Briefing on the Agribusiness Enabling Environment

AgCLIR LESSONS FROM THE FIELD: PROTECTING INVESTORS

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The business of agriculture occupies a critical space in most economies. Distinct and special among industries, agriculture is the dominant source of employment for a large share, even a majority, of the population in developing nations.

Accordingly, governments treat the regulation of agriculture and food differently than any other sector. Unlike the output of other sectors, many agricultural products are basic necessities: agriculture provides the food, fiber, fuel, and construction materials necessary to sustain human existence. Governments everywhere assume responsibility for assuring that the distribution of agricultural commodities is great enough and equitable enough to provide a reasonable quality of life for its citizens.

Agriculture and Agribusiness: Protecting Investors is a briefer that mirrors the analytical framework used by the World Bank Group's "Doing Business" series (www.doingbusiness.com) and adopted by *USAID's Business Climate Legal and Institutional Reform Project* (www.bizclir.com). Divided into four sections (Legal Framework, Implementing Institutions, Supporting Institutions, and Social Dynamics), this briefer highlights the specific issues that must be addressed in local legal, regulatory, and institutional environments if agribusiness is to be economically productive, contribute to environmental sustainability, and assure a safe and reliable food supply.

INTRODUCTION: KEY CONCEPTS

Agricultural enterprises have a number of options for raising capital to pay for their inputs, equipment, and other costs of growing a business, most of which are appropriate instead of—or in addition to—seeking a loan from a bank or other lender. Of course, each option carries not only the promise of economic gain, but also the risk of loss. The more that investors feel that they are protected against loss—particularly the kind that can be prevented through better information, more thorough scrutiny of an enterprise's financial history, and faster access to prompt and fair dispute resolution—the greater the possibility that they will invest.

First, at the grassroots level, individual farmers with relatively few resources may pool their capital as **cooperatives,** or, as referred to in many countries, "farmer-based organizations" or "associations." In general, cooperatives are businesses owned and controlled by the farmers who use their services. *Supply cooperatives* supply their members with inputs for agricultural production, including seeds, fertilizers, fuel, and machinery services. *Marketing cooperatives* are established by farmers to undertake transformation, packaging, distribution, and marketing of farm products (both crop and livestock). Farmers may also rely on *credit cooperatives* as a source of financing for both working capital and long-term investments. Cooperatives can play an important role in rural communities, where they encourage democratic decision-making processes, leadership development, and education.[1]

Second, agricultural enterprises—whether they are independent local producers or outsiders who aspire to develop business opportunities in the sector—can seek capital,

1 United States Department of Agriculture, *Agriculture Cooperatives in the 21st Century* (November 2002), at v.

whether in the form of money, equipment, or other valuable contributions, from **private investors,** including individuals, firms, and outlets of "venture capital." There are many examples of successful investments in agriculture throughout the developing world, and they exhibit certain key traits that provide lessons to others. These include the investors' willingness to invest for the long term, rather than to require immediate dividends; the use, in certain contexts, of a "nucleus" farm model that contributes to greater quality control on out-grower farms; creative use of public-private partnerships, including seed agencies, international manufacturers, farmers cooperatives, and others; a well-functioning legal system; a commitment to international standards in corporate governance, bookkeeping, and other business practices; and careful understanding and development of markets. However, due to the high degree of risk in agriculture—often compounded by poor seed, irrigation, transportation, infrastructure, and land rights—the availability of capital investments in agricultural enterprises may be low. Encouragement of investment in agriculture requires a multifaceted effort to reduce or control such risk.

Third, larger or especially ambitious enterprises may seek capital by offering shares to the public through a national **stock exchange.** Although public trading of stocks (also called "securities") usually appeals to larger, existing enterprises that seek to build capital (as opposed to most small and medium-size enterprises (SMEs)), public ownership should not be overlooked as a future destination for growing agricultural enterprises that are fundamentally strong and have demonstrated the potential to do even better. There is a range of public ownership models throughout the world. In some less-developed countries, particularly those engaged or recently engaged in conflict, there is no stock exchange at all. In several transitioning economies, a stock exchange has been established in recent years, often as a mechanism to privatize formerly state-owned enterprises or to otherwise attract foreign investment. In still others, such as India, Indonesia, Kenya, and a number of Latin American countries, there are dynamic, thriving stock exchanges that have been in place for many years.

