Business Environment Reform Facility

Business Impact on Reform of Private Economic Governance

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ODI

Department for International Development

About Business Environment Reform Facility (BERF)

The UK Department funds BERF for International Development (DFID) under the Business Environment for Economic Development (BEED) Programme. BERF is a central facility responding to demand from the DFID's priority Country Offices and stakeholders to initiate, improve and scale up business environment reform programmes. BERF is managed by a consortium led by KPMG LLP. The programme started in January 2016 and will finish in March 2019.

We provide expert advice, analysis of lessons learned, policy research about what works and what doesn't and develop innovative new approaches to involving businesses and consumers in investment climate reform.

BERF has a strong emphasis on strengthening the Business Environment for women and girls, as well as for young adults more generally. It is also aiming to improve the relationship between business and the physical environment including where relevant through linkage to climate change analysis. BERF recognises the need for appropriate political economy analysis in order to underpin business environment reform processes and interventions.

About this Report

Research for this study was conducted by Stephen Gelb, ODI between August 2018 and March 2019.

He was assisted in the case research by:

- Bijon Islam (LightCastle Partners, Dhaka) for the case on the RMG sector in Bangladesh;
- Nathaniel Mason (ODI Research Associate) and Julius Gatune (African Centre for Economic Transformation, Accra) for the case on the cocoa sector in Ghana; and
- Josephat Kweka (Talanta International, Dar es Salaam) for the case on accounting and auditing in Tanzania.

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Acronyms and Abbreviations

AFD	Agence Française de Développement
AfDB	African Development Bank
BERF	Business Environment Reform Facility
BGMEA	Bangladesh Garment Manufacturers and Exporters Association
BKMEA	Bangladesh Knitwear Manufacturers and Exporters Association
BoT	Bank of Tanzania
BRELA	Business Registration and Licensing Authority (Tanzania)
CAG	Controller and Auditor General
CCM	Chama Cha Mapinduzi (Tanzania Ruling Party)
CPA-PP	Certified Public Accountant (Tanzania) – Public Practice
CPD	Continuing Professional Development
CSR	Corporate Social Responsibility
DFID	Department for International Development
EITI	Extractive Industries Transparency Initiative
FRSME	Financial Reporting Standards for Micro Entities
GVC	Global Value Chain
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants of England and Wales
IFC	International Finance Corporate
IFRS	International Financial Reporting Standards
ILO	International Labour Organisation
ICCO	International Cocoa Organisation
IFAC	International Federation of Accountants
ISA	International Standards on Auditing
INGO	International Non-Governmental Organisation
LBC	Licensed Buying Companies
NBAA	National Board of Accountants and Auditors (Tanzania)
PIEs	Public interest entities
PEG	Private Economic Governance
PS	Political Settlement
RMG	Ready Made Garments
SDG	Sustainable Development Goals
SMEs	Small and Medium Enterprises
SRH	Sexual and Reproductive Healthcare
TRA	Tanzanian Revenue Authority
VC	Value Chain
WASH	Water, Sanitation and Hygiene

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Contents

1. Executive Summary

This report presents a study of the possible impacts of business firms on private economic governance (that is, regulation) within a sector, and its reform in developing countries. The study aims to provide evidence of how companies can promote sustainable reform of private economic governance within their sector, and how these reforms may be supported by donor agencies. Research was undertaken through a review of the literature on private economic governance and economic 'rent' allocation, and through field-based study in three sector/country contexts.

1.1 Rents

The study draws on Khan's (2000) analysis of economic rent; incomes earned which are higher than would have been earned from the recipient's next best opportunity, due to their possession of an asset or quality with scarcity value. The study identifies three categories of rent relevant to private economic governance (PEG), based on the source of the rent. These categories are:

- **Knowledge rents** – derived from the creation, acquisition or adaptation of production-linked knowledge;
- **Market barrier rents** – derived from property rights based on legally- or politically-restricted access to a source of income; and
- **Monitoring rents** – derived from the reduction or elimination of asymmetric information.

PEG reform in a sector involves shifting the sector's rent structure, through different processes for each type of rent, which in turn contributes to improved economic outcomes in terms of welfare and growth.

1.2 Building a new conceptual framework

The commonly used 'deals and development' model[1] is based on the interaction between rents and the political settlement at the *national* level. This study points to gaps in that model that are important when examining the relationship between rents coalition building and PEG reform at *sector* level. We emphasise the importance of value chains, foreign firms, business associations and institutionalised business-government relations:

- **Value chains** are conspicuously absent from the 'deals and development' model, which focuses only on market barrier rents related to political access. As a result, that model fails to take account of firms within the same value chain, which may have access to different types of rent and as a result have different interests in PEG reform within the sector.

[1] Pritchett et al., 2018

- The model also underplays the presence of **foreign firms** within value chains and these firms' potential role in reforming rent structures and PEG. For example, foreign firms may collectively push for industry self-regulation by agreeing to defined standards (e.g. the Conflict-Free Gold Standard), or may work with governments and civil society to set and monitor standards (e.g. the Extractive Industries Transparency Initiative).
- This study also emphasises the role in PEG reform of **business associations**, which may promote or oppose PEG reform involving the re-distribution of rents.

1.3 Case Studies

The conceptual framework was applied to three sector/country case studies to examine the potential for PEG reform by business. Cases were chosen to include different types of rent (knowledge, market barrier and monitoring), different regions (Southeast Asia, West Africa and East Africa) and different economic sectors (manufacturing, natural resources and services). The study involved field interviews with firms, development partners, regulators and policymakers in:

- **The Ready Made Garment (RMG) sector in Bangladesh:** The report examines the potential for PEG reform to improve women workers' health in the ready-made garment sector. Identifying lessons from the Accord and Alliance that addressed factory safety in the sector, the framework highlights how PEG reform could harness learning rents to support investments by factories in workers' health. Donors should convene foreign buying firms to commit to the process, which should include domestic Bangladeshi stakeholders (firms and government) from the outset. Donors could also draw on financial expertise in their own country (e.g. in the City of London) to structure financial instruments suitable to channel learning rents to factories and buyers.
- **The cocoa sector in Ghana:** The report examines the potential for PEG reform in the cocoa sector to raise farmers' incomes. These remain extremely low. Ghana's cocoa sector involves market barrier rents: the marketing agency (a public enterprise) appropriates rents (some of which are used to supply services to farmers), while cocoa processing in Ghana receives large public subsidies. However, removal or lowering of these barriers may not lead to improvements in farmer income. Instead, PEG reform should aim at a consolidation of cocoa farming – fewer but more productive farmers. This could be through provision of inputs and training, together with support for those farmers who move into other economic activities. This should be supported by collective action by the global cocoa processors and chocolate manufacturers. An initiative is already underway, but still voluntary and unsystematic. Donors could assist by strengthening farmer associations through:
  - technical assistance
  - finance (including profit-sharing plans), and
  - supporting the development of agreed sustainability standards and compliance assessment mechanisms.

- **The accounting and auditing sector in Tanzania**: The report examines the potential for PEG reform to raise accounting and auditing standards. This would lower firms' transactions costs, while expanding the value of firms' financial statements to banks and the tax authorities. The presence of foreign accounting firms, in particular the 'Big Four'[2], has led to a segmented sector in which small domestic accounting firms are unable to provide high quality auditing services. Small local businesses are expected to adhere to international financial reporting standards, but have great difficulty doing so. The industry body, both regulator and professional association, lacks the resources to match its responsibilities. Globally linked firms should support PEG reform to improve accounting and auditing quality, by increasing the transfer of knowledge and expertise from outside the country to a wider group than currently benefit from it, as well as providing support for accounting education. These firms could also help to mount internship programmes for young Tanzanians, and mentoring programmes bringing UK accountants to Tanzania. Donors can assist by
  - **convening the large accounting firms**, both in the UK as well as in in country, to formulate strategies for the sector's overall development, as well as providing financial support for knowledge transfer programmes.
  - **providing financial and technical assistance** to strengthen the industry association, especially its auditor quality assurance activities, and its cooperation with the company registration and the taxation authorities.

1.4 General conclusions and recommendations

There are a range of ways donors can support PEG reform. What is needed in a specific context will depend on detailed analysis of the existing rent structure and political economy of the sector. Possible donor actions include:

- **Support for foreign firms' collective action.** Collective action by foreign firms is crucial for PEG reform, but wherever possible should aim for enforceable commitments of foreign firms to economic, social or environmental improvements in their value chains. This often requires the involvement of independent stakeholders, including donors, in institutionalised collective action mechanisms. Collective action may be catalysed by the emergence of a 'crisis'. Even in the absence of such circumstances, there is a role for donors to play in convening foreign firms to consider strategic priorities for a sector's sustainable development. This would include in-country convening of foreign firms, as well as at global head office level.
- **Support for domestic associations in the sector.** PEG reform requires foreign firms (as a group) to build coalitions with domestic organisations, in particular business associations of domestic firms and representative bodies of 'the poor' (workers and small farmers). Donors can strengthen the capacity of domestic organisations through technical and financial assistance, to amplify their 'voice' within coalitions, and make

[2] PWC, EY, Deloitte, KPMG

them more dependable coalition partners. Domestic organisations should be involved in PEG reform processes from the outset, and the distribution of costs and benefits from reform must be seen to be equitable, especially as between domestic and foreign groupings.

- **Support for knowledge development and dissemination.** PEG reform often requires the introduction of standards systems including compliance assessment mechanisms. Donors can support the formulation and testing of these systems, which at the same time could contribute to the business case for PEG reform itself, by demonstrating benefits from interventions to firms in the sector.
- **Financial support.** Donors can use their own financial resources directly and indirectly – by leveraging private investment finance – to promote PEG reform in a sector by providing learning (or monitoring rents) to firms. In addition, donors can mobilise financial expertise within their own country's investment community (such as the City of London) to create bespoke financial instruments for risk-sharing and rent allocation within the sector in a partner developing country.
- **Support for new global approaches.** Finally, donors can help to initiate a global debate about small consumption taxes levied globally (or regionally) on mass-market goods to fund welfare improvements for workers and small farmers in developing producer countries.

2. Introduction

This report presents a study into the long-term positive impact that business firms can have on 'private economic governance' and its reform – the promotion of 'good governance' – in developing countries, especially DFID partner countries. Governance refers to both the content and structure of institutions (formal and informal rules) that shape behaviour, and to the processes that produce or result in those institutions. Private economic governance (PEG) is often taken to mean simply 'regulation', but more generally refers to the institutions which enable and shape the behaviour, activity and transactions of private economic 'actors', in particular of firms, and the processes producing those institutions. Governance institutions include both those which:

- **enable** firms' activities and transactions, for example property rights protection or contract enforcement; and those which
- **restrict** firms' activities and transactions, for example, competition regulations, or transparency and accountability requirements for company reporting, which balance private and public (or social) interest.

The governance process producing or reforming such institutions may involve private actors (corporations and other firms); public (or government) actors; and other organisations, such as business associations or 'civil society organisations'.

The goal of this policy research study is to generate evidence on:

- the *conditions* in which private companies can promote sustainable economic governance reforms, specifically within a particular economic sector;
- *how* these companies might do so; and
- how these companies might be *supported* by donors, for example through leveraging donors' convening power; helping to make business voices better heard in policy debates; providing subsidies or other forms of financial assistance; or other means.

The study aims to provide new and practicable insights on these aspects, by examining the actors and processes that could lead to such institutional reforms in a series of cases, and synthesising practical lessons applicable in planning and programming of DFID and other donors.

We focus on both foreign and domestic firms and on individual firms as well as firms acting collectively, though our interest is in *systemic* reforms – sector-wide change affecting all businesses or all Value Chains (VCs) in the sector – rather than changes in practice by individual businesses or within individual VCs. The implicit purpose of economic governance reform is taken to be economic growth, job creation and poverty reduction, together with other Sustainable Development Goals (SDGs).

The report is structured as follows:

- **Section 3** sets out a conceptual framework for understanding economic governance and its reform. It focuses on the structure of 'economic rent' in a sector. It reflects on how rents are created and distributed amongst firms and other economic actors (such as workers or the national treasury) inside and outside the sector. It also considers how the rent structure might be changed (or change might be prevented) by political economy factors within the sector and more broadly. The framework identifies three generic types of rent, with the potential for development-enhancing reform, which are examined in more detail in a specified sector and country.
- **Section 4** looks in turn at three sector case studies to examine the potential for PEG reform by business. We look at
  - women workers' health in the ready-made garment (RMG) sector in **Bangladesh**,
  - farmers' incomes in the cocoa sector in **Ghana**, and
  - accounting and auditing practices in **Tanzania**.
- The case studies are intended to illustrate the value of the conceptual framework for analysing private economic governance and the potential for its reform, rather than making the case for reform of these particular sectors and countries. **Appendixes 3-5** set out the three case studies in detail.
- **Section 5** concludes by drawing together some issues and lessons for business and for donors.

3. A conceptual framework

The term 'good economic governance' is often taken to mean efficiency-enhancing reform of markets, though liberalised regulation to allow more freedom of action by private market actors, or through increased transparency and accountability to reduce corruption, 'rent-seeking' and 'government failure'. Here however we follow Khan (2007) in expanding the definition of governance from this market-enhancing approach to add *growth*-enhancing dimensions, including institutions to manage technology acquisition and learning, which involves rent allocation and disciplining their recipients.[3] Khan insists that consideration of both aspects of governance is essential. We would refer to the second aspect of governance as 'development-enhancing' dimensions, to adopt a wider lens than a focus purely on growth allows.

3.1 Rents

We can connect these two aspects of governance by drawing on and extending the typology of 'economic rent' spelled out earlier by Khan (2000). An economic rent is earned when an agent earns an income higher than the minimum they would have accepted, usually defined as the income from their next best opportunity.[4] All rent results in some way from the possession by the rent-earner of something, an asset or a quality, with *scarcity* value, and the rent is the return to scarcity. Improving PEG in a sector shifts the sector's rent structure, with different effects for each of the three types of rent, which in turn contributes to improved economic outcomes in welfare and productivity terms. Khan identifies six different rents, which we group here into three by focusing on the source of rent, as in Table 1.

[3] Kahn, 2000:21 In addition, Khan refers to governance of non-market asset transfers necessary for initial development (primitive accumulation), and of patron-client political relations to minimise political instability and its costs for learning, investment and growth

[4] The term rent is often used to refer to the total income earned, but strictly speaking it is the difference between the income actually earned and the income from the next best opportunity – the 'opportunity gain'.

Table 1: Types of Rent

Types of rent	Categories used in Khan (2000)	Source of rent	Governance reform	Governance reform effect
Knowledge	• Innovation • Learning	Creation/ acquisition/ adaptation by the firm of knowledge/ technology/product,	Tighter regulation via establishment of quantitative or qualitative standard, with compliance monitoring	Increasing productivity to enhancing growth (by enabling rents)
Market barrier	• Monopoly • Natural resource • Transfer	Property right based on law/policy/politics restricting access to source of income	Looser regulation of entry barriers	Increasing competition to enhance growth (by reducing rents)
Monitoring	• Monitoring	Elimination or reduction of asymmetric information	Tighter regulation via more rigorous standards and/or more effective compliance mechanism	Lowering transaction costs and possibly factor costs to enhance growth (by shifting rents)

- **Knowledge rent**, takes two forms, with knowledge being the scarce resource that underlies the rent itself.
    - Firstly, innovation that is the development of new knowledge gives a firm a competitive advantage over its competitors, allowing it to earn rents *ex post* (after the product or process innovation is in place);
    - Secondly, firms may be provided with a rent *ex ante (*in advance). This would encourage future learning and the absorption of knowledge new to it, enabling production of products to be more efficient.

Provision of learning rents is of course both necessary and common in developing countries. Knowledge rents are incentive mechanisms to raise efficiency of firms, or change the composition of the products they produce. Improving PEG by strengthening the incentive mechanism – providing more rent – should enhance profitability of recipient firms and overall sector growth. A central challenge in the policy use of learning rents is regulation: ensuring compliance with the use of the rents for knowledge acquisition and application, which to be effective involves recipient firms meeting a pre-defined standard. Thus, PEG reform relating to knowledge rents involves tighter regulation through establishing or raising a standard. PEG reform can be distinguished from the common practice involving individual buying firms providing 'informal' learning rents to upgrade (some of) their supplier firms. This does not reflect a systematic sector-wide process, required for all buying firms for all suppliers, and in that sense would not be identified as PEG reform.

- **Market barrier rent** results from barriers to entry into a market (or other source of income), so that access is the scarce resource underlying the rent. Those with access earn more than they would if there were a larger number of claimants on total income from the market, and access is often based on a political process. *Monopoly*[5] *rents* may be linked to government licensing selected allies and supporters to operate in a particularly lucrative market – the classic 'deal'. *Transfer rents* may similarly provide public revenue (or goods and services financed with public revenue) to only selected groups, for political reasons. There are both negative and more benign[6] forms of each of these rents. The negative forms are commonly associated with what in standard treatments is labelled "rent-seeking behaviour", referring to lobbying and corrupt activities by incumbents (or aspirant incumbents) intended to protect their access to this type of rents through establishing or raising entry barriers. PEG reform opposes rent seeking through regulation: improving PEG *liberalises* market regulation, increasing competition by allowing easier entry or removing other regulatory barriers. This lowers market barrier rents and enhances efficiency, which is expected to lead to growth.
- **Monitoring rent** is linked to the reduction of asymmetric information between different stakeholders: for example between:
  - providers of loan finance and owners of a firm on the firm's borrower risk profile;
  - a firm's managers and its workers on the latter's work effort; or
  - a firm and its suppliers on the firm's payment reliability.

  Monitoring reduces the information asymmetry and transaction costs on both sides, yielding a rent for the monitor, based on their (scarce) capability to produce credible information: for example, the provision of credible information about its past performance and future prospects enables the firm to obtain a bank loan or trade credit. The monitor may be the bank itself (thus increasing its yield), or a certified third party, such as an auditor or credit bureau. Improving PEG leads to greater transparency and a reduction in asymmetric information. Improved accounting and auditing standards, for example, increases the credibility and use of company financial statements. This

[5] May also apply to oligopoly (few suppliers), monopsony (one buyer) or oligopsony (few buyers).

