

From Statutory to Private Contracts: Emerging Institutional Arrangements in the Smallholder Tea Sector in Malawi

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This case study addresses the issues of institutional change and the need for collective action in a commodity, tea, which requires high fixed investment in processing facilities. In the wake of political and economic changes, the case study illustrates how asset specificity and commodity characteristics facilitate vertical integration as discussed in Chapter 5 and how exogenous changes have influenced institutional arrangements and contract enforcement in the Malawian tea industry. The case study raises such issues in contract farming as enforcement of contracts and compatible incentives when the state is a major player, and it shows the consequences of state failure, an issue that is discussed further in Chapter 20.

Tea was Malawi's main export crop in the 1960s and 1970s but has recently fallen to the third most important export-earning commodity. Prior to the country's independence in 1964, tea was grown only on estates owned by expatriate-owned and multinational corporations. The estates are vertically integrated, owning both tea plantations and processing facilities. After independence, the state intervened to open up the industry to smallholder farming through outgrower schemes, managed and coordinated by a purpose-built state enterprise. The state enterprise was essential in facilitating the vertical integration of the smallholder sector in the supply chain, by coordinating smallholder output from production to marketing. However, because of problems created by the inefficiencies inherent to state enterprises, the state-coordinated system collapsed, and the state could not honor its obligations to smallholder farmers. As a result of problems of contract enforcement, smallholder farmers are

now seeking new ways of directly engaging with commercial estates in the marketing of green leaf and of gaining access to an array of agricultural services. It appears that there is incentive compatibility between the estates and smallholder farmers in the short- to medium-term, which enhances enforceability of contracts, as discussed in Chapter 4. On the one hand, estates demand smallholder clonal tea (which is of better variety) to improve the tea quality and capacity use of their factories, as they are replanting their seedling tea with clonal tea. On the other hand, because of the technological and commodity characteristics of tea, smallholder farmers require a reliable market for the perishable green leaf.

Tea farming has special characteristics that necessitate state intervention and institutional arrangements. Tea farming requires high fixed investment for production and processing, and it also requires large economies of scale in factory operations. Tea bushes have a 5-year period to full maturity for farmers to start plucking at economic levels and a short time span between harvesting and processing. At the farm level, cultivation requires continued financing to pay for inputs and labor. At the processing level, a steady flow of green leaf is required to support expensive specific investments in processing plants. Thus the tea industry makes major financial demands at the establishment stage that cannot be met by capital-constrained smallholder farmers. In such cases, the market may limit the participation of smallholder farmers in a high-value export crop.

Such market failures have often been addressed through state intervention. In agriculture, outgrower schemes and contract farming have been justified as institutions that address market failure in similar cash crops (Key and Runsten 1999; Kirsten and Sartorius 2002). Governments have created outgrower schemes with special institutions to link the smallholder growers with private multinational companies. Private firms that opt not to vertically integrate use contract farming to obtain raw materials for processing or marketing to reduce transaction costs and minimize supply uncertainties. Kirsten and Sartorius (2002) argue that contract farming can become an important institution for empowering poor smallholder farmers in developing countries and can improve their access to technology and high-value markets. Singh (2002) also notes that contract farming leads to increases in incomes in agriculturally backward regions.

8.1 Methods and Data

The structure of the smallholder tea sector is a good example of market coordination through vertical integration that is conditioned by asset specificity and commodity characteristics, such as perishability of green tea leaves. Smallholder tea farmers enter into a relational contract with either a state enterprise or private commercial farm-

ers; such contracts can be formal, statutory, or informal. These relational contracts have evolved over time. In this case study we sought to understand the institutional changes that have taken place in the smallholder tea sector in Malawi and the socio-political factors that have led to such changes. To study institutional arrangements that involve processes (formal and informal rules of the game, some of which cannot be adequately covered using methodologies in economic studies), we used a combination of quantitative and qualitative research methods.

