called for when identifying and implementing cost share agreements. The purpose of subsidy (cost share) is to mitigate risk and build capacity, thereby supporting innovation and change. There are limited hard and fast rules.*[1]

Thus while there are no universally-applicable rules for subsidy use in market facilitation, some general principles for facilitation include:

- Avoid subsidies wherever possible; use only with a clear vision for how they are necessary to achieve systemic change systemic change
- The better the facilitation, the less need for subsidies: strive to create conditions where market actors recognize business opportunities and pursue them independently of external subsidies.
- Consider the negative consequences of unnecessary subsidies (e.g. destruction of private businesses, dependency mentality, blockage of endogenous resources and creativity) and adopt a "do no harm" approach.
- Be aware of risk management and use subsidies to reduce the risk that market actors face (particularly as early adopters of a new technology or service), as long as it does not detract from sustainability or create dependency.
- Prefer subsidies to strengthen the demand or supply markets, rather than subsidizing the transaction itself. Use subsidies to link marginalized producers to market actors who can provide services and inputs on a sustainable basis (rather than the facilitator providing such services).
- Develop and implement strategies for promoting ownership by market actors.
- Understand who is going to perform and pay for the function that you are subsidizing following the period of the subsidy.
- Be as invisible as possible; try where possible to make your role as facilitator invisible to others in the market.

Applying subsidies:

- Select the *type* of subsidies to be used (e.g. development / production / promotion / provision / consumption of a service) based on the intended target group.

[1] FIELD Facilitation Brief No 3: Structuring and Managing Collaboration with Lead Firms (2009).

- Despite the final aim of development agents being to benefit the most marginalized actors, subsidies should be used to improve the structure and dynamics of the market system (e.g. a relationship between a credit provider and a local para-vet) in ways that redress inequalities and exclusion, and widen access to productive resources (financial, physical, human, etc).

- Recognize that the ones who need the subsidies are not always the "poorest" (see principles above).
- Encourage strategies of self-targeting (i.e. those who want to participate take one step forward).

Justifiable subsidies include:

- Facilitation itself (i.e. *temporary* external intervention by non-market actor)
- Capacity-building activities (mainly to unlock the market system, such as capacity to explore new business opportunities)
- Initial training and demonstration activities to generate evidence of impact of a new business model, technology or technique (e.g. learning visits, trade fair attendance)
- "Ice breaking": Activities to link market actors to new markets, buyers, suppliers, policy-makers, etc., with the objective of giving them opportunities to explore new ways of doing things (e.g. business or organizational models, technologies and techniques)
- Market research and feasibility studies to demonstrate the viability of doing things in a different way (e.g. opening a new market, forming a farmer organization, coordinating collection and transport, introducing a new technology or technique)
- Technical assistance for exploratory R&D (e.g. research and development to build evidence of new business models, technology)
- Group formation

Subsidies that are difficult to justify include:

- Recurring operational or working capital costs of a market actor, including personnel costs
- Physical assets (e.g. buildings or machines), except when subsidies can stimulate communal infrastructure (eg collection centers) that can catalyze change for many actors
- "Operational knowledge" (i.e. knowledge that is needed to produce or operate)
- Generally, those that lack an exit strategy

Tips for Implementation

- Identify public and private market actors who have the incentive to provide target services or products and support the development and testing of models for sustainable provision
- Always co-invest with market actors (i.e. match investments made by others)
- Find supporting market actors who can take responsibility for specific educational activities.
- Identify the purpose and target of the subsidy and communicate that information clearly.
- Only use time-bound subsidies, with a clear timeframe for the termination of the subsidies. Transition subsidies out over time.
- Remember that there are many non-financial reasons for non-investment by value chain actors. Identify these systemic constraints and work to address them.
- Ensure that market actors are primarily motivated by market incentives, not subsidies
- Subsidize as small a portion of the total cost as possible.
- Explore with market actors the possibility of embedding the cost of services within existing transactions already taking place. This is in effect an alternative to subsidy by a development agency – provision of a service by a market actor who is already trading with the client, but charging the cost within the terms of their other transactions. (e.g. a veterinarian including technical assistance on animal husbandry or marketing within the price of the veterinary treatment, or a microfinance institution including the cost of financial education in its interest rate).
- Making subsidy support contingent upon demonstrated financial or other commitment from the market actors allows for self-selection, which enhances the chance of success and sustainability of impact. (But may exclude the more disadvantaged)
- Use subsidies to get things going and only for a limited time to help market actors "feel" the impacts of new ways of doing things and to help them establish needed capacity and systems.
- Have a clear exit strategy
- Before introducing the subsidy, practitioners must identify and have plans for a long term solution for meeting those costs (e.g. a new loan product from an MFI)

Agricultural Knowledge and Information Services -Specific Subsidy Considerations

- Input suppliers (retailers or sales reps), outgrowers with a contractual selling agreement, or occasionally marketing cooperatives have been proven to function relatively well as sources of AKIS.
- The effectiveness of government-provided extension is usually limited by lack of performance incentives, information gaps between final users and extension agencies, researchers' misconceptions about marginalized farmers, and lack of influence of farmers on government agencies.

- Extension messaging provided through radio has proven difficult to operate commercially, rather it usually needs ongoing subsidy, or commercial sponsorship (e.g. from input supply company).
- The need for AKIS is ongoing (usually intermittent rather than every day), not one-off. Thus sources of AKIS should not be project-bound, oriented simply towards reaching a certain level of productivity improvement during the life of the project. Rather there should be ongoing processes of production, communication, access and use of AKIS.

Central Questions and Challenges

- Blanket provision of subsidized services or inputs can reduce effectiveness because they aren't targeted to those who are in need or can make effective use of the service or input. How can a high rate of self-selection amongst market actors be ensured and what is the role of subsidies in its achievement?
- Should we disclose to a group of stakeholders that we do have funds to subsidize services or inputs or should we keep this to ourselves until all non-subsidized alternatives have been explored? How does this affect the ideal of self-targeting?
- Subsidized services can exclude recipients from having a voice in what services they wish to obtain. What can we do to get those voices heard before subsidies are used? How to manage expectations that we want to hear their voices because we want to give subsidized of free stuff?
- If the targeted group is very disadvantaged, how do you meet the cost of training, group formation or other services? Should the market be expected to cover these additional social functions? What strategies have worked well to facilitate access to AKIS in areas that lack at least a moderately strong private sector (input suppliers or purchasers)? Is direct provision by a facilitator ever defendable in the short term?
- What methods have been found most effective to increase the quality of publically-provided AKIS? Are there experiences of this evolving into a viable option for remote smallholder farmers?
- Given that governments have always played a more interventionist, subsidizing role in AKIS than in most other livelihood sectors and are likely to continue to do so, where should we focus our subsidies?
- How do we co-ordinate / complement / mitigate the possible conflict of other AKIS – public or private –that have different subsidy practices with the development of a market for AKIS
- How can ineffectual public extension services be improved, particularly in cases where inadequate infrastructure and adverse structural incentives limit its effective operation?