[6] Natural resource rents derive from the scarcity value of the resource, but if the resource is renewable, the presence of an entry barrier is often essential to avoid depletion, the 'tragedy of the commons'.

in turn lowers transaction costs facing shareholders, potential creditors, and other stakeholders such as customers, suppliers, and tax authorities. This increases overall efficiency in the business environment, and contributes to easier access to capital and increased levels of economic activity.

3.2 Political economy considerations

As already implied above, in examining PEG reform, we focus on *systemic* processes. Sector-wide change affecting all businesses or all Value Chains (VCs) in the sector are considered rather than changes in practice by individual businesses or individual VCs. Starting with an analysis of the existing rent structure in a sector, we can then identify how that rent structure *should* be reformed to meet specified development objectives. This then needs to be combined with an analysis of how the rent structure *could* be reformed. That is, how the political dynamics within the sector, which are in turn embedded in wider national politics, might enable or obstruct change. The political economy of different interests within the sector might enable change coalitions to be assembled to address PEG improvements, or status quo coalitions to block such changes.

The 'model' currently widely used to think about PEG – or 'deals and development' as its authors dub it – suggests a link between a sector's rent structure and the 'political settlement', which is a national- rather than sector-level concept. The envisaged link is a two-way causal interaction between the PS and the 'rent space'[7]. However, the model does not explore this further, perhaps because of its exclusive focus on monopoly and transfer rents, those linked to political access, with other rent categories ignored.

In categorising firms by their relation to only one particular type of rent, the model has three other important gaps. They are significant in relation to PEG reform and the role of business within it:

- First, by identifying sectors with only a single type of firm, it does not adequately take account of **Value Chains**, and in particular that the rent structure is closely linked to the VC and its governance[8]. VCs include several different types of firm, each with differential access to rents of different types, which together comprise the rent structure of the chain, and the sector. Relatedly, different firms within a single value chain may have different positions within the political settlement. VCs involve both cooperation amongst the firms in a chain, to maximise their joint rent, and simultaneously competition amongst those firms, each firm trying to appropriate a larger share of the joint total. Thus firms within the same value chain, and the same sector, may well have different interests in PEG reform in the sector.
- Secondly the place of **foreign firms** within the rent structure and their role in changing it through PEG reform. Foreign firms usually have different positions within the rent structure of a VC to domestic firms. They may have a crucial role in a country's political

[7] Pritchett, Sen and Werker, 2018: 29

[8] Gereffi et al. 2005

economy, where the sector has strategic significance for the economy, for example due to its significant contribution to exports and foreign exchange reserves. Yet the political settlements concept largely ignores them, or at least their relation to it remains unclear. Foreign firms, however, have political influence over policy and regulation, either indirectly through the local firms with which they transact, and often directly, depending on the rent structure and the nature of regulation. Foreign firms involve not only direct investors, but also buyers with a negligible capital stake in the country but a crucial export market role. The role of foreign companies in the process may be key to shifting the rent structure and reforming PEG.

- Thirdly, the role of **business associations** in giving voice to groups of businesses. In many cases, associations are crucial to the politics of economic governance reform at sector level and arguably also at national level. Beyond formal party political structures, sector business organisations (or their absence) shape which businesses have 'voice' in policy discussions, and which issues are aired. The importance of business associations is enhanced if individual businesses are precluded from, or disadvantaged in, direct engagement on policy issues by their size, their regional location, or their owners' ethnicity (members of minorities or Diasporas). Foreign investors are often also better able to engage in policy discussion in a host country when acting as a group rather than as individual firms.

Action by an individual foreign firm that directly brings about PEG reform is not common. An exception may be cases where a firm is very large relative to the context, such as in a major infrastructure project or banking entry, or in a significant sector, such as extractives, which is new in a country. Collective action is much more likely to be necessary, though individual firms may take a lead in organising other firms for this.

One way in which foreign companies can play a role in PEG reform is through the establishment of private standards, as a regulatory mechanism within a sector. Private standards are 'club goods'[9] with positive externalities from their use accruing to all participants.

Reputational risk has a 'commons' dimension, [10] in that all firms in an industry may be affected by a significant negative event ('crisis'). A possible response is for a group of firms to introduce new collectively agreed industry standards. That is, to self-regulate, which shifts from the risks of the commons to the relative protection of a club where excludability may insulate participants from risks resulting from actions of non-members. The Kimberley Process Certification Scheme to exclude 'blood diamonds', and the Conflict-Free Gold Standard, are examples of club-like private standards established by industry stakeholders at global level, where shared market risk forced firms to undertake collective action establishing common rules for input sourcing.

[9] In other words, club goods are excludable – access to them can be barred for some potential users – and they are non-rival – they can be used by multiple users simultaneously.

[10] Commons goods are non-excludable and rivalrous, in contrast to club goods.

Under what circumstances would firms act collectively to reform PEG to promote development objectives by establishing a standard? One set of scenarios are situations where markets are at risk, that is, business-led PEG reform is undertaken to insure against market loss. The risk may come from a variety of different sources, though there are three main types of pressure:

- **disruption** resulting from natural disasters or overt political or social crisis, affecting their industry or an 'adjacent' industry (one facing similar risks to their own);
- **moral pressure** from customers in significant markets; or
- **regulatory or political pressure** from governments, in their home country or their input supply country (or countries) or significant markets countries.

In many cases, it has required more than one of these sources of pressure acting together to bring about collective action by business. In particular, customer moral pressure has often been inadequate to address a significant issue without a major disruptive event that illustrates the consequences of not doing so, ie to underline the risk and the benefits of insurance through reform.

Standards and associated certification can expand markets for all participants by lowering transaction costs and information barriers facing potential customers or suppliers. One example – business-led rather than more narrowly firm-led – is the development of financial accounting and auditing standards by the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC). This emerged during the 1990s in order to facilitate the growing integration of capital markets and rise in cross-border capital flows and asset holdings.

Clubs have **rules** to which members must adhere, or face sanction from other members, up to and including exclusion from the club. A club's credibility rests on both members' adherence to the rules, and the imposition of sanctions on those who have not done so.[11] In the case of sourcing standards, independent verification that standards have been met (in other words, there has been adherence to the rules) is essential, creating a role for outside auditors to assess participating firms' compliance.[12]

Confidence that **sanctions** will be imposed in the case of non-compliance is usually achieved by including other stakeholders in the standards administration mechanism, in addition to participating firms. For instance, civil society representatives can implicitly represent the interests of the firms' customers, or more generally, 'the public interest'. The Extractive Industries Transparency Initiative (EITI) board includes civil society representatives from international NGOs, together with home and host country government and corporate representatives. EITI national-level processes are also tri-partite, involving industry, government and civil society.

[11] The pre-defined standards mentioned above in relation to learning rents also create a 'club', for suppliers who have met the standard, often with support from customers (who assist the supplier to upgrade, ie to pay the 'entry fee' to the club).

[12] Outside auditors obtain monitoring rents by certifying compliance with the standards, the source of those rents being 'club membership fees' paid by firms who wish to obtain the benefit of being certified compliant.

Business associations facilitate the organising of coalitions of groups of firms and other stakeholders with different roles in a sector. Coalitions are likely to be based on some common interest, perhaps to promote PEG reform through an (even if implicitly) agreed re-distribution of rents, or perhaps to block reform and maintain the status quo distribution by a coalition of incumbents. They are difficult to construct, as groups inevitably try to maximise their own share of the rent at the expense of others'. Existing regulations and the existing rent structure will affect the feasibility of coalitions for or against PEG reform.

Foreign firms entering specified sectors are frequently required to take on local partners in **joint ventures**. This creates a 'natural constituency' of domestic firms within PEG reform processes. Whether this group promotes or blocks reform depends on the context. This would include their approach to the transfer rents they are already appropriating through their partnerships, and the impact of reform upon these rents. In some cases (as was common in China's initial industrialisation), the domestic recipients of transfer rents may see them as *de facto* learning rents. The Joint Venture partnership is regarded as an opportunity for the domestic firm to acquire knowledge and technology from the foreign firm, bringing them to a level where they can compete with their partner and others in the sector. At that point, both groups may wish to change the regulation by reforming PEG. Alternatively, the domestic partners may prevent reform efforts initiated by foreign firms to continue appropriating transfer rents.

The relationship between supplier and buyer firms within **Global Value Chains** (GVCs) is another example of the existing rent structure affecting coalitions. In a value chain, suppliers and customers are interdependent and need to cooperate to maximise the aggregate value appropriated by their common chain. At the same time, they compete with each other within their value chain to appropriate a larger share of the aggregate rent. In other words, they have both shared and competing interests and this will influence the coalitions that each group might form for collective action in specific contexts. Coalitions may be created through alliances across value chain segments. Coalitions may reflect distinct segments in the value chain. Whether segments are dominated by domestic firms, or by foreign firms, as is common, will obviously, also be a factor in coalition formation. Coalitions bringing together business and non-business interests are also possible, found in many PEG reform scenarios.

A fourth political economy issue relates to the presence or absence of **institutional** (or formalised) **mechanisms** for government-business interaction. If such bodies exist and allow for regular engagement between business groups and government officials (both politicians and bureaucrats), they provide a channel for information flow in both directions. Businesses are able to have input into policy and regulation, including identifying to officials the challenges and constraints facing the sector. On the other hand, these bodies can put some restraints on government officials, pushing the 'deals space' in the direction of open ordered deals without necessarily guaranteeing this outcome. If these bodies can be constituted independently of political parties, it may also be possible for foreign firms to participate, which would encourage the latter to organise themselves to act collectively where this has not happened.

4. Case studies

In this section, we look in detail at three cases of possible PEG reform, selected to cover the three different types of rent identified above. In each case, we have identified a development-related objective that would be enhanced by PEG reform; examined how the objective is currently addressed in the sector; and tried to identify the foreign firms who may be potential agents of PEG reform, and the path that reform might take.

- We start by looking at knowledge rents in the **RMG sector in <u>Bangladesh</u>**, focussing in particular on the low health status of workers (mainly women) in the sector. We argue that improved health status would increase productivity of the workforce and the industry overall, and explore how PEG reform could enable the provision of learning rents to support investments by factories in workers' health.
- The second case looks at market barrier rents in the **cocoa sector in <u>Ghana</u>**, and focus on the continuing poverty (or near-poverty) incomes of cocoa farmers. The marketing of the cocoa crop is controlled by COCOBOD, a state-owned enterprise, while cocoa beans are processed domestically by a small group of companies, both domestically and foreign-owned, who receive large public subsidies, and explore options for PEG reform. The case study explains that removing these subsidies, which is probably infeasible politically, would not necessarily address the issue of farmers' incomes, and examines alternative PEG reform avenues.
- The third and final case looks at monitoring rents in the **accounting and auditing profession in <u>Tanzania</u>**, focusing on the problems of growth and enterprise development linked to low adherence to international standards in accounting and auditing. This results in high transaction costs for firms in both sourcing inputs and selling outputs, as well as obstacles to firms' accessing bank credit and to public authorities collecting tax revenue, because commercial banks and the Tanzanian Revenue Authority do not see the audited accounts as credible for a very large number of firms in the country. We explore how PEG reform could increase the flow of expertise within the sector, both from outside and inside Tanzania.

We emphasise that these cases were selected in order to explore how PEG happens currently and the potential for reform, in the case of each of the three types of rent identified, rather than to suggest that these cases represent priorities in any sense, where firms and donors should embark on reform processes. In addition to covering the three types of rent, the cases were also selected to cover different major sectors - natural resources (mining/agriculture), manufacturing and services – and different regions – South Asia, West Africa, and East Africa.

Both garments and cocoa are key export sectors for the country, and as a result are important for macroeconomic stability. This gives firms in the sectors, including foreign firms, added political influence. Though less of a consideration in case selection, the three countries also reflect different 'political settlements':

- Bangladesh has often been labelled 'competitive clientelist' but has arguably moved towards a relatively strong dominant system in the past few years;
- Ghana is competitive clientelist;
- Tanzania has a weakly dominant party, with power contested by internal party factions.

4.1 Ready-made garments (RMG) in Bangladesh

The RMG industry has been the engine of Bangladesh's economy since the early 1980s, and supplies more than 80% of its exports[13]. Over 3,850 factories employ about 3.6 million workers, 53% of whom are women[14]. It has well-known labour challenges, including wages, working conditions in the factory and worker organisation and 'voice'.

We are interested in the problem of structuring learning rents through business involvement. In particular the need for 'reciprocity'; that is, for recipients of *ex ante* learning rent to meet pre-defined targets to justify the rents. In buyer-led GVCs, as in the RMG sector, lead companies commonly assist their suppliers with technological 'upgrading' - in effect providing learning rents to those suppliers. In this case, we want to look at the potential for PEG reform to create systematic incentives for all suppliers to engage in learning activity, to achieve a social outcome while also raising overall productivity.

We look at workers' health issues, particularly for women workers, and the link between improvements in health status and in factory productivity. We then look at PEG reform in response to two factors: the shock of the Rana Plaza disaster and the long-term health conditions in the RMG sector.

4.1.1 The post-Rana Plaza process and PEG reform

PEG reform has progressed following the collapse in April 2013 of the Rana Plaza building, housing several RMG factories. This shocked industry stakeholders and precipitated buyers into a PEG reform to address factory safety. Three formal organisations were established to implement binding agreements[15]. Many (3,778) factories had been or were to be inspected by December 2015 for structural, electrical and fire safety problems, and their remediation requirements identified[16]. Factories were expected to cover their own remediation costs – estimated at an aggregate of $929 million, with a financing gap of $448 million still outstanding in 2016[17]. The Accord required buyers to support factories' financing through commercial contracts or access to loan finance, and to commit to sourcing in Bangladesh during the Accord's life span. Buyers also had to finance factory inspections and audits.

[13] World Bank, 2016; Ahmed et al., 2014

[14] Moazzem and Radia, 2018

[15] The Accord and the Alliance, set up by EU and US buyers respectively, and the Bangladesh Government's National Initiative

[16] IFC, 2016

[17] IFC, 2016

Although the post-Rana Plaza process is a PEG reform, it is concerned with insurance premia against future factory disasters, rather than with learning rents to enhance productivity. Nonetheless, the process sets a precedent for legally *enforceable* buyers' commitments. The process underlines the political gap between domestically owned factories and foreign buyers. Neither the industry associations nor the Bangladeshi government were involved in setting up and running the Accord and the Alliance, though the Accord's extension involves supporting a government agency to take over factory inspections and certification.

4.1.2 Workers' health in the RMG sector

The health status of RMG workers and their families is very poor. Labour regulations require factories to have WASH facilities, drinking water and canteens, to support workers' maternal health, to provide a crèche, and to provide food or a food allowance to workers. Non-compliance is rare, but there is wide variation in quality. Workers lack adequate food, cooking, refrigeration and WASH facilities in homes and factories, and knowledge about sexual and reproductive healthcare and rights. They face long working hours with poor conditions. Working life is short, with a high proportion of women leaving the workforce by 30 or 35. .

The business case for health improvements on productivity is clear – poor worker health raises absenteeism and labour turnover, disrupting production and recruitment and training costs. Improved health raises worker morale and commitment to the employer. Whilst there is evidence for this[18], little factory level data exists on the cost of health programmes or productivity improvements. Attribution of higher output to specific interventions is a challenge.[19]

The proliferation of projects addressing health, nutrition and related issues, promoted by social enterprises, NGOs and donors, is based on implicit recognition of the business case for such interventions. Even if projects are motivated in part by social responsibility, an expected positive impact on production is also anticipated. This uncoordinated but highly innovative process is far from a coherent PEG reform. But two underlying models can be identified – a top-down compliance model and a 'bottom-up' inclusive business market model – which vary on four dimensions:

- **form** of engagement: buyer-driven vs. voluntary participation by factories and workers;
- **scope** of intervention: in-factory only vs. covering both factory and home environment;
- **mechanism** for intervention: training vs. discounted sales to workers; and
- **financing**: Corporate Social Responsibility (CSR) activities of buyers', vs. contributions from factories and their workers.

Advocates of the inclusive business market model argue that contributions of finance from both factories and their workers enhance project sustainability - workers obtain benefits

[18] For example BSR/Gain, 2015

[19] A recent large-scale cross-country, cross-industry study, one of the first of its type, argued that compliance with basic labour and environmental standards (not necessarily including workers' health) increased factories' turnover by 4% (Distelhorst and Locke, 2018).

beyond their work, while factories benefit from productivity gains. Long-term sustainability rests on market-based solutions, such as discounts from goods and services suppliers. However, several of these projects include temporary supplementary financial support from private CSR or bilateral donor. This support is in effect a learning rent. On the other hand, the training focus of the compliance model is in effect a learning process (for both workers and management).

4.1.3 Business and PEG reform

A merged ‘hybrid’ model may help to provide learning rents in relation to workers’ health or other interventions, if it can be embedded in a systematic process of rent allocation, to scale up the interventions to larger numbers of factories and buyers. The Accord/Alliance exercise resulted from the Rana Plaza disaster leading to widespread public support for a change in buyers’ stance on their responsibility for supplier factory safety. The health problems of RMG workers are likely as serious as the factory safety crisis in terms of risk of loss of life and of health system costs. However, the health crisis is ‘slow-moving’ – its gradual impact is less visible and has little ‘shock value’ of the sort needed to ‘kick-start’ a dynamic PEG reform process.

- To create momentum for reform, an essential first step is **increased coordination** amongst buyers, building on the Accord and the Alliance experience but extending to issues beyond factory safety. This will be difficult and slow, as the very existence of the Alliance underlines – it was started by buyers reluctant to accept the commitments required by the Accord. Buyers’ home governments need to support greater coordination amongst buyers, both in Bangladesh (where it is currently infrequent) but crucially also at global head office level. Since buyers are based in many countries, this require home governments, and their donor agencies, to themselves cooperate. Coordination at *both* country and head office level is essential to ensure buyer commitment. Notwithstanding the risk of buyer ‘fatigue’, engagement convened by their own governments could help build consensus on issues for factory and worker upgrading and ensure that PEG reform to address factory safety is extended to other labour conditions. To support a PEG reform process, we suggest:
- Bangladeshi **private stakeholders** should be directly involved from the outset in PEG reform. Business associations are not strongly focused on health or other aspects of labour force conditions. In particular, a sense of local ownership of processes is essential, together with financial and technical support.
- Similarly, **government engagement** is essential, because reforms concerned with health must address not only factories but also workers’ living conditions. This requires public regulation and public finance. Donors could assist governments to work with clusters of factories to begin addressing housing and community development needs.
- Donor efforts to promote more systematic collection of data in factories on the cost and impact of their interventions would help to build the **‘business case’ for investment** in workers’ health (or other social interventions).