Under typical cooperative, company, investment, and securities laws, investors are provided with a number of important rights. *Doing Business* distinguishes three dimensions of investor protection: transparency of the company's transactions, particularly those directly aimed to enrich company directors; liability for self-dealing of directors—specifically, the means by which they can reduce the value of the company rather than increasing it; and the ability of shareholders to sue officers and directors for misconduct. As in any area of the law, protections of rights are only as strong as the institutions that support them. Key institutions include local, regional, and national cooperative societies; investment agencies; securities regulators; courts and other legal institutions; and such ministries as agriculture and commerce or trade. Vibrant systems of professional services and associations, higher education, and media are also critical components of a healthy investment environment.

LEGAL FRAMEWORK

Access to laws and information. The demands of the global economy require a paradigm shift in many developing countries—one that welcomes and responds to the search for law and information, rather than mistrusts or dispels it—and in recent years this has been realized and acted upon to varying degrees. In short, there is more demand now than ever for current, verifiable, detailed, and thorough information about all aspects of economic activity, including opportunities in agriculture. In general, governments and private companies must provide ample access to laws and information; accurate statistics, including those pertaining to agricultural production and trade; reliable profiles of existing companies; credit information; court records; financial profiles of public officials; accurate media and academic analysis; and so forth. Without prompt and meaningful access to information, potential investors and traders are likely to search elsewhere for their business opportunities. Moreover, as a matter of practice, where governments and private companies endeavor to place their laws and other information online, they must also have a plan for keeping that information updated and current.

The law of cooperatives. Unfortunately, in many developing countries, the history of cooperatives is one that discourages confidence in the model as a promising investment opportunity for small producers. In many African countries in particular, cooperatives were initially established to serve colonial powers, and, by the mid-twentieth century, strict government controls over cooperatives broke down the confidence and trust of their members. The law of cooperatives in many developing countries now tends to be outdated or has essentially been abandoned as a structure for new agricultural enterprises: farmers instead often choose to join forces as formal companies or non-government organizations. Farmers working cooperatively also often remain informally organized, thereby forgoing the many benefits of entry into the formal economy.

A modern cooperative law that conforms to international best practices—particularly with respect to governance and management of the cooperative—is desirable but not essential for service and marketing cooperatives to be established and to function as they should. Nor is the existence of a cooperative law, in itself, sufficient for cooperatives to prosper.[2] Agricultural cooperatives can function where there is a sound law of contract and a viable system of dispute resolution, as well as a healthy respect for the rule of law. Most important, cooperatives require an atmosphere of trust, bolstered by formal tools of accountability.

Company law and corporate governance. Sound company law, which typically establishes the rules of corporate governance, is critical for post-conflict and transitioning economies that seek growth through expansion of their agricultural enterprises. Sound company law and practices protect investors—and encourage new investment—by establishing clear rules for the stewardship of enterprises and providing enforceable standards to protect shareholder rights and access to information. They can also bolster the country's reputation as being investor-friendly. As stated in the introduction to South Africa's corporate governance code, "If there is a lack of good corporate governance in a market, capital will leave that market with the click of a mouse."

Corporate governance is meant to foster efficient decisions that benefit a company's investors while discouraging insiders, such as majority shareholders and managers, from expropriating the assets of the firm or acting contrary to the interests of shareholders. Under most new company laws, duties of care and loyalty on the part of company directors are often firmly established, with rights of shareholder redress clearly delineated.

2 Henry Hagen, *The Creation of a Supportive Environment in Theory and Practice: Cooperative Law. Is it Necessary; Is It Sufficient for Cooperatives to Prosper?* (June 2002).

A sound law further establishes clear shareholder rights in decision-making processes, along with the ability of investors to propose changes in operations. Protections for smaller investors from possible unfair treatment by larger shareholders, and rules enabling investors to sell or transfer their shares, are also needed. Countries seeking to bolster their commitment to corporate governance should not only update their company laws to conform with well-established international best practice, but also support and promote private codes of conduct within the business community and individual sectors.