For the quantitative research, data were collected through questionnaire interviews with 190 smallholder tea outgrowers. The quantitative approach is more useful for understanding the existing economic conditions and management of smallholder tea farms but is inadequate for understanding the institutional changes. In contrast, the qualitative approach is more suitable for studying the nature of institutions and the drivers of institutional change over time. For the qualitative research, several tools were used, including focus group interviews with smallholder farmer groups, life histories of those farmers who have witnessed events over time, and interviews with managers of tea factories and commercial estates in two tea growing districts in southern Malawi. The face-to-face interviews and discussions with various stakeholders, in a historical perspective, helped us to understand the evolution of the smallholder tea sector, the institutional arrangements at different stages of smallholder tea development, the economic and political factors that led to changes in the institutional arrangements, and the relative performance of the sector under different institutional arrangements.

8.2 Political Economy of Smallholder Tea Farming in Malawi

8.2.1 Origin of Smallholder Tea and Institutional Arrangements

Smallholder tea farming in Malawi started through state intervention in 1967. According to TAML (1974) the response from Malawians to participate in tea farming was rather disappointing, such that by 1966 only 30.8 ha of land, mainly in Mulanje, were under smallholder tea cultivation. The government of Malawi purchased land for the introduction of tea to smallholder farmers, but in 1966 there was high demand from farmers to cultivate tea on customary land. This increase in demand led to the establishment of the Smallholder Tea Authority (STA) in 1967, as a quasi-commercial statutory corporation, to oversee the development of the smallholder tea subsector. STA was established by the Special Crops Act of Parliament to foster and promote the growing and marketing of tea by smallholder indigenous Malawians (STA 1998). STA was initially funded by the government

of Malawi, which provided extension services and field staff on secondment, and the Commonwealth Development Corporation financed the planting of 760 ha of smallholder tea between 1967 and 1971 in Phase I, and a further 1,660 ha in Phase II through a loan agreement (TAML 1974).

The big expansion phase of the smallholder tea sector occurred between 1970 and 1979, during which about 130 ha were planted per year and the total area under smallholder tea cultivation expanded from 287 ha in 1970 to 1,995 ha in 1980 (and subsequently to 2,902 ha in 2002; Chirwa and Kydd 2005). The average holding size was 0.5 ha, and the number of smallholder tea farmers rose to 4,904 in 1990 (TAML 1991).

Originally, smallholder green leaves were sold to tea estates that had factories, but farmers were paid by STA. However, with the expansion in the smallholder tea sector, it became apparent that the capacity of processing factories was not adequate to handle the volume of tea (TAML 1991). In 1975 the government established the Malawi Tea Factory Company, Limited (MATECO), as a joint venture of STA and the Agricultural Marketing and Development Corporation (ADMARC), in which ADMARC owned 40 percent of the share capital. MATECO was conceived as a commercially viable enterprise responsible for purchasing green leaf from smallholder farmers and marketing of processed smallholder tea. The high quality of smallholder tea and modern technology enabled MATECO to achieve prices well above the average prices for the industry (TAML 1991).

The transaction costs of dealing with small farmers were minimized by the organization of smallholder farmers into tiered groups (the organization of farmers into different groups varied from clubs to blocks to district committees). The smallholder tea growers were organized into area (blocks) and district committees consisting of five members in each committee elected by growers. The committees were responsible for selecting potential growers, informing smallholder farmers of policy decisions of STA, and advising and assisting STA in management through their representation on the STA Board (TAML 1974). The smallholder tea growers were under “statutory” contract to STA, such that all smallholder tea farmers were required to register with STA, and, by association, all smallholder tea farmers belonged to STA. There was no formal contract between STA and smallholder growers—the contractual arrangements were embedded in the statutes that established STA, in which smallholder farmers were voiceless on the terms of the contract and only trusted that the state would always work in their best interests. STA was accountable to the government of Malawi as one of the statutory corporations, and smallholder growers did not have any voice in policies affecting smallholder farmers.

The statutory contract obliged STA to provide services and benefits to smallholder farmers, including

- free tea seedlings financed by the government-sponsored development program under the auspices of the EU Export Earnings Stabilisation Scheme facility;
- input credit (fertilizers and chemicals) and expansion loans;
- market access to estate factories and a state-owned factory (STA purchased green leaf from smallholder farmers at predetermined prices, with the first payment usually made within 10 days from month end and the potential for a second payment, depending on the final market outcome);
- collection and weighing of the green leaf from smallholder blocks and transportation of the green leaf to the factories;
- extension services guiding smallholder farmers on tea farm management; and
- provision of maize on credit to smallholder tea farmers as an incentive to substitute tea for maize farming.