- Work done to establish the business case would lay a foundation for a set of **harmonised standards** against which productivity gains can be certified, including data collection requirements. This is required for factories and buyers to obtain recognition for their effective use of the learning rent. Donors have a role to play in the development of social sustainability standards and assurance.
- **Financial support** needs to be provided in advance to encourage firms to undertake the risk associated with learning. Risk sharing is difficult to structure in Bangladesh. Donor agencies and DFID in particular, could catalyse collaboration between home country private financial institutions with expertise and capital, and home country buyers with in-depth knowledge of the RMG sector and financing conditions in Bangladesh.
- Finally, donors could initiate a global debate on a '**workers' welfare tax'**, a consumer tax at a low rate on garments from Bangladesh (and similar producer countries), to fund a trust to improve workers' conditions, inside and outside factories[20].

4.2 Cocoa in Ghana

The cocoa sector has been successful at the macro level – providing 20-25% of export earnings and receiving a quality premium relative to global market prices. However, productivity of the 800,000 farmers remains low and farmers' incomes are barely above the poverty line, despite significant increases in farmer's share of export prices, the largely free services provided to farmers[21] and the farmers' voting weight in Ghana's competitive clientelist politics.

We examine the reasons for this paradox, and in particular, how action by companies to improve PEG can raise farmer's incomes. We examine whether market barrier rents, in the buying segment of the value chain controlled by the government-owned COCOBOD marketing board, and in the heavily subsidised domestic processing segment[22], have resulted in rent appropriation at the expense of farmers. If so, introducing greater competition in those segments might be expected to shift rents to the latter, but the case shows that this would not work. Instead, scaled-up, more focused sustainability programmes with farmers supported by the large corporates is a more promising approach.

4.2.1 Rent distribution in the sector

Despite Ghana's quality premium, its share of the global chocolate market is very low, earning the country around $2.5 billion in export revenues of an estimated global market of $100 billion. The cocoa producer gets only 4% of value in the final product. The processing and

[20] A suggestion of Bangladesh Nobel laureate Muhammad Yunus immediately after the Rana Plaza tragedy, which deserves wider discussion.

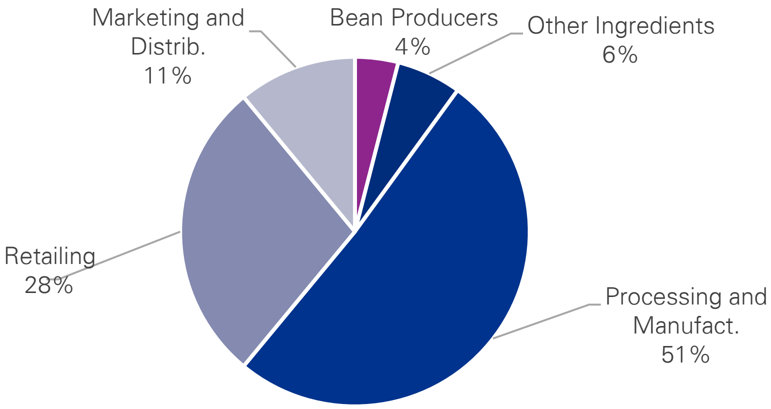
[21] by the state owned marketing board (COCOBOD),

[22] by locally-owned and foreign processors, including the dominant global players

manufacturing segments are very concentrated globally, though large firms in the two segments remain independent of each other.

Table 2: Distribution in the Chocolate Value Chain (% of Value Added)

Source: Barrientos, 2016



Within Ghana, the distribution of rents amongst the different actors in the value chain – farmers, buyers, marketing agency, and processors – is determined largely through public regulatory action, particularly those of COCOBOD. Farmers' income as a share of the export price has risen substantially, from 54% of export proceeds between 1996/97 and 2002/03, to 61% between 2008/09 and 2012/13. Over the same period, the share used to finance services provided to farmers, largely for direct farming support, rose from 2% to 13%, while the government's explicit tax take dropped from 16% to 3%. Processing is heavily subsidised. The three largest global processors all run mills in Ghana for strategic reasons, and are also increasingly dominating the buying segment there. Very little chocolate is manufactured in Ghana, but the global manufacturers are increasing their presence through sustainability programmes, delivered on their behalf by processors or trading companies.

Rent distribution within the Ghana cocoa value chain can be characterised as a 'stable equilibrium': stable in the sense that without shifts in the international context, there would be little incentive for the dominant actors to disrupt the distribution. This is reinforced by politics – the Ghanaian 'political settlement' may be competitive clientelist, but whichever party is in government benefits from the contribution to macroeconomic stability.

This suggests that the initial hypothesis of the case study – lower entry barriers in the marketing and processing segments in Ghana to shift rents towards farmers – may not be a viable approach. Current challenges in the sector lead towards a different set of recommendations focused on collective action of the global corporates.

4.2.2 Current challenges in the sector

The challenges facing the cocoa sector globally were brought into sharp focus by an *oversupply* of cocoa in 2017, causing world prices to fall by more than 30%. Weather was a factor, but many also blamed company-led sustainability programmes focused on productivity gains. Cote d'Ivoire suspended such programmes during 2018. The deepened sense of crisis led the International Cocoa Organisation (ICCO) to issue its first 'Declaration' in 2018, prioritising farmer poverty, and other social and environmental problems, but with few specifics on mechanisms.

The Ghanaian government's current strategy aims to increase Ghana's share of global rents in the sector, to allow it to maintain existing transfer rents to its key cocoa constituencies, domestic business and farmers. The strategy includes four elements:

- **export revenue** stabilisation through coordinated bean sales with Cote d'Ivoire to influence the world bean price;
- **higher farmers' yields** through technical interventions including irrigation, farm rehabilitation, replacement of diseased trees, and hand pollination programmes;
- **expanded domestic processing** as well as manufacturing, with an explicit target to process half of Ghana's beans domestically by 2022; and
- **sales to the Asian market, especially China,** where COCOBOD has opened a marketing office, while a Chinese-funded processor is to be built in Ghana.

The government's determination to shift the status quo in the sector is evident, though there are risks associated with its strategy. If substantial stocks are withheld from the market to support coordinated marketing to smooth prices and to support expanded domestic processing, the benefits from the 'Ghana premium' may be lost, in part or in full. The 'Ghana premium' allows forward sales of beans against which COCOBOD obtains loan financing to support bean purchases and service provision to farmers. Furthermore, global corporates are sceptical about the prospects for large-scale processing and manufacturing in West Africa, while processors argue that increasing the supply of beans to domestic processing in Ghana would cut bean exports and reduce revenue from the 'Ghana premium'.

4.2.3 Business and PEG reform

For business to begin to address PEG reform, a catalyst is needed - most commonly a crisis in the sector threatening business performance. Bean supply concerns in 2013/14 pushed corporates to begin moving, albeit hesitantly, towards a new approach to cocoa sector PEG. We focus here on whether this new PEG approach is adequate for its objectives, and what lessons it offers beyond the Ghana cocoa sector.

In 2014, the nine globally dominant corporates – four processors and five manufacturers – set up CocoaAction under the auspices of the World Cocoa Foundation, as a joint initiative to address the SDGs in cocoa. This is 'a voluntary, industry-wide strategy' to coordinate and scale up sustainability programmes. The Ghana and Cote d'Ivoire governments are external partners rather than participants. The initiative focuses on farmer productivity, and prioritises delivery of seed and soil management together with training, an essential element of farmer service packages[23]. This in effect recognises the need for corporates leading GVCs to provide

[23] Ingram et al., 2018

learning rents to cocoa farmers to replace or supplement the transfer rents they currently receive from government. However, CocoaAction faces several concerns relating to its potential to transform the cocoa sector:

- A rent substitution process must be complemented by a 'dual transition' in cocoa farming[24], in which more **competition** leads to **consolidation** in farming. The sector will shift toward fewer cocoa farmers who are more productive, with other farmers switching to other crops or out of the sector entirely. It is unclear whether CocoaAction programmes will take responsibility for the careful management of the latter, involving 'safety nets' and training in other skills.
- Improved farmer access to **financial services** (credit and insurance) is key to their business viability, yet is seen in CocoaAction as complementary rather than core;
- CocoaAction does not acknowledge that **farmer organisation** is essential to sector governance. Farmer associations, though currently few in Ghana, can support the effective delivery of 'learning rents', as well as of goods and services, improved access to finance, and political 'voice'; and
- CocoaAction is a **voluntary process** without compliance requirements, and its failure to make farmers' income a key performance indicator has been a particular concern. This is linked to views that the large corporates are reluctant to raise chocolate consumer market prices or to themselves absorb higher cocoa bean prices. This concern is reinforced by the corporates' retention of a share of certification-linked premia on beans to fund sustainability programmes.

In order to be successful in driving PEG reform, self-regulation initiatives like this one must have the club-like characteristic of excludability, or enforceable sanctions, for 'breaking the club's rules'. Two steps are needed:

- Development of a set of **sustainability targets** agreed by CocoaAction in consultation with other industry stakeholders, including producer country governments and civil society representatives from both producer and consumer countries; and
- Either **independent auditing** of programmes against these targets, or **peer review** of corporate sustainability programmes involving stakeholders consulted on the targets, with some type of penalty – for example, payments into a CocoaAction sustainability trust fund – for missed targets. There is a potential broking role here for donor governments, in collaboration with the International Cocoa Organisation to facilitate a broadening of the process to introduce some form of compliance.

4.3 Audit and Accounting Services in Tanzania

The audit and accounting sector has an unusually central role in Tanzania's national 'political settlement' at present. In 2015, new president John Magafuli introduced an anti-corruption agenda focused on tax non-compliance and higher revenue collection to pay for improved

[24] SEO, 2016

public infrastructure service delivery and lower business costs, together with more transparent ‘deals’ with large firms. This implicitly raised the value of transparent and credibly audited financial statements, though the Magafuli programme had become less assertive by late 2018, in the face of resistance from large and small business.

In this case we examine how accounting and auditing standards can be raised in Tanzania, and what role auditing firms can play in that process, with support from donor agencies. Improved accounting and auditing services should be reflected in higher monitoring rents accruing to accounting firms. These rents are available because credible financial statements for an enterprise would be expected to lower its transaction costs when dealing with public authorities, lenders and other businesses. Improved standards enhance the ‘social return’ to auditing and accounting, and contributes to economic growth and enterprise development. Thus, a higher standard of auditing should raise the aggregate rent available to the accounting and auditing sector, giving them as a group a direct interest in improving standards.

4.3.1 The segmented accounting and auditing sector

In Tanzania, certification of accountants and auditors is provided by the National Board of Accountants and Auditors (NBAA), a statutory body that regulates the accounting sector. The NBAA, constituted and financed by government, provides certifications for both Certified Public Accountants (CPAs) and CPAs in Public Practice (CPA-PPs). Only CPA-PPs are to sign off on audits, and are relatively scarce at under 1,000 certified or in training in Tanzania.

CPA-PPs are grouped into 240 auditing firms, of which only 13 are part of foreign networks. As in the UK and elsewhere, the accounting and auditing industry is highly segmented into three tiers:

First Tier	This comprises the ‘big four’ firms – PwC, Deloitte, EY (Ernst and Young) and KPMG – all of which are present in Tanzania. The partners in the Big Four firms are all Tanzanians or from the rest of East Africa. Tier 1 firms are large, with dozens of CPAs. They have been operating in Tanzania only since the 1990s or early 2000s.
Second Tier	This includes foreign-networked firms such as Mazars, RSM, BDO and Grant Thornton, together with about fifteen Tanzanian firms. The entry of the foreign firms in this tier has been even more recent than that of the Big Four, during the past decade. Like the Big Four, they have linked up with well-established local firms or well-respected Tanzanian professionals. Almost all of the founders and senior partners in the second tier firms, both Tanzanian and foreign-networked, are former employees of the Big Four firms. Firms in this tier are about one quarter of the size of the Big Four. There are two or three larger Tanzanian firms, including the ‘legacy firm’, TAC (formerly Tanzania Audit Corporation), which led the profession as a government-owned during Tanzania’s socialist era.

Third Tier	Approximately 200 small accounting firms comprise the third tier of the industry. Sometimes disparagingly labelled 'briefcase' or 'rubber-stamp' auditors, these firms have one or two partners certified as CPA-PPs, and a handful of graduates as professional staff. Their fees are low and they struggle financially – there is intense competition amongst them, as well as competition from uncertified financial advisors and bookkeepers who prepare financial statements for businesses.

- Most large businesses in Tanzania, including private and public sector enterprises as well as local subsidiaries and affiliates of multinationals, are audited by first and second tier firms. The CFOs and often also the CEOs of these large businesses are usually former Big Four CPAs who have moved into management in other sectors. Third tier audit clients are largely smaller domestic and international businesses, such as aid-funded projects.
- The industry is segmented not only by firms' size but also by access to systems – including those relating to personnel development, technology, and cross-border collaboration within networks. The Big Four invest heavily in graduate recruits, while staff obtain substantial international experience through secondments and placements in the network's offices elsewhere, through joint audits of multinationals with other member firms, and through quality reviews within the network.
- The Big Four firms are able to source proprietary technology and software from their global networks, while their size allows them to source further in-house expertise. Some of these advantages are shared on a more modest scale by second tier firms that are part of global networks. In contrast, third tier firms are largely excluded from these knowledge flows and are almost entirely reliant on the NBAA information and knowledge.
- Because of this market structure, commercial banks use their own 'informal' certification of auditors when using financial statements. For large banks, financial statements audited by first or second tier firms are required for loan requests as low as $650,000. Smaller banks generally rely on the assessment of bigger banks, but have a much higher non-performing loan rate. The Tanzanian Revenue Authority (TRA) carries out its own audits of many firms whose financial statements it does not regard as credibly audited, which is generally the case for third-tier auditors. The Business Registration and Licensing Authority (BRELA) is a key official agency as firms are officially required to file their audited statements annually, but it is only now moving to an e-system which will allow effective compliance monitoring, and coordination with the TRA.

4.3.2 Standards and the NBAA

In 2004, the NBAA adopted the International Financial Reporting Standards (IFRS), the global standards for accounting, and the International Standards on Auditing (ISA). The adoption of these global standards has been advantageous for the globally networked firms, allowing expanded flows of knowledge and information within their networks.

As elsewhere, SMEs in Tanzania required to prepare financial statements (all firms above a very low threshold of $8000 turnover) were officially supposed to use full IFRS standards, though few did. In 2009, a simplified global standard, the IFRS for SMEs, was issued, but in Tanzania, it could be used only by firms smaller than 100 employees or $350 000 assets. Only in 2019 has the threshold been finally adjusted upward, upon introduction of FRS for Micro Entities, adopted from the UK. It is also a problem that the standards have not been translated into Kiswahili.

Poor quality accounting remains a major problem in most Tanzanian companies. This is also reflected in the low quality of audits by small audit firms, who claim that the time required for them to meet the ISA auditing standards is onerous, and raises auditing fees beyond what their clients are able or willing to pay. Both the preparation of SME financial statements and their auditing are often exercises intended purely for formal tax compliance purposes, rather than to provide accurate business information. Interviews with an informant also suggested widespread collusion between businesses and third tier auditors on under-declaring taxable income, with the implication that small auditors are in many cases appropriating a share of transfer rents resulting from tax evasion by large numbers of businesses.

The NBAA still faces several challenges. It is severely under-resourced in terms of staff and finances despite its uncommon dual role as statutory regulator of the profession and as representative professional body. It is regarded as providing poor oversight of university teaching curricula and the professional qualification syllabus, and has been criticised for lack of leadership on the IFRS and ISA standards. Its auditing quality assurance process has little credibility amongst first and even many second-tier accounting firms.

4.3.3 PEG Reform

At present, firms in the top two tiers protect their brand value through their individual networks, and insulate themselves from third tier firms, in the process lowering average standards. A more efficient and effective system requires a shift in the long run to a single set of higher accounting and auditing standards. This would be achieved through better enforcement of rules, through stricter quality assurance of auditors, and upgrading quality through improved transfers of knowledge. This ‘market-building’ process would need to be led by the first and second tier firms, especially those that are globally networked, as they have the resources and access to the knowledge and systems required for higher quality practices. The question, as in the cases of Bangladesh and Ghana, is how to bring about collective action by the large firms to lead governance reform – the difference being that this would be through diffusion to firms within the same value chain segment.

As the home government of the Big Four firms, UK government representatives in Tanzania could create a forum of these firms and some second tier firms, to consider mechanisms systematic improvement of accounting and auditing standards. This would build on recent short-run and focussed cooperative initiatives of the Big Four. To help build a coalition with smaller accounting firms, the forum would need to operate in consultation with the NBAA, which should also be given direct support as a body able to give voice to smaller firms. Actions are needed in five specific areas.

- Direct action to **raise performance standards** in in the industry. One way to do this is through consolidating small firms and increasing competition in the second tier through the entry of more foreign networks (especially from the region);
- Expand access of individual Tanzanian accountants to **knowledge and expertise** from outside Tanzania, through internships and mentoring programmes involving UK counterparts;
- Significantly tighten **registration and compliance** procedures for auditing firms, including adoption of effective enforcement mechanisms. Where possible, strengthen compliance reviews and connect them to upgrading of small firms by establishing panels of mentors, through temporary placements in Tanzania of (retired) accountants from the UK;
- Improve formal **accounting education**, in particular by assisting the universities and high schools in this respect. This can be achieved through extending linkages with UK-based education institutions, through enabling slimmed-down versions of Big Four graduate training programmes for local firms, and through local and international internships; and
- Build **institutions**, in particular to strengthen the NBAA and its cooperation with other official organisations, especially TRA and BRELA. The possibility of a levy on audit fees to improve NBAA finances needs to be explored, as well as donor-financed support from organisations such as the Institute of Chartered Accountants of England and Wales (ICAEW). Donor-financed secondments to NBAA as well as BRELA and TRA of a small number of senior staff from Big Four firms, as well as of retirees from outside Tanzania should also be explored.