Company law and corporate governance is an area in which international best practices are well established and outside guidance and insight is freely available. One easily accessible benchmark is the Principles of Corporate Governance long established by the Organization for Economic Cooperation and Development (OECD). Decision-makers who attempt to defend deviations in their laws from these international standards rarely have the proverbial "leg to stand on"; ultimately, they do their country a disservice if they seek to avoid protections that favor transparency and accountability and discourage management secrecy or malfeasance.

Investment law. Most potential investors—both foreign and domestic—look first to a country's general economic opportunity and evidence of respect for the rule of law. For agricultural enterprises, potential investors also look especially at trade-related systems—specifically, the time it takes to transport raw or processed goods to market, often across international borders. They also look at the environment for licensing, including licensing for seed, fertilizer, and food-processing, as well as food safety regulations and enforcement. Thus, the existence of a stand-alone investment law is not critical. Nonetheless, many countries find that an independent law spelling out investor protections and incentives is one way that they can build confidence in their respective business environments.

A sound investment law typically provides for convertibility and foreign repatriation of profits, loan service payments, royalties, and similar items; for prohibition of nationalization or expropriation of investments without fair and prompt compensation; and for dispute settlement by arbitration. Investment laws also typically set forth incentives for investment in certain enterprises or sectors, including tax holidays and other benefits.

Furthermore, investment laws often provide for the creation of an investment agency dedicated to smoothing the way for both domestic and foreign investment into a country's various sectors of opportunity. A best practice that has evolved is the creation of a "one-stop shop" for investment—that is, an agency that helps investors obtain necessary permits, authorizations, approvals, registrations, consents, licenses, and any other matter required by law. In addition, investment agencies are often charged with connecting potential investors with local opportunities through promotion of key sectors, maintenance of statistics, and general information-sharing. Experience shows, however, that even in countries where agriculture employs more people than all other sectors combined, agriculture can be underserved by investment agencies, which often favor sectors with less perceived risk, such as construction, tourism, or trade.

Moreover, there is a surprising degree of resistance in some countries to the creation and implementation of a "one-stop shop." Particularly where there is a high level of state corruption, such agencies can be perceived as closing down opportunities for officials in other bureaus to collect the "informal fees" to which they historically have considered themselves entitled.

Securities law. Countries that seek to support the raising of capital through public ownership do so according to securities laws, which typically allow for the creation of one or more stock exchanges and, in turn, provide for their regulation and oversight. Where there is a stock market, there should also be clearly defined rules of corporate governance of publicly traded enterprises, whether through the securities law or a stand-alone code of conduct. To that end, securities laws tend to "overlay" or supplement company laws in the area of corporate governance. The institutions charged with oversight of stock exchanges—often known as "securities and exchange commissions"—must be properly funded and their staff adequately trained, or the potential of public ownership will not be realized. Shareholders too must be informed of their rights and responsibilities, while judges and other key decision-makers must be trained to understand and enforce the law.

Special economic zones. Many developing countries have established laws that create "special economic zones" or "free zones" that aim to encourage investment, particularly where the goods produced are bound for international markets. These zones can be especially beneficial to agricultural enterprises because they combine many different government functions and services into a single geographic area. These include not only food health and safety inspections, export licensing, and customs administration, but also such key resources as electricity, water, cold storage, and access to ports. Laws supporting special economic zones also may provide tax incentives and exceptions from certain labor laws. Where special economic zones are run properly, they diminish various risks of investment, especially in agricultural enterprises.

IMPLEMENTING INSTITUTIONS

The rights afforded by law are only as strong as the institutions that support them. The core set of institutions charged with protecting the rights of investors in agricultural enterprises generally includes the following: the Ministry of Agriculture and other key economic ministries; private cooperatives and the agency charged with overseeing them; the company registrar; the investment promotion agency; the securities and exchange commission; and the courts and other dispute resolution agencies.