Smallholder farmers in return sold their tea to MATECO and estates through STA. The statutory contract was essentially a marketing contract in which smallholder farmers sold green leaf to STA at specified prices, with the farmer retaining full autonomy on production decisions, although the buyer provided inputs on credit and other incentive services.

8.2.2 State Failure and the Smallholder Sector Crisis

The performance of STA was initially satisfactory, especially in delivering services, between 1967 and 1985. This period coincided with the highest expansion phase in the smallholder tea sector. Nonetheless, STA never showed convincing evidence that it was financially sustainable. Financial performance was erratic, and it incurred losses, especially in the 1980s, with some intermittent recovery in the early 1990s. The financial position worsened in the late 1990s with a loss of US\$0.53 million. The deteriorating financial position led to massive debt accumulation by STA. By 2002 STA owed the government of Malawi US\$16 million and US\$14.7 million on loan interest payments and principal, respectively.

Several factors contributed to the poor performance of STA, including conflicting objectives that resulted in operational inefficiency (Kaluwa 1989; Lawson and Kaluwa 1996); overstaffing and mismanagement; growing political intervention in operational issues with the appointment of politicians on the boards of STA and MATECO; the labor crisis and disputes in 1992 that led to the introduction of

a multiparty political system, with the result that smallholder farmers demanded higher prices for tea; and increasing costs of fuel, leading to high transport costs of collecting green leaf (some smallholder farms were located more than 70 km away from the factory). The political pressure was more damaging in the less repressive multiparty political culture of the late 1990s. For instance, the vehicles of STA and MATECO were increasingly being used without compensation for political activities while smallholders' plucked green leaf was left wilting at the collection points. Most smallholder farmers believed that STA and MATECO had neglected their cause since the introduction of multiparty government in 1994, and therefore they did not trust that the organization was operating in smallholders' interest. STA and MATECO became more corrupt and were overstaffed with ghost workers and high levels of political interference. There was also neglect of equipment at the factory, and MATECO and smallholder farmers had no legal mandate to influence the management of STA (Chirwa and Kydd 2005).

These factors led to a crisis in the organization of smallholder farmers. STA failed to honor its statutory obligation of paying smallholder farmers in time for their green leaf, but farmers were powerless to enforce the statutory contract. Some farmers experienced delays of up to 6 months in receiving payments, although the factories had paid STA in time. These delays impacted negatively on the livelihoods of smallholder farmers—for most farmers, tea farming was their main source of livelihood. The input credit program that operated in the 1980s and 1990s collapsed because of the financial problems that led to the failure of STA to pay its debts. According to STA (1997), although loans were recovered from growers, the loan was not repaid to the financing company because funds were diverted to bonus payments in spite of the losses MATECO made in the 1995/96 financial year. In 1998, the financing company only financed 350.5 tons of fertilizers out of the required 616 tons.

The financial problems in STA also led to the erosion of the services that the organization was providing, such as input and maize credits and extension services. According to STA (1997), frontline extension workers were removed in the 1993/94 season, and the extension service was virtually nonexistent in the 1996/97 season. The quality of transport facilities eroded, and smallholder-plucked green leaf wilted because of delays in transport. The erosion of extension services and lack of inputs in turn led to a decline in the quality of tea leaves and low productivity in the smallholder tea sector. With deteriorating access to inputs and extension services, smallholder productivity slumped to 810 kg/ha in 2002 compared to 2,129 kg/ha on the estates (GoM 2004).

Most growers lost faith in STA and MATECO and started demanding changes in the statutory contract with the state-owned enterprises. Most growers sought alternative marketing relationships with other factories, especially with commercial estates.

The estates, though willing, would only deal with smallholders with the authorization of STA. Initially, estates were allowed to purchase green leaf from smallholder farmers around their estates, but the proceeds were paid to STA. Although commercial estates were paying STA regularly, smallholder farmers continued to experience delays in receiving payments from green leaf sales. This situation further strengthened the resolve of smallholder farmers to completely detach from their statutory contract with STA and MATECO.