5. Conclusions

5.1 Common themes

A number of common themes and lessons can be drawn from these three examples examining potential private economic governance reform through shifting a sector's rent structure.

- The first is that it is important to recognise that governance reform takes two forms.
  - The first and more widely-discussed form is **market-enhancement**, referring to liberalised regulation to allow greater freedom of entry and action by private actors in the market to enhance efficiency through more competition, on one hand, and on the other hand to greater transparency and accountability to reduce corruption, rent-seeking and government failure.
  - The second form of governance reform is **development-enhancement**, referring to processes and institutions to manage the creation, transfer and acquisition of knowledge and information to achieve growth that is sustainable in economic, social and environmental terms.

  Taking account of both forms of governance requires consideration of a wider range of rents than the conventional focus exclusively on those that result from politically restricted barriers to market access.

  In addition to these, we need to consider **knowledge-based rents**, and in developing country contexts, especially those linked to learning and are provided to firms to induce them to undertake the risks associated with learning and technological change that raise productivity.

  We also need to consider also **monitoring-based rents** that reduce asymmetric information between transacting parties in markets, and the consequent transaction costs, thus allowing more transactions to occur.

- Secondly, the three cases discussed above show that **actions both within and beyond the sector of inter**est are usually required to bring about the intended impacts of governance reform. This is of course a consequence of expanding the remit of governance to include 'development' rather than simply markets, but it emphasises that governance reform alone, narrowly understood, and is unlikely to be sufficient to achieve SDG objectives.
  - The RMG case underlined that improving workers' health depends not only on improvements in factories, but also on improved living conditions and consumption patterns, requiring action on housing and urban infrastructure and in food markets.
  - The cocoa case pointed to the need for consolidation of the cocoa farming sector towards fewer but more productive farmers, requiring action to support the transition of many cocoa farmers into other activities inside and outside agriculture.

  - The accounting and auditing case was linked to the need for broader action on combating corruption and improving tax compliance, or to put it more generally, to the need to renew the 'social contract' between government and citizens.

- Thirdly, all the cases underlined the importance of **collective action by firms**, while pointing to the difficulties of achieving this outside the context of a 'crisis'. Possibilities for collective action by business do not lend themselves to universal 'best practice' responses, but are highly context-specific. Understanding the existing rent structure in a sector and the potential to change it requires

  - a deep analysis of both the sector's global context, and
  - its position within a country's political economy.

  Both of these dimensions shape the potential for building coalitions, which need to specify, at least implicitly, burden sharing between their component groups. They can therefore be difficult to construct, as each group will try to minimize its share at the expense of the others. Coalitions may involve some combination of foreign firms, domestic businesses in the sector, and 'the poor' (workers or small farmers), and may promote or obstruct change in private economic governance.

  Foreign (or foreign-networked) firms, in particular global corporations such as those at the centre of each of the three cases, often have substantial 'structural power' within a developing country, even if their direct political power within the country is limited because they are not owned by citizens. Their structural power is based:

  - firstly, on their market domination and access to global resources, and
  - secondly, on the sector's significance in the domestic economy, due to its contribution to GDP or to exports, or to its infrastructural role in easing potential bottlenecks, physical or other.

  Notwithstanding their power, achieving 'impactful' collective action by foreign firms – going beyond rhetorical statements – is perhaps the most intractable challenge facing business-led private economic governance (PEG) reform. As the cases show, this may emerge when firms are forced by events to address risks in the context of a 'crisis', as the RMG factory safety example illustrates, and the formation of CocoaAction in response to the cocoa supply crisis. The Accord and CocoaAction provide institutionalised mechanisms – along similar lines to business associations – for the exchange of (non-commercial) information and knowledge amongst businesses, and for discussion of business strategy in relation to the respective objectives. In other words, their institutionalisation enables collective learning and innovation by the global firms.

  This learning process is given 'teeth' by the involvement of organisations other than firms, that is, firms are required to commit to PEG reform by the presence of **other stakeholders**. Without this pressure, market competition considerations are likely to lead each firm to commit as little as possible, for fear that the others will 'free-ride' on their contribution. Outside stakeholders were central in the initial establishment of the

Bangladesh Safety Accord – buyers were convened by a donor[25] – and in its management. In contrast, non-commercial stakeholders did not play a role in establishing or managing CocoaAction. The contrasting impacts of these two initiatives underlines the importance of such non-firm organisations representing the 'public interest' (which could be a government, but not necessarily only government), in catalysing collective action, and in monitoring of commitments and implementing sanctions for non-compliance.

What if there is no 'crisis' to facilitate the convening of firms for **collective action**?

- If the **number of relevant firms is small**, collective action may still be possible, because firms can be persuaded individually to participate so that coordination failure due to fear of 'free riding' can be overcome.
    - In the case of accounting and auditing, this suggests the potential of the Big Four firms to act as a group. As discussed above, collective action by the Big Four in Tanzania has in fact happened, but only as a one-off intervention in a short-term exercise. It is conceivable that engagement by outside agents, subsequent to that collective intervention, might produce an institutional mechanism bringing the Big Four together with a few other globally networked firms in the sector. Ongoing action could be undertaken on a range of issues relating to the transfer of knowledge and expertise into Tanzania, and diffusion within the country. The intervening agents could be a relevant UK public agency engaging with the global firms' UK offices in parallel with UK government officials in Tanzania engaging with the local offices of the Big Four.
    - In the cocoa case, the number of global firms is also small
- If the **number of foreign firms is large**, it may still be possible to convene a sub-group to participate in collective action, in particular to undertake a joint learning exercise, supported by learning rents provided by a public source. Such a learning exercise carries risks for the firms involved, so public resources would offset this. The learning exercise could be used to develop and test interventions to promote development-enhancing PEG, including formulation of standards and compliance assessment mechanisms. Innovation by a smaller group could become the basis for widening collective action to include more firms.

- Fourthly, **business associations** bringing domestic firms together are central in economic governance reform. However, they may play a defensive, reform-blocking role. Whether or not they do this depends in part on the source of the rents appropriated by domestic firms in an association.

[25] In the case of the Accord, key roles were played by GIZ and international trade unions. See Clean Clothes Campaign and Maquiladora Solidarity Network (2013).

- Firms are likely to push their association to block reforms if their rents arise from participation in 'deals', in other words, from market-barriers restricting competition or entry by non-incumbents. Barriers commonly take the form of licenses – to import specific goods for sale on domestic markets (cars, mobile phones), supply specific services (electricity, banking, telecoms services), or export natural resources (minerals, specific crops). Business associations of domestic firms linked to foreign firms within global value chains may be more likely in theory to support reform. However, whether or not they do so will depend on whether the reform process effectively addresses the risks they face in participating in reform.
- If the costs and benefits of reform are felt to be distributed unfairly, particularly between domestic and foreign firms linked in value chains, it is possible for business associations of domestic firms to block reform. They may use their more direct access (relative to foreign firms) to national political power. In simple terms, they can play the 'nationalist card', which is likely to be possible even if the domestic firms are not central to the prevailing 'political settlement'. The process of coalition building therefore needs to manage carefully the distribution of reform costs and benefits to maintain a sense of fairness, taking account of any need to improve equity across groups relative to the pre-reform rent structure. Financial support for reform from donors can contribute to this process, as the cocoa and RMG cases illustrate, though significant expansion of its scale may be necessary. Notwithstanding donor support, a sense of fairness is also likely to depend on transparent contributions from foreign firms.

5.2 What can donors do?

Donors can contribute to PEG reform in five ways.

- First, they can **strengthen the capacity of domestic business associations** and organisations of 'the poor' (workers, small farmers), where this capacity is weak. Donors can provide support to enable more staff recruitment and organisational development, as well as technical expertise where needed (as the potential contribution of the ICAEW in the accounting case illustrates). This will enable these organisations to mobilise more members, amplifying their 'voice' within coalitions, and to expand their focus to a wider set of issues, especially those involving longer time horizons, making them more dependable coalition partners.
    - In the RMG case, the domestic business associations are politically strong, but the scope of technical issues on which they engage their members is rather narrow. The labour groups in the RMG sector are largely small and weak.
    - In the accounting case, the NBAA is the representative group for the small accounting firms, but has limited resources.
- Secondly, donors can **promote collective action by foreign firms**, including supporting financial commitment by foreign firms to governance reform: that is, rent re-

distribution within the value chain. Donors can start by convening firms headquartered in their own country, but in most cases, these firms will need to be brought together across national lines through cooperation amongst donors. The convening process should happen at two levels – involving foreign firms' in-country representatives, as well as headquarter staff to whom in-country staff are accountable. The latter are more likely to facilitate the long-term perspective that is essential. Where the number of foreign firms is small, as in the cocoa and accounting cases, this convening (including cooperation amongst donors) should be possible.

Convening firms in a sector to promote PEG reform needs to be viewed by donors as a **long-term and multi-faceted process**, which will require commitment of resources (human and financial). It need not wait for a 'crisis' in the sector as a way to mobilise firms, but can begin by trying to establish some consensus about long-term priorities and challenges for sustainable development in the sector. Foreign stakeholder discussions about RMG factory safety began in Bangladesh before Rana Plaza. However, they were energised by the tragedy to move very quickly to implementation.

It is also important that **sustainable development** issues be 'mainstreamed' on both sides of home country government-business dialogues. By this is meant that,

- on one hand, donor agencies work with other relevant donor government institutions, such as trade promotion or tax authorities, when engaging with foreign firms in partner countries.
- on the other hand, global corporations are themselves large and complex organisations with a range of functional departments operating across multiple geographies.

The units charged with aligning the corporation with sustainable development objectives are themselves often marginalised inside their own organisation. Donor agencies may need to work with them, engaging directly with the more powerful sections of firms, to underline the benefits to the firm of PEG reform.

The objective of promoting collective action for PEG reform must be the structuring of **enforceable commitments** by foreign firms to economic, social or environmental improvements in their sector.

- This was done in the <u>RMG</u> Bangladesh Safety Accord, but collective action needs to go much further in its scope.
- Collective action in the <u>cocoa</u> case thus far is only voluntary, and lacks enforceability.
- In the <u>accounting</u> case, collective action is sporadic and extremely narrow in scope.

To enable enforceability, the convening process may need to include additional stakeholders, from the sector in the partner country, and possibly from NGOs and representative organisations such as trade unions in home countries.

- Thirdly, donors can help to create and **disseminate knowledge**, initially in the form of support for joint learning exercises to develop standards systems, as described just above.
  - In the RMG case, for example, donors could support the development of data collection systems in factories, initially to help make the 'business case' for PEG reform focusing on improved worker health status. These systems could subsequently be adapted for use as standards across the sector, and in other sectors. This is particularly complex in this case because a hybrid model needs to be created bringing together the top-down and bottom-up inclusive business approaches.
  - In the cocoa case, targets for economic, social and environmental sustainability need to be developed, together with standardised compliance assessment approaches.
  - In the accounting case, standards already exist but there is a need for some adaptation (and translation into national languages), as well as dissemination, through expansion of training and mentoring schemes.
- Fourthly, donors can **leverage finance** to facilitate rent re-allocation and coalition building, as well as supporting action beyond the sector of immediate focus, where possible. Financial commitments from global firms in the sector, including rent re-distribution within the value chain where appropriate, is an important signal of their commitment to PEG reform, but it may only be possible to elicit these commitments once reform is underway. Donors' own financial resources face multiple demands and are unlikely to be sufficient. However, they could be used to initiate processes, either to promote participation by foreign firms in collective action (as in the joint learning exercise example discussed), or to leverage larger amounts of private finance from the investment community in their home country.
  - The City of London is one example in the case of the UK. Within this community, there is considerable financial engineering expertise that could be drawn upon to structure bespoke financial instruments – along the lines of social impact bonds or development impact bonds[26] – for risk-sharing and rent allocation, to attract private finance to enable PEG reform in specific developing country sector contexts.
- Finally, donors can initiate or support a global **policy debate about a consumption tax** on mass-market goods, such as clothing or chocolate products, to fund improved social and environmental standards in the production of these goods. Consumption taxes at very low rates can help to build trust funds to finance welfare improvements for farmers or workers in producer countries, without significantly affecting consumption levels in rich countries, or global firms' revenues.

[26] CGD, 2013

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Appendix 2 Terms of Reference – Study on Private Economic Governance

Overview

Business Environment Reform Facility (BERF) is funded by the UK Department for International Development (DFID) under the Business Environment for Economic Development (BEED) Programme. BERF is a central facility responding to demand from DFID's priority country offices and stakeholders to initiate, improve and scale up business environment reform programmes. BERF is managed by a consortium led by KPMG LLP. The programme started in January 2016 and will finish in March 2019. BERF provides expert advice, analysis of lessons learned, policy research about what works and what doesn't, and develops innovative new approaches to involving businesses and consumers in investment climate reform.

The objective of Policy Research commissioned through BERF is to help DFID country offices (COs), central policy teams (CPTs) to improve their understanding, and implementation of business environment (BE) reform by contributing to the evidence base of what works and what does not work. The research will inform the focus of DFID's programmes, DFID's central policy work and the global development community more broadly.

These terms of reference are for a study into the long term positive impact that firms can have on partner countries in terms of institutional and policy reforms to improve the business environment (in the context of, for example, procurement).

The goal of this policy research study is to generate evidence on and to provide practical policy recommendations for future programming by DFID, HMG as well as other donors and governments regarding how private sector companies could be supported to positively impact long-term institutional reforms in developing countries (this might include leveraging the organisations' convening power, making business voices heard, subsidising firms, etc.).

Objectives

The objective of the study is to provide new and practicable insights on

- **conditions** under which foreign investors might lead or influence institutional changes that improve economic governance of private sector activities in developing countries. This would usually be across an economic sector; and
- **mechanisms** through which donors might support such foreign investor action to reform institutions and improve private economic governance.

The study will examine the actors and processes that have led, or could lead, to such institutional reforms in a series of recent and current cases, and synthesise practical lessons relevant to DFID and other donors, applicable in their planning and programming. Actors are unique and particular across different instances of reform, but it is assumed that systematic and well-grounded approaches can be formulated to identify, analyse and address challenges of working with private investors to influence private economic governance.

Analysis will be required of how 'economic rents' are structured in the sector: how rents are created and distributed amongst firms (and other economic actors), and how the rent structure might be changed. The rent structure is shaped by politics and its effects on institutions of private economic governance. 'Institutions' in this context include both formal rules and organisations, as well as informal processes (such as unwritten rules).[27] We will look at whether, and how, the rent structure can be re-shaped by political (economy) action involving private firms, in particular foreign private firms, as well as donors (also foreign). Both foreign investors and donors need to engage with political actors with sufficient power, if they are to (help to) bring about institutional change and economic governance reform.

The study adopts a sectoral (or partial) focus while recognising:

- rent structure and economic governance in a sector is partially determined by national processes and institutions (and in many cases also international factors and processes); and
- sectoral/partial institutional reform might 'spill over' to have a wider impact beyond the sector of initial interest.

Scope

The study will focus on cases where there are institutional blockages or obstacles to shifting the rent structure in directions more supportive of economic growth with structural transformation, or institutional gaps which if filled would enable a more transformative rent structure and more durable growth. The study will consider different types of institutional blockage or absence, including:

- sectoral entry barriers, such as licensing requirements;
- restrictions on market competition, for government procurement, for example;
- inadequate market regulation of corporate conduct within markets, with possible adverse consequences or under-supply of social and environmental standards; or
- limited market linkages between foreign firms and the domestic economy (often found in extractive activities, but also other sectors), which would lead to a failure to promote local enterprises.

Addressing these institutional problems involves shifting the rent structure. This includes changing:

- the ways in which rents are created and appropriated;
- the ways in which they are distributed –
  - amongst firms,
  - between firms and workers (and other stakeholders), and/or
  - between the domestic economy and the rest of the world.

[27] This is what Pritchett, Sen and Werker (2018) call the 'deals space' that for them includes formal rules.

The study will aim to identify cases where institutional reform might be led or stimulated by firms acting individually or collectively, and possibly acting only once their incentives to do so have been influenced by 'public' action (notably in this case, donor intervention). Institutional reforms are likely also to result in some shift in 'state-business relations', within the sector and perhaps more widely across the economy.[28]

Method

We will use a qualitative (process-focussed), case-study method to investigate approaches to identify, analyse and address reform of firm-led private economic governance. The case approach is the only feasible methodology given constraints of time and resources for this study.

The study will have two phases.

- **Phase I** will involve desktop research to clarify the conceptual framework and to identify and motivate the in-depth cases to be undertaken in Phase II. Phase I will present six to eight short cases of recent examples where foreign firms' intervention has impacted positively on institutional reform to enhance private economic governance, or where such intervention has failed to lead to governance reform. The research in Phase I on recent episodes will use existing literature and documents (grey literature, media reports) as well as interviews of participants in the episode, where possible. The work will also review relevant work underway in DFID and other organisations, (such as the stocktake of integrity-enhancing collective action for the BII).
- **Phase II** will involve in-depth, in-country research on three illustrative cases (in at most three DFID partner countries), intended to scope the potential for future institutional reform of private economic governance at the sector level, and outline mechanisms and instruments with which DFID (or other donors) might be able support such reform. The cases will be selected to cover as far as possible the range of different institutional blockages listed above. The cases will be illustrative rather than prescriptive: given the variety of such blockages and associated shifts in rent structure required as part of reform, it will be expected that the potential mechanisms and instruments available to DFID to support firms' intervention will also vary across cases. Hence the report will not produce a standardised list of interventions, but rather a 'toolbox' of possible mechanisms and instruments, with indications of when and how each might be appropriate.

A fourth case may be added, looking at a second sector in one of the three countries, if this is feasible within resource limits, and will provide appropriately useful comparative perspective relative to one or more of the selected case studies.

For each case, we will engage with small numbers of firms and other stakeholders in each case-study country/sector, using semi-structured interviews. The study will target at least 20 interviews per case, with at least ten of these expected to be with firms in the sector (both foreign and domestic firms). The interviews will be supplemented by document analysis,

[28] Though whether such shifts constitute an improvement or deterioration in private economic governance is not necessarily captured by the idea of movement along a one-dimensional spectrum representing 'distance' or autonomy between state and business

including media reports, grey and academic literature, and annual reports of firms and stakeholder organisations.