Ministry of Agriculture and other key economic ministries. In many countries, the Ministry of Agriculture is a large, far-flung organization that is engaged in a vast number of activities aimed at supporting agriculture, including extension services, livestock control, seed development, regulation of fertilizer, food health and safety, and many others. Too often, the ministry is viewed as a bureaucracy that presents more roadblocks than benefits. When run properly, however, it can make a tremendous impact on the way that investors view opportunities in agriculture. The better a country's seed, fertilizer, and farmer know-how, the better the product and the less risk presented to potential investors. Other ministries, such as those overseeing trade, commerce, and infrastructure, should also view their mission as that of supporting opportunities for private enterprise, rather than obstructing efficient access to markets.

Cooperatives. The cooperative model holds enormous potential for domestic agricultural enterprises, but it also can be enormously challenging to implement. Specific roadblocks often include low rates of literacy and capacity among farmers; insufficient levels of trust among members of a cooperative; inconsistent treatment of agricultural contracts among members; and overall ambivalence about the role of cooperatives, based on local culture or history. Investors in cooperatives—that is, small producers who are members of cooperatives—often are not especially well protected, given the typically unpredictable and informal operations of most rural cooperatives.

Standards of corporate governance should apply not only to enterprises organized under traditional company laws, but also to enterprises organized as cooperatives. A workshop in 2007 sponsored by the United Kingdom's Department for International Development (DFID) and others on "Corporate Governance and Cooperatives" found that:

> [G]overnance problems that plague cooperatives also account for their poor reputation and neglect by policymakers and the wider public. Among the most salient governance problems…are those of confusion on the role and mission of the cooperative, the entrenchment of power elites, conflicts between the principles of profitability and the social objectives of the cooperative, opacity in decision making, weak oversight and control mechanisms, and lack of clear rules on how to adapt strategic objectives to changes in the market environment, particularly those stemming from a global economy.[3]

Thus, public agencies charged with overseeing cooperatives typically have their work cut out for them. The support they receive from government and donors, however, tends to be surprisingly minimal.

Company registrar. A commitment to abide by standards of corporate governance, thereby lessening risk to investors, begins with an enterprise's registration with the company registrar. This agency, which is often the first major point-of-contact for all enterprises seeking to do business in the formal sector, has the ability to influence corporate governance from the inception of an enterprise. Namely, the strongest company registrars provide access to information about the obligations of governance and may even work with local chambers of commerce and other entities in promoting awareness of this key issue.

Investment promotion agency. A well-run investment promotion agency serves as a "gateway" for domestic and foreign investment and joint ventures and, as noted earlier, is most effective when acting as a "one-stop shop" for investors. There is little excuse for the website of an investment agency to be inactive or out-of-date—maintenance of a thorough web presence, which includes relevant laws, statistics, and sectoral information, is a straightforward and inexpensive way for countries to present their opportunities to the outside world. As also noted, however, the agricultural sector is often overlooked by investment agencies, which may perceive greater potential payoff from other types of investments. Agricultural organizations, cooperatives, and even the Ministry of Agriculture should work with the investment promotion agency to understand and promote opportunities in agricultural investment.

Securities and exchange commission. The establishment of a stock exchange requires the resources and knowledge to support robust enforcement of securities law. Where potential investors perceive that the securities and exchange commission is monitoring the statements of publicly traded companies and acting when there is evidence of malfeasance, they are more likely to invest in the stock market (which almost always includes several agricultural enterprises, including breweries, dairies, horticulture firms, and other major food processors and traders). If enforcement and accountability is lacking—as evidenced by poor maintenance of statistics, company statements, and other key information, not to mention financial losses—investors will seek to place their money elsewhere.

Courts and other venues of dispute resolution. Modern company law gives courts and alternative dispute resolution agencies a significant role in protecting and enforcing the principles of corporate governance and in resolving disputes that arise between economic actors. Given this role, it is very important that judges, arbitrators, and other key decision-makers understand their responsibilities and receive adequate training in the law of contracts, company law, and corporate governance. The following factors often contribute to a positive environment for dispute resolution, which, in turn, reduces perceived risk on the part of investors:

- The creation of a well-resourced commercial court or commercial section of the regular courts, and, equally important, access to these courts in agricultural areas;
- The growth of alternative dispute resolution (ADR) mechanisms, including both arbitration and mediation, particularly those that allow for fast resolution of disputes involving highly perishable agricultural goods;
- A well-established community of valuation and accounting professionals; and
- A strong legal community, for which continuing education in commercial law is of high quality and is readily available.