MATECO lost most of the smallholder farmers to commercial estates, so that by 2002, of about 8,000 smallholder growers, only 800 were still selling green leaf to MATECO. With a reduction in the supply of green leaf, MATECO was only using 30 percent of its installed capacity. Its financial performance deteriorated further, and it had accumulated a debt of US\$0.6 million, the factory equipment was rarely maintained, and vehicles and tractors that were donated by the EU had worn out and were poorly maintained. STA and MATECO had a combined operating loss of US\$1.3 million in the 2002 financial year after farmers were paid their arrears.

8.2.3 Reforms in the Smallholder Tea Sector

The management crisis and the operational inefficiency of STA and MATECO triggered a reform process by the government through the Privatisation Commission, in preparation for the eventual privatization of STA and MATECO (Privatisation Commission 2002, 2003). STA was merged with MATECO. A trust, the Smallholder Tea Growers Trust (STGT), was registered in April 2002 as a holding company of MATECO. The Trust has seven trustees, three of whom are growers, two traditional chiefs, two from professional bodies (the Society of Certified Accountants of Malawi and the Law Society of Malawi). Under the restructuring, all smallholder tea growers were designated as members of STGT, reinstating the statutory contract.

In June 2002 MATECO completed a rationalization program in which excess employees were laid off. MATECO became known as the Smallholder Tea Company (STECO) as a government enterprise in a transitional arrangement and was entrusted to STGT. The creation of STGT and its mandate to manage STECO was a 3-year transitional arrangement that culminated in STECO's privatization in 2007/08. Smallholder farmers now have an ownership stake in the factory. According to the Privatisation Commission (2003), the shares of STECO are held by the trust for ultimate disposal to growers, management, and staff. STGT is responsible for managing STECO through the appointment of the board, and effectively STECO became a quasi-farmer-operated processing factory. The board of STECO has nine members with four growers (two of whom are STGT trustees) and five individuals appointed for their competence. An important point to note is that

STGT is dominated by farmers, whereas the board of STECO is dominated by individuals appointed for their professional competence. However, the disproportionate representation of smallholder growers on STGT and the board of STECO has been a source of discontent about the proposed privatization or rationalization of STA and MATECO among some powerful growers, who felt left out in the management of the smallholder tea sector.

The restructuring of STA and MATECO led to recruitment of new management for STECO. These reforms have brought substantial improvements in performance in an environment without access to finance from the banking system. The number of farmers selling green leaf to STECO increased from 800 growers in 2002 to 2,500 by 2004, mainly because of improvements in payments to farmers and the timely provision of inputs. As a result of improvements in service delivery, factory capacity increased from 30 percent in 2002 to 62 percent in 2004. STECO has also managed to secure forward contracts with buyers in Malawi, providing the necessary working capital. STECO has managed to pay part of the debt inherited from MATECO, to the tune of US\$0.16 million, from tea proceeds, and it has invested in upgrading factory equipment and has paid growers' bonus payments (Chirwa and Kydd 2005).

8.3 Emerging Institutional Arrangements

8.3.1 Reorganization of the Smallholder Tea Sector

The strategy of the Privatisation Commission and the government of Malawi was to unify all smallholder tea growers under one association—STGT—as was the case under the defunct STA. The smallholder growers were organized into clubs as the smallest unit. The clubs form the business centers (formerly blocks) and the business centers form zones. Three zones constitute STGT. Under the restructuring, smallholder tea growers that had abandoned STA and MATECO were expected to resume selling green leaf to STECO. STECO in turn was expected to purchase tea from them and honor its obligations to pay the farmers in time and to provide inputs on credit. However, the issue of providing extension services did not form part of the postrestructuring statutory contract.

Nonetheless, some of the smallholder farmers, especially those who were larger scale, better educated, and more powerful, were unhappy about the restructuring and the privatization process, believing that the process was irrational. For some smallholder farmers, the creation of STGT was seen as the maintenance of the status quo in which smallholder farmers were forced into an association not of their own making. Exacerbated by the inefficiency of STA and MATECO and the political

dispensation, and encouraged by the fact that they were doing well in their engagement with commercial farmers, the elite farmers started influencing other farmers to form their own associations.