Deliverables and Accountability

The output of Phase I will be a short draft paper, which will be revised and incorporated into the longer report produced during Phase II. It will include the conceptual framework, short write-ups of the recent cases, and short motivations for the cases of potential reform selected for Phase II. Total length will be 15 – 20 pages.

The final report will include write-ups of the cases covered during Phase II to add to the Phase I report. Each case will be approximately ten pages, with additional case detail can be provided via appendices as necessary. Total report length will be 40 – 50 pages, excluding appendices.

The work will be undertaken by ODI, subcontracted by BERF (KPMG). ODI will identify and subcontract three in-country experts (to be approved by DFID), with appropriate experience of the economy and institutional reform in their country, and with appropriate networks from working with businesses, donors and government actors in their country.

The DFID GOSAC team will provide final technical approval of each of the two reports which will be subject to quality assurance by the KPMG BERF team prior to submission to DFID.

Appendix 3 Ready-made garments (RMG) in Bangladesh

The BD RMG industry has been the engine of the country's economy since the early 1980s, and supplies more than 80% of its exports[29], with just over 3850 factories employing an estimated 3.6 million workers, of whom 53% are estimated to be women[30]. It has well-known challenges with regard to labour, including wages, working conditions in the factory and worker organisation and 'voice'. We look in this case at workers' health issues, particularly for women workers, and the link between improvements in health status and in factory productivity. Needless to say, health is not purely an in-factory issue within the remit of employers, but relates also to housing and community and social infrastructure.

We are interested in the problem of structuring learning rents through business involvement, and in particular the need for reciprocity, that is, for recipients of learning rent to meet pre-defined targets to justify their *ex ante* rents. It is common in GVCs led by buyers,[31] such as those in the RMG sector, that lead companies assist their suppliers with technological 'upgrading', in effect providing learning rents to those suppliers. The knowledge sharing and training that is part of upgrading, is (usually) accompanied by the buyer's commitment to source from the supplier. However, this relies on individual buyers choosing both to upgrade suppliers, and which suppliers to work with, to gain a competitive advantage. In this case, we want to look at the potential for PEG reform to create systematic incentives for all suppliers to engage in learning activity, to achieve a social outcome while also raising overall productivity.

The post-Rana Plaza process and PEG reform

PEG reform has already happened in the sector in the context of the post-Rana Plaza process. In April 2013, the collapse of the Rana Plaza building housing several RMG factories caused the death of 1134 workers, soon after a fire at another factory (Tazreen) caused 117 deaths in November 2012.

These two incidents shocked all stakeholders in the industry and precipitated the buyers into a PEG reform to address factory safety. Three formal organisations were established to implement binding agreements:

- the ***Accord on Fire and Building Safety*** in Bangladesh was signed within three weeks of Rana Plaza, and involves mainly European buyers in an agreement with global trade unions which allows for arbitration in an independent forum;
- the ***Alliance for Bangladesh Worker Safety*** (which closed down in December 2018) involved 28 US buyers who did not wish to participate in the Accord's arbitral

[29] World Bank, 2016; Ahmed et al., 2014

[30] Moazzem and Radia, 2018 It is commonly reported that 80% of the industry's workers are women. The figure of 53% is from an unofficial but careful effort to integrate official and unofficial datasets on the sector.

[31] By buyers, we mean brands, retailers, and specialist companies providing sourcing and GVC management services to brands and retailers.

mechanism, and was a self-regulating group allowing for enforcement through its own board disciplining delinquent members; and

- the ***Bangladesh Government's National Initiative*** which involves other buyers not in the Accord or Alliance, broadly smaller and from outside the US and EU. Between the three processes, 3778 factories had been or were to be inspected by December 2015 for structural, electrical and fire safety problems and their remediation requirements identified[32].

Factories were expected to cover their own remediation costs, but the Accord required buyers to support financing by negotiating 'commercial terms' with suppliers. This included product price adjustments or shorter payment periods, or alternatively assisting them to access loan finance, including by providing loan guarantees.[33] In addition, buyers were required to commit to their suppliers for at least two years, and continue sourcing from Bangladesh through the life of the Accord (an initial five years, extended for three years in 2018). Finally, buyers were expected to contribute to the costs of the Accord itself (inspections and audits) proportionate to their sourcing in Bangladesh, up to a $500,000 *per annum* ceiling.

Little information is available on revised supplier commercial terms and buyer financial support. However, of the estimated aggregate remediation cost of $929 million, as of June 2016, only $294 million remediation work had been done. The Bangladeshi financial system could not meet the challenge, especially given low creditworthiness of many factories. Donor programmes had been established to finance $187 million of the $635 million still outstanding, leaving a huge financing gap of $448 million[34].

The post-Rana Plaza process has accelerated the process of supplier consolidation and a decreasing number of factories which had already started, driven by buyer interest in more stable relationships with fewer suppliers (partly because of compliance demands), by rising wages, by differential access to finance, and other factors.[35] The process also underlined the political gap between the domestically owned factories and the foreign buyers. Neither the factories (including their associations – the Bangladesh Garment and Manufacturers and Exporters Association (BGMEA) and the Bangladesh Knitwear Manufacturers and Exporters Association (BKMEA)) – nor the government were involved in setting up and running the Accord and the Alliance.

Though the Accord's three-year extension makes provision for building capacity of a government agency, the Remediation Coordination Cell, to take over factory inspections and certification functions in 2021, some factory owners mounted a court challenge to the

[32] IFC, 2016

[33] The Alliance provided for assisted access to finance for factories.

[34] IFC, 2016

[35] There is debate over whether the total number of factories has dropped, but it appears there are fewer 'Tier 1' and 'Tier 2' factories, that is, contractors and sub-contractors known to buyers.

extension. Factory owners are anxious about Bangladesh losing global market share to lower wage locations, especially in Africa, after the country's imminent 'graduation' out of the LDC group of countries ending duty-free access to the EU and US markets.[36] There is also the common view that automation will significantly reduce demand from all low wage locations. These worries are compounded by the cost rises, linked to factory safety remediation and a 51% rise in the minimum wage in December 2018, from 5300 to 8000 taka per month ($63 to $95 approximately).

As noted, the post-Rana Plaza process can be understood as PEG reform. However, it is important to emphasise that the Accord and the Alliance have not involved the allocation of learning rents *per se*, but can be understood rather as involving payment of insurance premia to avoid future factory disasters. While obviously essential, factory safety[37] does not directly aim at productivity enhancement. Nonetheless, the process set a precedent for legally *enforceable* contracts involving buyers.

Workers' health in the RMG sector

We will not outline in detail the health status of RMG workers and their various health-related challenges. One study of 108 adolescent workers found that 92% were anaemic, and 89% worked 10 or more hours a day[38]. Another recent survey of 300 workers reported that 88% do not purify their drinking water, 82% had infestation problems and 63% stagnant water in or near their houses. 16% missed work due to their own or family health problems[39], 61% had been ill with fever and flu or had family members ill during the previous month, and 78% did not purchase sanitary products[40].

Causal factors contributing to poor health include:

- lack of access to, and high cost of, food and clean drinking water;
- inadequate cooking, refrigeration and Water, Sanitation and Hygiene (WASH) facilities in homes, factories or both;
- lack of knowledge about sexual and reproductive healthcare (SRH), lack of access to products, and their cost;
- long working hours, production pressure and gender-based violence leading to stress and poor mental health; and

[36] Bangladesh's average income crossed the low middle-income threshold in 2014.

[37] This is defined as occupational safety and health (OSH) where the health aspect focuses on hazards in factories, eg toxins from dyes.

[38] Saha et al., 2014

[39] Family problems relate to children's health but often also parents', given the family structure.

[40] LightCastle Partners, 2017

- poor workplace ergonomics leading to muscular-skeletal problems.[41]

It is increasingly recognised that workers' working life is short – 10-15 years – and that while children and family are an important factor, a high proportion of women leave the workforce by age 30 or 35 exhausted by their work.

Labour regulations require factories to have WASH facilities, drinking water and canteens, to support workers' maternal health, to provide a crèche for workers' children, and to provide food or a food allowance to workers.[42] Non-compliance is rare, but there is wide variation in quality of facilities. Some factories provide hot meals, but most workers live near the factory and go home to eat lunch. Standard housing conditions in both urban and peri-urban areas involve overcrowding and shared cooking and WASH facilities, so that congestion prevents many workers accessing these when they need to.

The business case for the effects of health improvements on productivity is clear in theory, as the negative consequences for production of poor worker health are often spelled out – poor health raises rates of worker absenteeism and labour turnover, leading to disrupted production lines and higher error rates, and additional recruitment and training costs. In addition to direct impact on production, improving health raises worker morale and commitment to the employer, which indirectly reinforces the production impact.

There is much qualitative evidence for these outcomes in the form of factory management anecdote (for example BSR/Gain, 2015), but little systematically collected quantitative data at factory level. However, one of our informant firms, DBL Group, argues that as a result of their SRHR interventions, absenteeism and labour turnover rates among female employees dropped from 8% and 6% respectively in 2011 to 3.6% and 2% in 2018, resulting in additional production amounting to $1.4 million[43]. The cost of DBL's interventions is unknown, and thus also their return on investment. One of the first studies to use factory-level data – from over 2000 factories across garments and several other industries in 36 countries – recently argued that compliance with basic labour and environmental standards (not necessarily including workers' health) increased factories' turnover by 4%[44].

However, recognition of the business case by factories and by buyers is reflected implicitly in the proliferation of projects addressing health, nutrition and related issues which are underway in Bangladesh's RMG sector, together involving dozens of factories and many buyers. Of course, many of the projects are motivated in part by a sense of social responsibility but the positive impact on production is also made explicit, even if the link is sometimes vague. Numerous issues are addressed, such as fortification of staple foods, in-factory stores selling discounted basic food and household goods, upgrading WASH facilities in housing, health

[41] See BSR/Gain (2015), MicroFinance Opportunities (2108), Hosain et al. (2017), Moazzem and Arfanuzzaman (2018), UNICEF (2015), Mazumder (2017) for further detailed studies of RMG workers health conditions and the causal factors.

[42] The amount is 900 taka per month, about $11, or roughly $0.50 per working day. The new minimum wage since November 2018 is 8000 taka per month, about $97.00.

[43] DBL Group, 2019

[44] Distelhorst and Locke, 2018

insurance for workers and families, worker training on nutrition and menstrual health, and several others. Project promoters include social enterprises, NGOs and INGOs, and donor agencies, as well as factories and buyers.

The wide variety of objectives and mechanisms in this range of projects reflects great creativity and willingness to experiment. However, the range of also reflects an uncoordinated process of innovation which remains far from coherent PEG reform. In particular, many of the projects are explicitly or implicitly 'pilots' operating at a small scale, in a small number of factories, and it is not clear, at least to an outside observer, whether or how they might be scaled up across the RMG sector.

We can identify two underlying models in broad terms – a top-down compliance model and a 'bottom-up' inclusive business market model – varying on four dimensions:

- the form of factory engagement: buyer-driven versus voluntary participation by factories and workers;
- the scope of intervention: focus on in-factory issues only versus a more 'holistic' approach, as its advocates label it, covering both the factory and workers' home environment;
- the mechanism for intervention: 'awareness raising', in other words, worker training versus sale of discounted goods and services to workers; and
- the financing: mainly Corporate Social Responsibility (CSR) funds of buyers' (plus in-kind factory contributions in the form of workers' time), versus financial contributions from factories and their workers.

Advocates of the inclusive business market model argues that contributions of actual finance from both factories and their workers enhances project sustainability because the workers obtain benefits extending beyond the factory. Supplementary financial support from private CSR or bilateral donor sources is a feature of several inclusive business projects but is usually seen as temporary – long-term sustainability rests on market-based solutions, such as volume discounts from goods and services suppliers.[45]

Without more in-depth research on individual projects than this report allowed for, it is not possible to assess whether one or other model is becoming more common, or whether there is convergence between the two approaches. Although project promoters point to sharp differences between the two approaches, spelling them out in this way suggests there are also complementarities between them. In terms of the framework in this report, temporary support from CSR or donor sources for inclusive business model projects offers in effect a learning rent to the factory, channelled through the project promoter, to undertake innovations relating to the labour force, intended to have positive cost and productivity future outcomes. The compliance model offers knowledge to workers and to factory managers via its focus on

[45] One project promoter argued explicitly against buyers providing CSR financial support to their own suppliers on grounds this would not be sustainable – project support might be caught up in the bargaining relationship between buyer and supplier, or the buyer might move to other suppliers.

training, which may be a crucial element for payoff from the learning rents in these innovations. Evidently, the workers play a crucial role in the learning process, and share in the resulting productivity gains through their improved health status.

Business and PEG reform

This suggests that a merged 'hybrid' model may be helpful for allocation of learning rents in relation to workers' health. It may also in principle be applicable to other aspects of workers' situation. What is needed is to create a systematic process of rent *allocation*, which can disseminate the interventions to large numbers of factories, buyers and other stakeholders.

As noted, the Accord/Alliance exercise took off as PEG reform because of the shock of the Tazreen and Rana Plaza disasters. This created very substantial public support for a change in buyers' stance on their responsibility for supplier factory safety. Most significantly, customers in buyers' home markets in Europe and North America responded to extensive western media coverage, especially of Rana Plaza. The health problems of RMG workers present a crisis for the workers themselves, and indeed for Bangladesh, which is at least as serious as the factory safety crisis in terms of risk of loss of lives and of health system costs. However, the difference is that the health crisis is 'slow-moving' – its effects are gradual and incremental, and thus invisible to the world. The health crisis as a result has little 'shock' value and limited political impact on factories or buyers, of the sort needed to 'kick-start' a more dynamic PEG reform process than is reflected in the experimental projects discussed above.

It is not clear what *could* 'kick-start' a process, short of a disease outbreak or other public health disaster. Nevertheless, crucial initial steps can be taken which might over time create some momentum for reform, and which build upon the gains and the lessons of the Accord and Alliance experiences. Increased buyer coordination is essential – it may happen to some extent at the global level and should have been facilitated in Bangladesh by the Accord and the Alliance. The existence of the Alliance itself reflected limits on buyer coordination however – it was started by buyers who refused to join the Accord because of what they saw as onerous conditions.

It would appear that notwithstanding that, the country reflects a 'competitive clientelist' political settlement[46]; the major political economy fracture is between foreign buyers and domestic suppliers, reflecting the tension between them over rents within individual value chains. Until the Accord and Alliance emerged out of the rubble of Rana Plaza, the buyers were not organised for collective action, as the suppliers were, within the BGMEA and the BKMEA. However, the Accord and the Alliance have begun to change that, reflecting strong movement towards buyer collective action; though it remains to be seen how far beyond factory safety, this can be extended.

Buyers engage with each other on labour and social issues at the global level, yet buyer interaction in Bangladesh itself is apparently very limited: a thrice-yearly forum was mentioned, convened by a multilateral agency. Frequent engagement amongst buyers in Bangladesh

[46] Hassan and Reihan, 2018

would be helpful. Buyers' representatives there understand the situation 'on the ground' best. This could be facilitated by buyers' home government bilateral donor agencies (who themselves would have to cooperate to do this), working with both buying offices in Bangladesh and buyers' head offices. There is a risk of buyer 'fatigue' on social issues, but mutual engagement could help to develop buyer consensus on the next priorities for factory and worker upgrading, to ensure that the work done on PEG to address factory safety is the start of improving labour force conditions in the sector, rather than an endpoint.

Another key lesson from the Alliance and Accord processes is that Bangladeshi private and public stakeholders should be directly involved from the outset in PEG reform. The two business associations in the sector are not strongly focussed on workers' health or other aspects of labour force conditions at present, but this could shift under the right circumstances, as their 'green factory' programme illustrates.

This very active programme focusses on factory environmental sustainability issues, and involves not simply awareness raising amongst factories, but financing, technical support and certification of factory environmental improvements. This is essentially a learning rent system aiming at the introduction of new technologies which are more environmentally efficient (lower effluent and pollution effects) and more productive in unit cost terms.[47] Bangladesh policymakers took a lead long ago on this issue. The Bangladesh Bank introduced financial regulations and instruments in 2011. There is a (US-developed) certification scheme. A sense of local ownership may help to explain the associations' strong engagement, over and above the potentially positive financial returns to individual factories.

RMG owners' involvement is also important because of the sector's political weight in the country. This is only through their associations, but also their direct presence in the Bangladesh parliament, spanning both political parties. Government support is essential given that reforms concerned with health (or most other social sustainability issues) must address workers' living conditions as well as the factories themselves, requiring public regulation and almost certainly public finance. In addition, cost issues need to take account of government and other stakeholders' worries about long-term market conditions facing the industry.

As noted earlier, learning rents are conditional: they are provided with an expectation that the recipient will use them to 'deliver' productivity improvement. The rents therefore require a set of standards against which indicators of productivity gains can be certified, as well as an independent or objective auditing process to ensure there has been compliance. Developing standards for health or other social sustainability issues needs common metrics and indicators to measure gains across a diverse set of proximate objectives – workers' own and family's health-related absenteeism and labour turnover – reflected in different ongoing projects. This would allow factories and buyers to obtain recognition for their effective use of the learning rent, whatever the 'social technology' – the specific delivery mechanism to deliver health gains – they choose as part of their upgrading.

[47] Green factories also have energy and water cost-saving impacts.

Allied to this is the need to assist factories to collect and process data on their social sustainability interventions that is a key part of the learning needed, and essential for implementation of standards. The commercial sensitivity of individual factories' data and the consequent need for confidentiality is an issue, but solving this should be technically possible. Initial efforts to support factories to collect data would also help to build the 'business case' for different interventions, demonstrating to factories and buyers that investments in workers' health (or other social interventions) do have positive private returns in financial terms.

At present, there are multiple sets of in-factory compliance standards, leading to compliance difficulties for factories, duplicated audits, and other inefficiencies. This is partly driven by lack of coordination amongst buyers, and hopes that the ILO would be able to assume leadership of the standards system have not yet been realised[48]. A process of developing harmonised social accounting and auditing standards is necessary to regulate this activity (similar to financial accounting and auditing standards discussed in Section 3.3 below). Donors – recognising the need for harmonisation – should have a role to play in each of the different steps to support research and development of a standards system for social sustainability.

Finally, there is the question of finance, that is, the provision of the rent itself, which needs to happen *ex ante*, before the learning, to encourage firms to undertake the associated risk. In general, this needs some form of risk sharing which is difficult to structure in Bangladesh. In many countries, learning rents have taken the form of direct subsidies or credit subsidies, but this has not been used in Bangladesh's RMG sector.