SUPPORTING INSTITUTIONS

The health of an investment environment can be gauged to a significant degree by the availability and quality of information and professional services in a given community. Among the key supporting actors that reduce risk to investors are the institutions listed below.

Professional services and associations. Investors in agricultural enterprises—particularly well-resourced foreign investors—will seek access to a strong cadre of professional services, including lawyers, accountants, valuation professionals, and others. Lawyers and law firms should be able to provide services that help investors meet their needs for more market information, for understanding and taking advantage of investment incentives, for assuming their regulatory obligations, and for handling international transactions.

Many professions, however, including law, banking, accounting, and others, lack broad-based expertise in the area of agriculture specifically. Thus, perceived investment risks may be cited as reason for not going forward with loans, investments, or enterprise growth plans, even though, as summarized by one agricultural economist in Ghana, "risks of agriculture can be over-exaggerated" and, particularly among people who understand the sector,

3 DFID/CIPE, Global *Corporate Governance Forum, Corporate Governance and Cooperatives: Peer Review Workshop,* London (February 8, 2007).

"they can be managed and minimized." Law schools in developing countries often teach very few courses—other than land law—that speak directly to concerns of the agricultural sector. Similarly, bankers often lack training in special products or risk-minimizing tools pertaining to agriculture.

Associations of businesses and professions can have an important impact on the quality of an investment environment. Chambers of commerce or other business associations can play a watchdog role over information promulgated by the government and, through regular publications, keep investors apprised of industry developments against which they may benchmark individual firms.

Universities. Investors in agricultural enterprises can be well served by educational institutions, including those that train food scientists, agronomists, and other specialties, such as commercial entrepreneurs. In the area of agricultural production, universities can work directly with farmers, accessing them for internship opportunities and for exchanging experiences and expertise.

Media. Newspapers, radio, and TV stations can serve as a powerful influence on the quality of an investment environment because they have a direct impact on the quality of information available in an economy. In many developing countries, however, even where the media is permitted to deliver the news freely and without censorship, the quality of reporting on business news generally, and on agricultural matters in particular, is not considered especially strong.

Media can also be used to assist farmers in better understanding the use of their inputs and in maximizing productivity. For example, short radio and television ads may be used by investors to explain in local languages how farmers can best cope with weather and other conditions.

SOCIAL DYNAMICS

There are many social, political, and cultural issues that influence the extent to which a society feels obliged to protect private investments in agricultural enterprises. These issues often relate very closely to local context; accordingly, development professionals must strive to understand and integrate these considerations. For example, as noted, the twentieth-century history of cooperatives may have a strong bearing on whether that model can serve as a positive mechanism for investment in the short term. Similarly, current political winds may influence a country's hospitality to foreign investors. The relative education of a populace, the availability of English as a second language, and access to professional services for investors may further impact the extent to which a private investment or investment in a stock market will be successful.

All investors should be aware that, to realize meaningful returns, investment in agriculture takes time. Those who succeed in agriculture—and the institutions that support them—exhibit clear awareness that time is a critical input, without which high productivity and consistent access to markets cannot be achieved. A country's search for investors must underscore the fact that investment in agriculture is not for the impatient, but that the government will support those who make the long-term commitment, through healthy and honest institutions, tax holidays and other incentives, and institutional preparedness when the time for trading or exporting arrives.

About AgCLIR:

AgCLIR is a unique agribusiness enabling environment diagnostic that provides a comprehensive method to diagnose the root causes and inefficiencies of an underperforming agricultural sector. AgCLIR is one of a series of sector specific diagnostics produced under the USAID BizCLIR project. BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development (USAID) with the goal of improving the business enabling environments through sound analysis and strategic interventions. This series, Briefings on the Agribusiness Enabling Environment is intended to shed light on some of the most important, and least understood, components at the intersection of agribusiness and commercial law and institutional reform. All issues are available at www.bizclir.com.

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