8.3.2 Formation of New Smallholder Tea Associations

Smallholder farmers started forming their own association while maintaining the club and business-center structures of STGT. Three other associations have emerged as breakaways from STGT. Some of the smallholder farmers have maintained their loyalty to STECO despite the difficulties the company has experienced. Others that used to sell to estates have resumed selling the green leaf to STECO. Although STGT has retained 2,500 growers, one of the new associations has 4,807 growers and is leasing a small tea factory (with a processing capacity of 40 tons/day of green leaf) from the Tea Research Foundation, assuming responsibility for provision of input credit and other services.

It is apparent that there have been dramatic changes in the organization of smallholder tea growers since 2002. The financial and management crises both at STA and MATECO, freedom of association, and a democratic political dispensation have contributed to the changing structure of smallholder organizations in the tea sector. The top-down approach of creating farmer organizations has not been sustainable, and smallholder farmers are seeking alternative ways of organizing themselves into smaller associations. However, the elite smallholder farmers have been instrumental in the formation of these new associations. The opening up of the marketing of smallholder green leaf has widened the choice of market channels for smallholder farmers. Farmers are able to switch between different marketplaces based on the quality of services offered by factories.

8.3.3 Smallholder Associations and Tea Factory Relations

The high investment needs of tea production meant that those farmers who had abandoned the statutory contract had to seek alternative private contracts with tea processors. The new associations started negotiating contractual relationships directly with commercial estates that own processing factories. The commercial estates are willing partners partly because of their interest in seeing the smallholder sector grow in Malawi and the desire to improve their factory capacity use. Furthermore, smallholder tea is perceived to be of a higher quality, being mainly from clonal varieties, which in turn has improved the quality of processed seedling tea produced by the estates.

The tea factories have signed private contracts with smallholder associations whose nature is similar to the statutory contract with STA or STGT. The factories provide input credit (for fertilizers, including such high-yielding fertilizers as NPK,

and for seedlings for infilling), market access through direct contracts with respective smallholder associations, leaf collection and transport facilities, and extension services with commercial estates employing dedicated officers to guide smallholder farmers in farm management. In contrast, smallholder farmers that have maintained the statutory contract with STECO do not have access to extension services. Under the private contract, the smallholder associations commit business centers (farmer groups) to sell their green leaf to the respective estates as a way of facilitating credit repayments, and estates guarantee to purchase smallholder green leaf and to pay farmers in good time. The estates pay smallholder farmers directly without going through the association or other intermediary.

The commercial estates are also providing an array of services to the surrounding communities, including social development work, such as providing access to health care, education, and other social services. Most of the estates are active in construction and rehabilitation of education facilities, provision of clean water, and provision of health services. One commercial estate has an HIV clinic for the community while another has extended its water supply to the communities and also provides transport facilities to the hospital.

8.3.4 Response of the Commercial Tea Industry

The tea industry has responded positively to the changes that have taken place in the smallholder sector. The formation of smaller associations also means that smallholder farmers have become more fragmented and are not speaking with one voice. Consequently it is difficult to channel external support to smallholder farmers as they used to receive from STA. The associations are new and will take some time to demonstrate good governance and accountability to potential donors and local farmers. The estates saw the fragmentation of smallholder groups as a disadvantage to the development of the smallholder sector, potentially leading to increases in transaction costs, and therefore they want the sector to be better organized. The Tea Association of Malawi (TAML), the umbrella association for commercial tea growers, is increasingly involved in smallholder growers' issues.