The sector's initial emergence was supported by what Khan (2013) calls an 'accidental rent' in the form of the Multi-Fibre Agreement quota in place up to 2005. This gave Bangladesh exports duty-free market access to Europe and North America, meaning Bangladesh RMG manufacturers were able to sell higher-cost products in these markets, while they learned to produce more efficiently. There was also an incentive for knowledge transfer to Bangladesh by established garment-producing firms elsewhere. As a result of the quota-based learning rents, Bangladesh did not develop a financial mechanism to support learning rents in garments, which may be one factor in the slow upgrading of the sector to higher value added, more technologically demanding activities.

The financial obstacles to addressing factory safety remediation discussed above also underline the challenges, especially as remediation faces fewer of the learning-related uncertainties associated with rents. Yet safety remediation financing will have yielded many lessons. In addition, there are possibilities - examples of innovative financing mechanisms that might be adapted to health or other social sustainability issues. Agence Française de Développement (AFD) has developed a financial instrument to support remediation financing, which is small, only $7.5 million, but with some important features:

- it explicitly goes beyond safety remediation to "encourage RMG factories to make green and social investments";

[48] European Commission, 2018

- it offers loans for the latter at effective zero interest and
- it includes a small grant element as an additional sweetener.

However, the grant element is provided only *after* the investment is assessed as satisfactory, that is, as an 'innovation rent'.

Another interesting development, already noted, is growing 'green finance' activity in Bangladesh that is funding new 'green factory' technologies in many sectors including RMG, and including innovations in renewable energy. Both examples need to be looked at more closely for their potential to be adapted and scaled up to finance different issues. Financial engineering expertise, found in abundance in the City of London, could be usefully deployed, if it were brought together (by DFID) with UK and European buyers with in-depth knowledge of the RMG sector and financing conditions in Bangladesh.

Financing rents for health and other social sustainability issues in the RMG sector raises the issue of housing and housing policy for the sector's workers. Garment factories in some countries provide worker housing but this does not seem to be the case in Bangladesh, though some factories do support social infrastructure provision in their workers' communities. With an increasing share of factories and workers located in peri-urban areas, there may be a case for some clusters of factories working jointly on housing and community development for their workers, together with local governments.

In the immediate aftermath of the Rana Plaza collapse, Muhammad Yunus, the founder of Grameen Bank in Bangladesh, proposed a small (low rate) consumer tax on Bangladeshi garments, a 'worker welfare tax', to fund a welfare trust to improve workers' conditions in the industry. His proposal suggested a surcharge of $0.50 per garment to be paid by consumers in Western markets, which he claimed would raise $1.8 billion annually, that is, double the aggregate safety remediation cost in the sector[49]. The idea did not gain any traction at the time, it seems, but remains an interesting one. Perhaps seemingly far-fetched, it is not dissimilar to a financial transactions tax that has been implemented in France, and is close to implementation by the EU.[50] A tax or levy of this sort would arguably have to be collected on a global (or regional) basis, and be available to all RMG producer countries, to avoid loss of competitiveness by any country. Tax collection, administration and distribution would be complicated. But it is estimated that 80 billion clothing items are purchased each year globally, so that a small tax could raise significant sums for use by producer countries as 'learning rents' to address workers' needs while also raising productivity in the sector. This should be explored further through research and discussion.

[49] Yunus, 2013

[50] A financial transactions tax was first proposed by James Tobin in 1972, it should be mentioned, who intended it to reduce the number of (cross-border) transactions involving the same asset, rather than to raise revenue, which is the purpose of the financial transactions tax today, as for the clothing tax.

Appendix 4 Cocoa in Ghana

Ghana's cocoa sector is paradoxical. On one hand, it has been relatively successful at macro level, at least over the long run, providing 20-25% of export earnings. Ghana beans earn a premium relative to global market prices, partly due to a quality control system carefully managed by the marketing board, COCOBOD, which remains state-owned.

COCOBOD's direct farmer-facing bean purchasing activities and its bean grinding (processing) operations were privatised during the 1990s, but it continues to control all sales of beans into export and domestic markets. Ghanaian farmers' drying and fermenting technique[51] underpins the quality premium and enables forward sales by COCOBOD that in turn allows it to borrow on international capital markets, providing the country with foreign exchange while also creating a pool of working capital to finance the cocoa sector.

However, productivity of Ghana's 800,000 cocoa farmers remains very low, and their incomes are barely above the poverty line, even if somewhat higher than that of farmers outside cocoa. This is despite significant increases in farmers' share of cocoa export prices, and the (largely free) services provided to farmers by COCOBOD, and despite farmers' implicit weight (numbers and thus voting power) in Ghana's competitive clientelist politics.[52]

In this case, we examine the reasons for this paradox: Whether, and how, action by companies in the sector to improve PEG can help to address it by raising farmer's incomes. In particular, we begin with the question of whether market barrier rents:

- in the buying segment of the value chain (by COCOBOD) and
- in the heavily subsidised domestic processing segment (by locally owned and foreign processors, including the dominant global players)

have resulted in rent appropriation at the expense of farmers. Introducing greater competition in those segments would change rent distribution in favour of the latter.

As we see below, analysis of the sector indicates that greater competition in the segments characterised by market barrier rents would not necessarily provide a solution to farmer poverty, and scaled-up, more focussed sustainability programmes supported by the large corporates was a more promising approach.

Rent distribution in the sector

We begin by outlining how rents in the cocoa global value chain (GVC) are distributed. There has been a steep decline in the developing country – that is producer country – share of global value added, from 60% in 1970-72 to 28% in 1998-2000[53]. Despite Ghana's quality premium, its market share is very low, earning the country around $2.5 billion in export revenues of an estimated global market of $100 million. The cocoa producer gets only 4% of value in the final

[51] Different from Cote d'Ivoire and elsewhere.

[52] All political parties in Ghana emphasise cocoa farmer welfare in their manifestoes.

[53] Barrientos, 2016

product, with other ingredients (mainly milk and sugar) getting more than this, at 6%. Bean processors and chocolate manufacturers between them get 51%, retailers get 28%, and the remaining 11% is spent on advertising and marketing and on distribution and logistics.

During the past 20-25 years, there has been substantial restructuring of the GVC, linked to concentration in buying, in processing and in chocolate manufacture.[54] Vertical integration between buying and processing has led to the disappearance of many pure trading companies, and both processing and manufacturing segments have become much more concentrated, though still largely separate from each other.

There are three major grinders with around 54% of the global market: Barry Callebaut, Olam and Cargill, all major global food commodity buyers and processors with substantial presence in other crops.[55] All three have a presence in Ghana, with longstanding grinding (processing) operations and more recent entry into the buying segment, where licensed buying companies (LBCs) buy beans directly from farmers for resale to COCOBOD, which then sells into export and domestic processing markets. A smaller international grinder, Touton, entered Ghana more recently - purchasing a locally owned processor in 2015 - is also setting up a local buying operation.

In chocolate manufacturing, the four largest companies[56] (controlled 41% of the global market in 2013, and the eight largest companies controlled 61% (Oomes et al., 2016). These corporations do not manufacture significant volumes in Ghana[57], but are significant users of Ghanaian beans purchased via international trading companies or in processed form from processors. The GVC reflects contested leadership between processors and manufacturers over rents, though the two groups of companies are also interdependent, and do co-operate over the overall size and sustainability of the market (Fold, 2002).

Within Ghana, the distribution of rents amongst the different actors in the value chain – farmers, buyers, marketing agency, and processors - is determined largely through public regulatory action, with political factors probably significant in many decisions, given that COCOBOD, CPC and PBC are all government-controlled, and senior executives have, as a rule, been replaced following changes of governing party. As noted, farmers' income as a share of the export price has risen substantially, from averaging 54% of export proceeds between 1996/97 and 2002/03 to 61% between 2008/09 and 2012/13. Over the same period, the share used to finance services provided to farmers, individually and collectively, rose from 2% to 13%, while the government's explicit tax take dropped from 16% to 3%.[58]

[54] See Fold (2001, 2002) and Fold and Neilson (2016).

[55] Oomes et al. (2016). The fourth largest cocoa grinder, Blommer with a 7% market share) does not process in Ghana. ADM, another global food commodity corporation, operated in Ghana until 2012, when it withdrew from cocoa globally, selling its assets to Olam. See also Fold and Neilson, 2014.

[56] Mondelez, Mars, Nestlé and Ferrero)

[57] There are small operations, for example a Nestle Milo factory, and

[58] Kolavilli and Vigneri, 2017, Table 4.1. Data based on based on actual gross free-on-board price.

The services provided by COCOBOD to farmers include items such as education scholarships, housing and social security provided to individual households and collective goods to communities such as solar water pumps and streetlights. However, the overwhelming share of funds (93%) are spent on services that directly support farming, such as fertiliser subsidies, spraying and cocoa extension services. These are unevenly distributed, but they nonetheless represent transfer rents to farmers as a group. It seems plausible that contracts for the distribution of these services, and for the construction of roads and other infrastructure (much of which remains undelivered), have provided a source of transfer rents reflecting rural patronage (Kolavilli and Vigneri, 2017), though some interviewees suggested that these practices may have declined recently.

Farmers are not well organised in associations, which disadvantages them when transacting with LBCs, who are *de facto* COCOBOD collection agents. LBC purchases from farmers and sales to COCOBOD are at pre-specified prices, set annually by a government committee with strong COCOBOD representation. The final decision rests with a Minister, reflecting the importance of cocoa exports in Ghana's macroeconomic stability, though increasing exports of oil will have reduced balance of payments dependence on cocoa export revenues.

The domestic LBCs are generally undercapitalised but relatively easy entry means a highly competitive market with tight margins. Profitability depends on acquiring beans from farmers through collection efficiency and agile financial management to provide timely payments, and there are strong incentives for rule bending. Though in principle LBCS can access working capital finance from COCOBOD's international loan proceeds, in reality most hold inadequate collateral to get the necessary bank guarantees, according to interviewees.

The LBC market has been very fluid, with frequent entry and exit, for example the second largest buyer in 2014, Akuafo Adamfo, closing in 2016 due to bank debt. An exception is the largest buyer, PBC, which originated from the privatisation in 1999 of COCOBOD's farmer-facing buying division, and which still has a regulatory responsibility to be the residual buyer of beans. In the past few years, the large international processors have entered the LBC market, which though not directly profitable, helps to secure their bean supply and its traceability, while at the same time giving them credibility amongst cocoa farmers and a closer relationship with COCOBOD.

It is likely that foreign processors will dominate the segment in the next few years, given their access to foreign finance and their strong capabilities in sourcing and managing food crops. Aside from PBC and one or two others closely linked to farmer associations, Ghanaian companies are likely to be increasingly marginalised in this consolidation of the LBC market.

The large global processors – Cargill, Olam, Barry Callebaut and Touton – also dominate domestic processing, which grinds about one-third of Ghana's crop. There are seven domestically owned processors, the largest being the CPC, also established in COCOBOD's partial privatisation.[59] The processing segment operates at only 53% capacity (COCOBOD,

[59] Two of the seven have some foreign ownership.

2018), and is profitable only as a result of receiving significant subsidies (transfer rents), in the form of discounted bean purchases and infrastructure service charges, and preferential tax rates.

Like buying, processing in Ghana is a strategic investment rather than a direct source of profit for the global companies, ensuring their supply of Ghanaian beans for processing in their major markets. Local processors depend on patronage, as illustrated by the 2016 closure of one local processor unable (according to news reports) to source beans under the then-government, which was revived in 2018 by COCOBOD under a new government and earned a substantial income.[60] This episode illustrates both the subsidy dependence of processing and the competitive clientelism characteristic of Ghanaian politics (Darko Osei et al., 2018).

Domestic chocolate manufacturing is not significant in Ghana, with chocolate exports only $23 million (and $5 million imports). Via their GVCs, the dominant global chocolate brands appropriate a large share of the rent attributable to Ghanaian cocoa even though they do not produce in Ghana.[61]

Manufacturers have increased their visibility in the country through their cocoa sustainability programmes, delivered 'on the ground' by processors and trading companies, many of which have their own programmes.[62] Sustainability programmes proliferated in response to concerns about long-term global cocoa production, which culminated in a 'cocoa shortage panic' in 2013/14. Identified threats to the level of supply included demographics, the rising average age of cocoa farmers as young people avoid the sector; extended political instability in major producer countries, Cote d'Ivoire in particular; and susceptibility of trees to disease and pests.[63]

Other supply concerns have been growing in recognition, including amongst western chocolate consumers, of negative environmental and social impacts of cocoa production, such as deforestation and the use of child labour, and in Ghana, competition over land (and to some extent labour) from artisanal informal gold mining. Complicating their anxieties about the security of cocoa supply, the global chocolate giants worried about competitive pressure on access to beans. Demand from emerging markets, especially China and other Asian countries, is increasing.

In sum, rent distribution within the Ghana cocoa value chain can be characterised as a 'stable equilibrium', stable in the sense that without shifts in the international context, there would little incentive for the dominant actors – COCOBOD, and the global processors and manufacturers – to disrupt the rent distribution. This is reinforced by politics – the Ghanaian 'political settlement' may be competitive clientelist, but whichever party is in government

[60] See https://www.ghanaweb.com/GhanaHomePage/business/WAMCO-makes-600-000-profit-700951.

[61] Mondelez has a small plant producing chocolate beverages mainly.

[62] See IDS/University of Ghana (2014).

[63] These issues are all relevant in Ghana, though civil war in neighbouring Cote d'Ivoire may have been benefited Ghana's cocoa export revenues.

benefits from cocoa exports' contribution to macroeconomic stability, even if their distribution of patronage using the proceeds may vary.

This suggests that the initial hypothesis of the case study – lower entry barriers in the marketing and processing segments in Ghana to shift rents towards farmers – may not be a viable approach. A look at current challenges in the sector, and the responses of the dominant actors, leads towards a different set of recommendations, focussed on collective action of the global corporates.

Current challenges in the sector

The challenges facing the cocoa sector globally were brought into sharp focus by an *oversupply* of cocoa in 2017 leading to the world price crashing more than 30% with predictably difficult consequences for farmers. Favourably warm weather conditions and the difficulties of rapid supply response to dropping prices (low price inelasticity) certainly played a role. But many argued that the ramping-up of company-led sustainability programmes, focussed largely on productivity through increased use of higher-yield seeds, fertiliser and pesticide, also contributed, and Cote d'Ivoire suspended the programmes during 2018.

Whatever the causes of price volatility, it has deepened the sense of 'crisis' in the sector. Recognition is growing that sector governance needs reform. The Fourth World Cocoa Conference in Berlin in April 2018, organised by the multi-stakeholder International Cocoa Organisation (ICCO), issued a "Declaration" targeting farmer poverty as a priority, alongside deforestation, child labour and other social and environmental problems. It called for a shift from 'business as usual' to "collective responsibility of all stakeholders… increased non-competitive collaboration [and] ….co-ordination" (ICCO, 2018). While a worthy 'mission statement', the Declaration contains few specifics on mechanisms, and conceals significant differences between different groups of stakeholders, in particular growing country governments and large corporates.

The Ghanaian government's current strategy evidently aims to increase Ghana's share of global rent, which would maintain existing transfer rents to its key cocoa constituencies, domestic business and farmers. The strategy appears to have four elements[64]:

- ***export revenue*** stabilisation through coordinated bean sales with Cote d'Ivoire to influence the world bean price, as expressed in the joint Abidjan Declaration in March 2018. Each country is in the process of agreeing a $600 million loan from the African Development Bank, allowing Ghana to spend $50 million on expanded warehousing to hold bean stocks.
- improved ***farmers' yields*** through technical interventions including irrigation, farm rehabilitation, replacement of diseased trees, and hand pollination programmes, through four loan sub-programmes absorbing $331 million.

[64] This is inferred from the plans for use of the $600 million AfDB loan. See COCOBOD (2018), and Ekow Dontoh, "Ghana $600 Million Cocoa Plan Prioritizes Processing, Trees", Bloomberg, April 12, 2018.

- the government emphasises expansion of ***domestic processing*** as well as manufacturing, with an explicit target to process half of Ghana's beans domestically by 2022, despite current low processing capacity utilisation. Another component of the loan will establish a $200 million revolving fund to finance bean purchases by local processors.
- Ghana will focus more on ***the Asian market, especially China.*** COCOBOD has opened a marketing office in China and is building a Chinese-funded processor in Ghana to expand national processing capacity by about 10%. A second cocoa loan, for $1.5 billion, is reported to be under negotiation with China's Exim Bank.

The government's determination to shift the status quo in the sector is evident, though there are risks associated with its strategy. If substantial stocks are withheld from the market to support coordinated marketing to smooth prices and to support expanded domestic processing, the benefits from the 'Ghana premium' – which allows forward sales of beans against which COCOBOD obtains loan financing to support bean purchases and service provision to farmers – may be lost, in part or in full. Furthermore, global corporates are sceptical about the prospects for large-scale processing and manufacturing in West Africa, the standard view being that only operations close to large markets can be profitable, while climate and lack of domestic supply of non-cocoa ingredients are additional difficulties (Fold, 2001; 2002).[65] Processors also argue that increasing the supply of beans to domestic processing in Ghana would require a discount on main crop beans (currently only available on 'light' beans)[66] which would in turn cut bean exports and reduce revenue from the 'Ghana premium'.

Business and PEG reform

As noted earlier, for business to begin to address PEG reform, a stimulus is needed, most commonly a crisis in the sector threatening business performance. The 2013/14 supply concerns pushed corporates to begin moving, albeit hesitantly towards a new approach to cocoa sector PEG, emphasising issues addressed in their sustainability programmes, which were picked up in Berlin Declaration after the 2017 glut and price crash. Here, rather than presenting broad recommendations, it makes sense to focus on whether this new PEG approach is adequate for its objectives, and what lessons it offers beyond the Ghana cocoa sector.