The active engagement of estates in smallholder tea issues has brought benefits that would not have existed when farmers were bound by the statutory contract. First, TAML initiated involvement of smallholder farmers in the setting of prices for green leaf and agreed to make second payments based on the marketing outcome of processed tea. Larger estates pay relatively more than the smaller estates or farmer-operated factories (such as STECO) that are leased by a smallholder association. The consultative pricing has resulted in reversing the downward trend in real farmgate prices for green leaf (Chirwa and Kydd 2005). Second, TAML has facilitated the formation of the National Steering Committee of Smallholder Tea Growers as an um-

rella organization. TAML sponsored meetings with smallholder associations, including STGT, at which a 10-member committee was elected, and TAML insisted on the involvement of women in the committee. Women form a significant proportion of smallholder farmers (35 percent of the sample farmers in the study), and their involvement in the growers' committee is vital for the development of the tea sector. This pressure from estates has resulted in the inclusion of 2 women farmers in the 10-person steering committee. Third, TAML has created a smallholder desk at TAML head offices with a smallholder manager responsible for the affairs of smallholder tea growers. The smallholder desk was created to promote the organization of smallholder farmers and as a vehicle of channeling donor assistance to smallholder farmers through a more transparent and accountable body.

Are these new institutional arrangements beneficial to smallholder farmers? Most smallholder growers rely on tea farming as their primary source of income and livelihood, and tea farming provides some income security throughout the year (although because of rain-fed agriculture the peak period is the rainy season). Chirwa and Kydd (2005), in their analysis of the relative profitability of different contractual arrangements, find that growers that sell to estates earn twice as much profit as those selling to STECO, which still operates on the basis of a statutory contract with growers. Only 27 percent of growers selling to STECO, compared to 44 percent of growers selling to estates, thought that tea had become more profitable than in the pre-reform period.

Most farmers attributed such changes to better tea prices and lower costs of inputs obtained from the estates. The factory leased by a smallholder association pays higher prices to its growers than do the estates and STECO. However, there are also differences in terms of the levels of second payments, with large estates paying relatively higher second payments than do STECO and the factory leased by the smallholder association. The quality of services also varies: growers selling to the smallholder-leased factory experienced transport problems and delays in payments, whereas those selling to estates are receiving better services.

8.4 Conclusions

This case study has demonstrated the important role of institutions in the tea industry in Malawi and has also highlighted how changes in the policy and governance environment influenced the nature of the institutions that facilitate the coordination of exchange. Tea farming is a high-investment activity that requires vertical integration between farming and processing. Commercial estates, mainly foreign and multinational companies, are vertically integrated, but smallholder farmers with an average land holding of 0.5 ha of tea cannot afford processing facilities. In addi-

tion, green tea leaves require immediate processing soon after harvest. These features necessitate proper coordination for the exchange of tea and other services between smallholder farmers and estates. Estates benefit from lower transaction costs through outgrower contracts—statutory or private—by engaging with smallholder associations. The case study has also demonstrated the vulnerability of the smallholder farmers to a statutory contract in which they have very little enforcement powers. State-sanctioned institutions may not serve the best interests of smallholder farmers. Contractual issues with smallholder farmers are not well defined, and typically smallholder farmers do not have any effective voice in such contracts.

State failure in smallholder tea has led to some changes in contractual arrangements in the Malawian tea industry. STA became too inefficient, and its financial performance deteriorated significantly, such that it could not even provide efficient transport services and failed to pay farmers in time for their green leaf. Although there have been attempts to reorganize the smallholder tea sector, many smallholder farmers have broken away from the statutory smallholder growers association and are forming their own associations. The statutory association is selling its green tea to STA, reformed as a government trust, whereas the new associations have sought alternative markets by direct contracts with estates.

Smallholder farmers who have moved from the statutory contract to direct private contracts with estates and the smallholder-leased factory are performing much better than those who have maintained the statutory contract. Smallholder farmers who are dealing with estates are receiving better services, and their tea farming has become more profitable. The compatibility of incentives as a mechanism of enforcing the contract between estates and smallholder farmers is strong in the short to medium term, driven by the desire for estates to improve factory capacity as they embark on a replanting program and the desire to improve the quality of processed tea. For the smallholder farmers, the technological characteristics of tea and regular working capital needs require a more reliable and guaranteed market for green leaf. However, as the new and replanted tea plantations of the estates mature and the productivity of smallholder farmers improves (because of improved services), the existing capacity of factories, if not expanded, has the potential to weaken incentives for contract enforcement in the long run. These issues have started emerging in a factory that is leased by a group of smallholder farmers, where farmers are experiencing delays in payments and the factory has been battling to cope with the supply of green leaf.

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