In 2014, the nine dominant corporates, four processors and five manufacturers, set up CocoaAction as a joint initiative under the auspices of the World Cocoa Foundation, to address the SDGs in cocoa. This is 'a voluntary, industry-wide strategy' to coordinate and scale up sustainability programmes. There are formal agreements with the Ghana and Cote d'Ivoire

[65] The arguments are (i) that processing and manufacture need to be close to each other, to allow just-in-time processing, particularly the transport of cocoa butter in melted (liquid) form to the manufacturer; (ii) that manufacture needs to be close to large markets to ensure freshness; (iii) that the need for refrigeration in hot climates adds costs; and (iv) that the need to import milk and sugar would also add substantial costs.

[66] The main crop is grown October – June, and the light crop July – August.

governments, but they are not directly part of the initiative, which is targeting engagement with 6% of farmers globally by 2020: at end-2016, it was working with around 4% of the farmers in Ghana, about 32500 (World Cocoa Foundation, 2016).

The initiative focuses on farmer productivity, and prioritises delivery of seed and soil management together with training, an essential element of farmer service packages (Ingram et al., 2018). This in effect recognises the need for corporates leading GVCs to provide learning rents to cocoa farmers to replace or supplement the transfer rents they currently receive from government.

As recognised by some corporates (Nieburg, 2018), such a rent substitution process must be complemented by a 'dual transition' in cocoa farming (SEO, 2016), in which more competition leads to consolidation in farming: a shift to fewer cocoa farmers who are more productive, while less productive cocoa farmers shift to other crops, or perhaps out of farming altogether. While there is also recognition that the latter needs careful management, involving 'safety nets' and training in other skills, it is not clear that CocoaAction members are willing to share the responsibility for this, or whether it is left to producer country governments.

There are other concerns around CocoaAction's potential to transform the cocoa sector. For example, improved farmer access to financial services (credit and insurance) is key to their business viability, as underlined by the LBC-farmer transactions discussed earlier. Yet this is identified as a 'complementary action' rather than a 'core commitment', by implication to be addressed by other stakeholders.

Here we emphasise two other absences in CocoaAction of more general interest in relation to PEG reform. Both gaps are explicitly identified as desirable aspects of cocoa sector governance in the Berlin Declaration. The first is the lack of recognition that farmer organisation is essential to sector governance. It seems evident that both aspects of a 'dual transition' will depend on strong farmer associations, which currently are few in number in Ghana. Farmer associations can support the effective delivery of 'learning rents' (training on cocoa farming practices and livelihood transition), as well as of goods and services (farming extension and non-farming services, such as health), improved access to finance, and political 'voice'.

One of the largest associations in Ghana is Kuapa Kokoo, a farmer co-op with over 80 000 members, about 10% of cocoa farmers. Kuapa Kokoo owns an LBC that integrates service provision with cocoa purchasing. It also helped set up – with help from a 'fair trade' NGO, as well as DFID and a UK commercial bank[67] – a boutique UK manufacturer, Divine Chocolate, now a certified 'B corporation'.[68] Kuapa Kokoo still holds an equity stake (and two board seats) in Divine, and its 44% share of profits contributes to its operating finances. This model of equity and profit participation by farmer associations may have potential for adaptation on a larger

[67] See http://www.divinechocolate.com/uk/about-us/research-resources/divine-story.

[68] "Certified B Corporations are businesses that meet the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose." See https://bcorporation.net/about-b-corps. Tony Chocolonely, a Dutch boutique manufacturer, is also a B Corp.

scale for both global manufacturers and processors, as a way to support farmers' incomes while sharing some of the risk.

DFID and other donors could play a broking role in supporting the strengthening of farmers' associations (or where necessary, their formation) with possible capability to participate from profit-sharing schemes[69], and also in bringing associations together with home-country financial institutions who could assist in structuring financial instruments (or trusts) to benefit both sides of such a transaction. This is a form used increasingly commonly to enable local community groups to benefit from extractives and renewable energy projects in rural areas.

The second problem with CocoaAction is that it is a voluntary strategy involving only corporate *participants* and lacking a compliance mechanism. As is common with voluntary standards, CocoaAction encourages companies to harmonise collection and publication of their sustainability programme data, but there is no compulsion to do so. The absence of farmers' incomes as a programme 'key performance indicator' has been a particular focus of concern, linked to views that the large corporates are reluctant to raise chocolate consumer market prices or to themselves absorb higher cocoa bean prices. These concerns are reinforced by the corporates' retention of a share of certification-linked premia on beans, to fund sustainability programmes.

Notwithstanding that it represents the most extensive form to date of collective action by this group of stakeholders, and participants argue that it is a new initiative which will take time to show results, low credibility due to lack of enforcement could fatally undermine CocoaAction. As discussed earlier, self-regulation initiatives like this one must have the club-like characteristic of excludability, or enforceable sanction, for 'breaking the club's rules'. There are two steps:

- Development of a set of sustainability targets agreed by CocoaAction in consultation with other industry stakeholders, including producer country governments and civil society representatives from both producer and consumer countries.
- Either independent auditing of programmes against these targets, or a peer review of corporate sustainability programmes involving stakeholders consulted on the targets, with some type of penalty – for example, payments into a CocoaAction sustainability trust fund – for missed targets. There is a potential broking role here for donor governments, in collaboration with ICCO, to facilitate a broadening of the process to introduce some form of compliance.

[69] It is assumed that large corporates in the sector would be able to identify appropriate associations or groups of farmers who might form an association.

Appendix 5 Accounting and auditing in Tanzania

Perhaps unusually for accounting and auditing in any country, this sector has a potentially central role, even if not a high-profile one, in Tanzania's national politics at present. When he won office at the head of the governing party, the Chama Cha Mapinduzi (CCM), in late 2015, President John Magafuli made cracking down on corruption a major focus for his incoming administration. He was reacting to a sense of public weariness of years of malfeasance by public officials at all levels, both day to day and in large public sector projects.

This was part of President Magafuli's substantial re-orientation of the 'political settlement', reflecting a greater concentration of power within the state, and aiming to deliver distributional gains to a new and narrower political coalition than before (Kelsall, 2018, Andreoni, 2017). Well-publicised deals between the government and large companies on fruit processing, sugar and cement operations as well as a new mining tax regime reflected President Magafuli's objective of shifting from 'open disordered' deals to 'closed ordered' ones, or that is, to (market barrier) rents with discipline. A new social contract around taxation was a central element in the new agenda, focusing on tax non-compliance, and higher revenue collection to pay for improved public infrastructure service delivery and lower business costs. This implicitly gave greater weight to transparency – comprehensive and credibly audited financial statements – for enterprises in both public and private sectors.

Unsurprisingly, President Magafuli's approach was initially very popular, and had some success in raising public revenue. However, as higher effective tax rates bit, tax rows (such as with the Acacia gold mine) remained unresolved. Public service delivery improvement was slow, disillusion set in and investor uncertainty grew. By late 2018, President Magafuli was rowing back on his agenda, lowering tax rates for domestic small business, promising more relaxed tax compliance in response to business complaints about bankruptcies, and promising to look again at the mining tax regime.[70]

In this case we examine how accounting and auditing standards can be raised in Tanzania, and what role auditing firms can play in that process, with support from donor agencies. An important factor in selecting Tanzania as the country for this case was the government's political agenda, and how it might be affected by (and affect) the country's accounting and auditing sector.

The value added in the accounting and auditing sector in Tanzania is unknown, but in the UK, accounting services provided by accounting firms represent 1.14% of GDP, a significant share, with another 2.06% of GDP attributed to in-house accounting services provided within firms in other sectors (Oxford Economics, 2018).[71] Improved accounting and auditing services should

[70] See Mosenda Jacob and Halili Letea, The Citizen, 11.12.2018. https://www.thecitizen.co.tz/News/-Change-of-tune-as--Magufuli-orders-tax-measures/1840340-4890198-dv7psoz/index.html. See also Thomas Scurfield, Silas Olan'g, "Magufuli Seeks the Right Balance for Tanzania's Mining Fiscal Regime", Natural Resource Governance Institute, 31 January 2019. https://resourcegovernance.org/blog/magufuli-seeks-right-balance-tanzania-mining-fiscal .

[71] The contribution to GDP of accounting firms includes their provision of consulting services, as well as accounting, auditing and tax services.

be reflected in higher monitoring rents accruing to accounting firms. These rents are available because credible financial statements for an enterprise would be expected to lower its transaction costs when dealing with other businesses such as suppliers or customers, with potential lenders such as banks (or others in the credit system such as credit bureaux), and with public agencies, most importantly the tax authorities. Society benefits from improved efficiency in the overall system, contributing to expansions in bank lending, in tax revenue, and in market transactions. This is the *prima facie* case for raising auditing standards – it enhances the 'social return' to auditing and accounting, and contributes to economic growth and enterprise development.

Thus, a higher standard of auditing should raise the aggregate rent available to the accounting and auditing sector, giving them as a group a direct interest in improving standards. Auditing firms obtain these rents because they are certified to provide an independent 'stamp of approval' that an enterprise's financial statements are a 'true and fair' reflection of its financial situation. Firms in Tanzania above a very low threshold (about $8,500 turnover) are required by law to publish audited financial statements. The payment to the auditor (the monitoring rent) reflects the scarcity value of auditing certification. Low accounting and auditing standards may enable individual firms to pay lower taxes, and lower audit fees. The benefits of lower transaction costs with other firms and with the banking-system may emerge for individual firms only once there has been a wider system shift to higher standards, that is, more credible audited financial statements.

The segmented accounting and auditing sector

In Tanzania, certification of accountants and auditors is provided by the National Board of Accountants and Auditors (NBAA), a statutory body that regulates the accounting sector.[72] The NBAA is constituted and financed by government, and it doubles up as the professional body representing members' interests. There are currently just under 9,000 Certified Public Accountants in Tanzania, according to the NBAA. This is a very significant increase from an unofficial estimate of about 2,300 registered Certified Public Accountants (CPAs) four years earlier. At that time, an estimated 530 were CPAs in Public Practice (CPA-PPs), meaning they were certified to sign off on audits. The NBAA operates an assessment system under which university graduates with an accounting degree must complete six training modules, in addition to three years of supervised practical experience by a CPA to obtain their CPA certification. To obtain the CPA-PP certification, the CPA's three years of practical experience must be in an auditing firm under supervision of a registered CPA-PP (UNCTAD, 2014). The NBAA indicates that 350 Associate CPA-PPs have been registered over the past five years to undertake their practical experience.

CPA-PPs are grouped into 240 auditing firms, of which only 13 are part of foreign networks. As in the UK and elsewhere, the accounting and auditing industry is highly segmented into three tiers. The NBAA groups firms into three size categories, putting eight firms in the 'large'

[72] For background on the sector, see ROSC (2005).

category (of which six are globally linked firms[73]) and classifying 26 as 'medium'. Here we follow a slightly different approach focussing on knowledge resources as well as the number of staff.

The First Tier

This comprises the 'big four' firms – PwC, Deloitte, EY (Ernst and Young) and KPMG – all of which are present in Tanzania. The partners in the Big Four firms are all Tanzanians or from the rest of East Africa. We do not have revenue figures for the industry in Tanzania,[74] but segmentation by size is very clear. Tier 1 firms are large, for example, PwC has 230 professional staff while KPMG has between 55 and 70 CPAs and about 190 professional staff in total including consulting services, which is a big part of their revenue, as in Big Four firms in all their markets.

Because market liberalisation in Tanzania began only in the second half of the 1980s, all the foreign-networked firms have entered Tanzania quite recently, at least in their current incarnations. PwC and Deloitte had a presence in Tanzania during the colonial and early post-colonial periods, but closed or substantially scaled back their offices when Tanzania turned in a socialist direction in the late 1960s. The Big Four firms began to re-engage with Tanzania after liberalisation, initially from their Kenyan offices and then establishing local offices in Dar es Salaam. PwC re-entered in 1993, KPMG and Deloitte in the 1990s, and EY in 2000. Some of the Big Four's initial linkages in the 1990s were with members of the group of twelve accountants from TAC were sent by the Tanzanian government to study in the UK during the early 1970s, an initiative that was not repeated.

The Second Tier

In Tanzania, this consists of nine-second tier foreign-networked firms such as Mazars, RSM, BDO and Grant Thornton, together with fourteen or fifteen Tanzanian firms. The entry of the foreign firms in this tier has been even more recent than that of the Big Four. Most have entered during the past decade and, like the Big Four, have linked up with already established local firms or with well-respected local figures in the profession. Almost all of the founders and senior partners in the second tier firms, both Tanzanian and foreign-networked, are former employees of the Big Four firms. Firms in this tier are about one quarter of the size of the Big Four. There are two or three larger Tanzanian firms, including the 'legacy firm', TAC (formerly Tanzania Audit Corporation), which started as a government-owned firm responsible for

[73] We use the term 'globally-linked' rather than foreign firms, as global accounting firms are networks rather than single entities, in which the partners of each country office run the office independently. They are affiliated to the international network, to which they pay fees for resources such as software technology, and with some degree of control over the global network, akin to that of shareholders in a company.

[74] In the UK, there is a similar structure, with sharp differences in revenue, where the Big 4 together get £10.695 m as compared with £1.283 for the next three together, and £2.241 for the remaining 93 firms in the top 100. Of course, the revenue of the Big 4 is swollen by consulting income. Nonetheless, the Big 4 get 75% of the total revenue of the top 100, and on average 6.5 times the next 3 and 110 times the rest of the top 100.

enterprise auditing during the socialist era between the late 1960s and mid-1980s. It was later privatised, and had a correspondent link with KPMG during the 1990s.

The recent entry of second tier foreign-networked firms suggests there have been market opportunities available to this group as a result of strong economic growth, which has been around 7% per annum since 2005. Most large businesses in Tanzania, both Tanzanian enterprises in the private and public sectors (banks and other financial institutions, companies listed on the Dar es Salaam Stock Exchange, large state-owned enterprises[75]) as well as local subsidiaries and affiliates of multinationals, are audited by first and second tier accounting firms.[76]

Though the Big Four argue that they operate in a different market from the next tier firms, with a different fee structure, market segmentation is not complete. Second tier firms suggested that there is competition across the top two tiers – while their fee rates are about 70-80% of the Big Four's, Tier 2 firms suggest that Big Four fees are sometimes adjusted downwards to acquire or retain clients. Both groups have a rigorous client acceptance process, and the foreign-networked second tier firms obtain revenue from consulting.

Industry segmentation is not simply a matter of size, but also of systems, relating to personnel development, technology, and cross-border collaboration within networks. The Big Four invest heavily in new graduate recruits, through intensive internal training (in at least one case, a yearlong training) covering both technical and 'soft skills' (work ethic and socialisation into the firms' business practices). Much of the content is defined at the global network level, but some of this training is aimed at addressing what the accounting firms identify as basic deficiencies in recruits' skill sets, notwithstanding their university degrees. The intensive internal training, it was argued, leads to a significant divergence in quality between Big Four staff and others in the same Tanzanian cohort, within one to two years of their entry into the workforce, and this divergence in turn means that entry into a Big Four firm for mid-career accountants is difficult. The firms also engage in a systematic process of secondments, cross-postings and two-way movement of early mid-career staff – almost all Big Four partners have had overseas experience at some stage in their career.

The labour market in the profession is also segmented, in other words, with the Big Four only hiring from each other. Salaries in Big Four firms were suggested to be about 50% higher than in second-tier firms. As noted, there is one-way movement of staff from the Big Four to second tier accounting firms, and also from the Big Four to large companies, both domestic-owned and multinational subsidiaries. Many of their CEOs and CFOs are former Big Four staff. Many of the accountants who moved after several years at a Big Four firm have had the benefit of both internal training and substantial international exposure from their previous employer.

[75] The audits of government departments and public enterprises are the responsibility of the Controller and Auditor General (CAG), which often is assisted by a private auditor, especially for large audits. These audits are allocated by the CAG via a 'roster' system, in which small local auditors also participate where the public entity's size warrants.

[76] The identity of the auditors of large family-or privately owned conglomerates are not known to the authors of this report.

In addition to placements of staff abroad, the Big Four have substantial international interaction in their ongoing activities, including joint audits of multinationals with other accounting firms (usually) in their network, and internal quality reviews within their network, with foreign partners reviewing the Tanzanian practices, and Tanzanian partners participating in reviews in other countries. Their technological capabilities reinforce the segmentation, since they are able to source proprietary software from their global networks, while their size also enables broader scope: for example, in-house corporate finance expertise can provide technical advice on balance sheet treatment of assets to auditing teams. Those second tier firms that are part of global networks are also able to undertake internal staff training and provide software to local affiliates, albeit on a more modest scale. They also do joint audits with global partners of multinationals operating in Tanzania. Independent Tanzanian accounting firms in the second tier use off the shelf software.

In sum, there is a flow of knowledge and expertise into the accounting industry in Tanzania from abroad, primarily within the globally networked firms, especially the Big Four. As discussed below, knowledge inflows are greatly influenced by the need for Tanzanian businesses to adhere to global financial reporting standards, and for accounting firms to adhere to global auditing standards. Diffusion of this knowledge within the country – in the sense of raising the overall quality of accounting and auditing – occurs most significantly through movement of people out of the Big Four firms to other positions, inside and outside the accounting industry. However, diffusion of this sort is restricted in scale, scope and pace by the small number of foreign firms.

The Third Tier

Approximately 200 small accounting firms comprise the third tier of the industry. Sometimes disparagingly labelled ‘briefcase’ or ‘rubber-stamp’ auditors, these firms have one or two partners certified as CPA-PPs, and a handful of graduates as professional staff. Their fees range upwards from as little as $300 – 400 for an audit, though fees as high as $20,000 for large audits were mentioned as being received on occasion. Audit clients include both domestic and international businesses, such as aid-funded projects. Not surprisingly, these firms struggle financially – there is intense competition amongst them, as well as competition from uncertified financial advisors and bookkeepers who prepare financial statements for businesses. Third tier accounting firms seek better protection of their market from the latter. They complain that the Tanzanian Revenue Authority (TRA) and the Business Registration and Licensing Authority (BRELA) do not effectively enforce the Companies Act requirement that all Tanzanian companies with turnover above TZS 20 million (about $8,500)[77] are required

[77] This threshold is defined in the Income Tax Act as the requirement for companies to submit financial statements with their tax returns. The same threshold is used for the BRELA requirement for annual submission of audited financial statements. According to the International Federation of Accountants, as of June 2017 the size threshold below which companies need not be audited has never been specified by the Minister of Finance, as formally required by the Companies Act 2002. See https://www.ifac.org/about-ifac/membership/country/tanzania-united-republic. The Income Tax Act threshold is generally applied instead.

to submit annual audited financial statements to BRELA, and to submit financial statements with their tax returns.

The third tier auditors are largely excluded from the knowledge flows associated with the foreign-networked firms, and are almost entirely reliant on the NBAA information and knowledge. Most use the PCAS audit software[78] that the NBAA sources for its members, while their clients use low-cost off-the-shelf accounting software such as Quickbooks or Tally, an Indian programme used by a very large proportion of Tanzanian companies. All Tanzanian CPA-PPs are required to attend 40 hours *per annum* of Continuing Professional Development (CPD), and third-tier auditors are likely to meet their CPD target via NBAA-sponsored programmes.

Accounting and auditing standards

In 2004, the NBAA decided that Tanzania would adopt the (then) newly developed global standards, the International Financial Reporting Standards (IFRS) for accounting – to be used by all firms in preparing their financial statements – and the International Standards on Auditing (ISA), to be used by accounting firms in their auditing activities. Accounting firms would of course also need to ensure that their auditing clients were correctly using IFRS and assist them to do so, where necessary. A single set of global standards used across national jurisdictions was seen to have a number of advantages in an era of globalisation and in particular substantial cross-border capital flows. Uniform standards would enable comparison of companies' financial statements across jurisdictions, and integrated reporting by affiliates of multinationals. It would also allow global accounting firms to standardise training and quality assurance across their networks (Tweedie & Seidenstein, 2005).

As noted above, the creation of global standards has been very advantageous to the globally networked firms, allowing much-expanded flows of knowledge and information within their networks, and assisting them to maintain market leadership across jurisdictions. Not surprisingly, there has been much debate over the utility of the standards in low income and lower-middle income countries, given that much of the IFRS standards relate to issues, for example complex financial assets, which are not relevant to Small and Medium Enterprises (SMEs) in developing (or even developed) countries (Owolabi & Iyoha, 2012; Aboagye-Otchere and Agbeibor, 2012).

After NBAA adoption of the IFRS in 2004, all Tanzanian businesses, including SMEs and micro-enterprises above the TZS 20 million threshold, were officially required to apply the complete set of IFRS standards in preparing financial statements. In 2009, an adapted and simplified set of standards, the IFRS for SMEs, was issued globally. In Tanzania, however, all businesses with more than 100 employees or assets above TZS 800 million (about $350,000) were required to continue to use the full IFRS: the IFRS for SMEs was only applicable to businesses below these very low thresholds, taken from the Ministry of Trade and Industry's SME policy. This was a major problem for many medium and small formal businesses, as a

[78] Private Company Audit Software, produced in the UK.

majority were too big to meet the threshold for using the simplified standards. Poor quality accounting in Tanzanian companies remains a major problem, which is reported by informants at all levels of the accounting profession. A second tier firm suggested that very few Tanzanian businesses were 100% compliant with the existing IFRS standards.

Outside observers evaluating Tanzanian auditing suggest that audits by third tier firms are generally low quality, due to firms' limited resources – hence the derogatory labels referred to earlier. Small auditing firms point out that the time required for them to meet the ISA auditing standards is onerous and raises auditing fees beyond what their clients are able or willing to pay.

Both the preparation of financial statements by SMEs and their auditing therefore often become exercises intended purely for formal tax compliance purposes – prepared primarily for submission to the Tanzanian Revenue Authority (TRA) – rather than for business information purposes, helpful to the businesses themselves as a management tool, and to other businesses with which they transact. An anonymous informant from the TRA suggested that the Authority places very low credibility on many returns prepared by third tier accounting firms. They also suggested widespread collusion between businesses and auditors on under-declaring income, with accounting firms' behaviour shaped by the extremely competitive market in which they operate, together with their inadequate training and access to industry knowledge. The implication is that small auditors are in many cases appropriating a share of transfer rents resulting from tax evasion by large numbers of businesses, through their facilitation of the evasion. This has an impact, not only on tax revenue, but also on bank credit extension and transactions efficiency in goods and services markets.

In 2018, the NBAA finally eased their requirements with respect to accounting standards for very small businesses, specifying a higher threshold for businesses required to use IFRS for SMEs: more than TZS 800 million ($350,000) turnover or TZS 400 million ($170,000) in assets. This applies from April 1 2019, fifteen years after IFRS was first adopted in the country. Businesses below these cut-offs or with fewer than 10 employees will be allowed to use a newly introduced simplified standard for micro-entities in preparing their financial statements, the Financial Reporting Standards for Micro Entities (FRSME) adopted from the UK, where it was developed and introduced in 2018. In other words, the NBAA is not far behind much larger economies in introducing a much simpler standard for very small firms. However, neither the IFRS for SMEs nor the new FRSME standard have been translated into KiSwahili, even though this is the *lingua franca* for very large numbers of, if not most, small enterprises.[79] Micro-enterprises above the very low TZS 20 million-turnover threshold are still required to have their financial statements audited. This is in contrast to the UK, which since 2014 has allowed micro-entities (as defined there) to avoid auditing if they wish.

Large firms and public interest entities (PIEs) – those with publicly traded equities, fiduciary responsibilities (banks, insurance companies, pension funds and the like) and enterprises

[79] If the reason for this is lack of resources, this could easily be rectified with donor support.

providing essential public services – are required to continue to use the full IFRS, and will continue to hire first and second tier accounting firms as their auditors.

Industry regulation – the NBAA

The NBAA has a dual role, as statutory regulator of the profession and as representative professional body.[80] In its regulatory role, the NBAA is responsible for oversight of training and certification of individual professions, oversight and compliance enforcement of their and their firms' professional practices, and oversight of the accounting and auditing standards they use. As the CEO pointed out to us, in other countries each of these various roles are undertaken by different bodies.

The NBAA is severely under-resourced in terms of both staff and finances. It employs 56 people, of whom 12 are CPA-PPs.[81] This number is insufficient to meet its responsibilities, but is larger than would be possible if the organisation were to rely solely on being financed by government. The NBAA has established additional income streams, most significantly through the provision of CPD programmes to accountants, who are required (by NBAA regulation) to attend a specified number of hours annually. There is however a capacity trade-off between the organisation's need to generate income through training, and its responsibility to discharge its regulatory and oversight functions. Inevitably, its performance on the latter is sacrificed. The NBAA is currently considering imposing a levy on audit fees to increase its income.

Given its obligations relative to its resources, it is not surprising that private criticism of the NBAA is rife within the accounting profession. It is seen to provide poor oversight of both university teaching curricula and the professional qualification (PQ) syllabus and its delivery by the private training organisations that need to be NBAA-accredited. The university curriculum surprisingly includes neither ICT skills nor economics. A senior person in a globally networked firm suggested that graduates starting work needed to be taught basic spreadsheet skills.

First and second tier accounting firms tolerate the NBAA as the statutory industry regulator but identify few benefits that it provides. The view of many in those firms is that the NBAA is not effective in either enforcing standards or upgrading quality. Its lack of action to reduce or eliminate 'rubber-stamp' auditing severely undermines the regulator's overall credibility within these two tiers of the profession. The NBAA's auditing compliance reviews are carried out by a retired Big Four partner with a handful of NBAA staff, reviewing firms on a three-year cycle, roughly two reviews per week on average. Poorly performing firms are re-visited within a year to assess improvements. No firms have ever been suspended or shut down. Disciplinary actions against individuals are largely dealt with by the NBAA leadership, with few or no sanctions ever imposed. Most importantly for its members, there is no transparency regarding performance reviews of firms or disciplinary actions against individuals. The Big Four and the second-tier globally networked firms rely on their own networks' internal performance and

[80] A second professional body, the Tanzanian Accountants Association (TAA), exists but appears to be largely dormant.

[81] NBAA staff are civil servants.

quality reviews, seeing engagement with the NBAA on these issues as mainly a compliance requirement. Similarly, on upgrading, many people in all tiers of the profession appear to regard the NBAA's provision of CPD as a compliance burden, rather than a useful upgrading of skills and knowledge.

The NBAA is also criticised for its lack of leadership on the IFRS and ISA standards, for delays in introducing adaptations of standards appropriate for small firms in Tanzania. To be fair, the IASB itself has been slow to create small firm standards, though it is surprising that the firm size thresholds were kept low in Tanzania, and the standards not quickly translated into Swahili as part of their dissemination in business.

Aside from the NBAA, a number of other statutory bodies have specific oversight responsibilities in relation to accounting and auditing, including the Bank of Tanzania for bank financial reporting and auditing, the Tanzania Insurance Regulatory Authority for insurance companies and the Social Security Regulatory Authority for pension funds. The Controller and Auditor General (CAG) has oversight of auditing in government departments and public sector bodies, with the Accountant General responsible for accounting and the preparation of financial statements. The NBAA is criticised for a lack of information sharing and coordination with all these regulators.

Users of financial statements

As with the tax authorities discussed above, the commercial banks use their own 'informal' certification of auditors when using financial statements, based on the segmentation in the audit market. For the large banks, loan requests of around TZS3 billion ($1.5 million) and above generally come from businesses audited by the first and second tier accounting firms. Below that, even for loan requests as high as TZS 1.5 billion (about $650,000), these banks may not accept financial statements unless audited by first or second tier firms. Smaller banks will generally rely on the assessment of the bigger banks, but have a much higher non-performing loan rate.

TRA carries out its own tax audits of businesses, where it views financial statements as not being credible, which is tied to the company's track-record as a taxpayer, as well as its tax consultant.[82] An anonymous TRA informant suggested that globally linked accounting firms were generally trusted by TRA, in contrast to audits by small Tanzanian accounting firms, as noted above, which were often of dubious quality. A key institution in the system is BRELA, which has not been able to enforce the requirement for businesses to file audited financial statements annually, nor to make business records transparent. This constitutes a significant weakness in the accounting and auditing system, and creates difficulties for other users, including banks and the TRA. BRELA is in the process of shifting to an e-filing system and is optimistic that this will be operational in about four years from now. The new system is linked to the TRA's Taxpayer Identification Number (TIN) system making tax evasion more difficult,

[82] The TRA is responsible (independently of the NBAA) for the certification of tax consultants, who need not be CPAs.

while private users of BRELA checking on companies will also be able to learn if they are tax-compliant.

One important set of users of financial statements with whom we are concerned here are the businesses themselves. Only one interviewee raised the issue of corporate governance of businesses and the responsibility of a firm's external auditors to evaluate corporate governance and assist the client (especially its board) to improve it. It was suggested that this is not commonly done by auditors in Tanzania, as worries about fee income makes them reluctant to encourage independence of boards (from management) or to cooperate with internal auditors. This leads to inefficiencies as auditing work is duplicated.

PEG Reform

At present, the market position of the first tier globally networked firms is based on their brand and other elements of their global network. The firms in the second tier have built their position over time within the domestic market, including several who are now tied in with second tier global networks. Firms in both groups protect their brand value, that is, manage risk and maintain reputation, through their individual networks, insulating them as a group from the third tier firms. The consequent industry segmentation and distinct levels of accounting and auditing standards contributes to entrenching disordered open 'deals' across wide swathes of the economy, to use the language of Pritchett et al. (2018). Credible public information exists only for a minority of businesses[83], raising transaction costs for the rest and restricting their own expansion and that of the overall market.

What is needed for a more efficient and effective system overall is a shift in the long-run to a single set of higher accounting and auditing standards, through better enforcement of rules through stricter quality assurance of auditors, and to upgrading quality through improved transfers of knowledge, especially within the profession. This also fits with the original objectives of President Magafuli's political agenda, to reduce the arbitrariness and higher costs of corruption, increase the tax 'take' and spend it on cost-lowering public services.

This process of 'raising the bar' would need to be led by first and second tier firms, in particular those that are globally-networked, since they have the resources, and most importantly, access to the knowledge and systems required for higher quality accounting and auditing practices. The question as in the other cases is how to bring about collective action by the large firms to lead governance reform, but in this case through knowledge diffusion to firms within the same value chain segment, rather than knowledge diffusion vertically within a value chain structure, as in the other two cases.[84]

A key step is to get the globally-networked firms to understand the process as long-run 'market-building' of their own market, that is, acting as 'guardians' (in the sense of nurturing)

[83] However, these probably contribute the majority of GDP.

[84] Whereas the RMG and cocoa cases involved creating a 'club' for suppliers through establishment of a standard, together with support for them to pay their 'entrance fee' to the club, here the opposite is required – the 'club' restricting access needs to be opened up and made more 'public'.

of the ‘common pool’ of monitoring rents, to ensure its sustainability and growth. A situation of significant investor uncertainty linked to ‘disorderly’ non-transparent deals, in which large firms might scale back or leave the Tanzanian market, would intensify competition within the top two tiers of the accounting industry. This would ultimately damage first and second tier accounting firms, both domestic firms and globally linked. The ownership structure of the globally linked firms – Tanzanian firms ultimately dependent on the long-run growth of the Tanzanian economy – gives them an incentive to support market building in this sense, by acting collectively.

Given their resources, which are in fact more substantial than the NBAA’s, collective action must be led by the Big Four. The first tier firms do act jointly on occasion, a recent example following the emergence of an inconsistency between regulations issued by the Bank of Tanzania (BoT) on balance sheet treatment of certain asset classes, and the IFRS-defined treatment of the same assets. This created a dilemma for bank auditors, and the Big Four firms together with a representative of the second tier firms helped to convene a discussion between the BoT and the NBAA to resolve the issue. An attempt several years earlier to address a similar issue had ended in impasse.

A potentially important role for UK government representatives in Tanzania, as the ‘home government’ of all of the Big Four firms, would be to create a forum which could consider mechanisms for long-term, systematic improvement of accounting and auditing standards across the industry, going beyond ‘one-off’ exercises such as the above. This would have to be done in consultation with the NBAA, which would benefit from financial support. Consideration should be given to institutionalising a formal mechanism within the NBAA to structure participation by top tier firms, though such a mechanism should involve other stakeholders, in particular small accounting firms. Given its dual role, as regulator and as representative body, the NBAA has the potential to give greater voice to small firms in the profession and build a coalition between small and large firms, if this is carefully structured.

Actions are needed in five specific areas.

- The first is direct action to ***raise standards*** in in the industry. One way to do this is to reduce competition in the third tier through consolidating small firms through mergers. This could be linked to stricter compliance, as below. At the same time, increased competition in the second tier should be encouraged through the entry of more foreign networks, especially from the region (East and Southern Africa), which will also increase the inflow of knowledge into Tanzania.
- A second route to raising standards is to expand access of individual accountants to knowledge from outside Tanzania. This can be through internships for Tanzanian accountants in the UK, in both accounting firms and in businesses in other sectors. Mentoring programmes can bring both early career and late career accountants from the UK to Tanzania to work directly with small accounting firms and their clients. Training programmes may also be useful.

- A third step in terms of direct action is significant ***tightening of registration and compliance procedures*** for auditing firms, and adoption of effective enforcement mechanisms. The Big Four firms are reluctant to assist in upgrading of smaller firms through collaborative joint audits, because of intellectual property concerns. However, it may also be possible to strengthen compliance reviews and connect them to upgrading of small firms by establishing panels of mentors, through temporary placements in Tanzania of (retired) accountants from the UK.
- Fourthly, there seems to be very little support given by firms to improving formal ***accounting education***, in particular by assisting the universities and high schools in this respect. Some linkages with UK-based education institutions exist but this could be extended with more support. The Big Four in-house programmes for new recruits are a critical mechanism for upgrading of young professionals' skills. For competitive intellectual property reasons, second tier firms express reluctance to mount jointly similar extended training programmes for new recruits, which they cannot afford to do individually. Solutions to this could perhaps be found through concerted efforts, to enable a slimmed-down version of these programmes to be provided to local firms. Internships are another mechanism to provide experience which currently is available only to those employed by the Big Four – these can be explored both within 'industry', that is, in large businesses in Tanzania, as well as internationally, that is, in the UK.
- Finally, it is important to ***build institutions***, in particular to strengthen the NBAA. The option of a levy on audit fees needs to be explored. Support could be provided from organisations such as the Institute of Chartered Accountants of England and Wales (ICAEW) that ran a project to assist the NBAA in 2009/10. It has run projects to support national accounting regulators in several other countries, such as Ghana and Malawi. Temporary secondment[85] of a small number of senior staff from Big Four firms, as well as of retirees from outside Tanzania, should also be explored, as a mechanism to strengthen the NBAA, as well as BRELA and the TRA. The process of integrating systems across the latter two institutions is well advanced, but assistance with reinforcing their impact on raising accounting standards may well be of value.

[85] Temporary meaning for one to two years

Appendix 6 List of organisations interviewed in the three country case studies

Bangladesh

Alpha Clothing

Apon Wellbeing

Awaj Foundation

Better Work/ILO

Bangladesh Garment Manufacturers and Exporters Association (BGMEA)

Centre for Policy Dialogue (CPD)

DBL Group

Global Alliance for Improved Nutrition (GAIN)

GIZ

Lawyee Fashion

LightCastle Partners

Marks and Spencer

MBM Group

New Asia Group

Primark

SR Asia

SNV Netherlands Development Organisation

WaterAid

Wellbeing Capital

Ghana

ABRAPOPA

African Centre for Economic Transformation (ACET)

Adikanfo Commodities Ltd.

Anonymous manufacturer

Anonymous processor

Cocoa Marketing Company (CMC)

COCOBOD

Cocoa Processing Company

Forestry Research Institute of Ghana

Hersheys

Kuapa Kokoo Farmers Union

KumanKoma Licensed Buying Company (LBC)

Ministry of Food and Agriculture

Ministry of Finance and Economic Planning

Mondelez - Cocoa Life

National Development Planning Commission

Nestlé

Office of the Vice President

PBC Limited

Rainforest alliance

RMG Ghana Limited

Touton

Tanzania

Bank of Tanzania

Business Registration and Licensing Authority (BRELA)

Controller and Auditor General of Tanzania (CAG)

CEO Roundtable

Claritas

Ernst & Young Tanzania (EY)

Innovex

KPMG Tanzania

Mazars Tanzania

National Board of Accountants and Auditors (NBAA)

NMB Bank

P Clem Associates

PwC Tanzania

RSM Tanzania

TMC Associates

Tanzania Revenue Authority (TRA)

Tanna Sreekumar Grant Thornton

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