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Procurement mechanisms and the emergence of new governance structures in the CEECs: evidence from the Bulgarian wine industry

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Abstract

During transition, Bulgaria witnessed the dismantling of communist agri-food supply channels and a weakening of contract enforcement mechanisms. Wineries have had to establish grape procurement and purchasing relationships with a more diverse set of growers and intermediaries. In an attempt to overcome the weaknesses of procurement via spot markets, they have sought more interdependent contractual forms that secure greater control over the quality of inputs and minimise the possibility of opportunistic behaviour. The desired option by wineries is complete backward integration but attempts to achieve this have been limited by fragmented land ownership, credit constraints and incomplete property rights.

Keywords: Procurement; Transaction costs; Bulgarian wine

1. Introduction

During the communist period, agri-food chains in Central and East European Countries (CEECs) were strongly vertically co-ordinated and monopsonistic structures secured contractual enforcement. Subsequent agricultural restructuring led to a decline in output, decapitalisation of both the up- and downstream sectors and processors suffered from the disruption to conventional marketing channels and a weakening of contractual and legal enforcement mechanisms. Reform specific factors such as the cessation of state support to agricultural producers, painfully slow land restitution, atomisation of production structures and a slow process of privatisation and liquidation have resulted in a number of distortions in the functioning of supply channels (Jackson and Swinnen, 1995; Swinnen and Gow, 1999).

While the interrelationships between input suppliers, wine producers and buyers have become increasingly important in the international wine industry (Walker, 2001), in Bulgaria their counterparts are still finding their way in structural adjustment. Due to the weaknesses of the post-communist Bulgarian economy and the collapse of former COMECON markets, producers have attempted to re-direct a significant part of their production to more lucrative EU markets (Davidova et al., 1994). However this strategy was unsuccessful in the 1990s as Bulgaria suffered from a decline in its share of international wine markets. For example, until 1993 Bulgaria was the most important non-member supplier of wines to the EU (both in volume and value terms). However, by 1999 Bulgaria accounted for just 2.4% of the EU wine market by volume, which was less than the shares of the USA, South Africa and Chile. In the same year, Bulgaria's share of the market in value terms was only 1.3%, relegating it to ninth place in the list of most important non-member suppliers to the EU (Zaharieva, 2003). The discrepancy between volume and value shares also indicates that, on average, Bulgarian wines have much lower unit values. Quality inconsistency has been a major factor in this decline (National Vine and Wine-Making Chamber, 2000).

The Bulgarian Wine Industry (BWI) is taken as a case study to provide an understanding of how the post-communist restructuring of markets and firms has created problems of supply chain governance and how processors have attempted to deal with failure in grape procurement markets. The study employs transaction cost theory (TCT) to analyse procurement problems

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between wine producers and grape growers and the motives for contractual innovation in an uncertain environment of emerging markets and imperfectly developed legal institutions. It highlights a divergence between theoretical predictions and the types of purchasing arrangements witnessed. The paper concludes with a discussion on the implications for both wine producers and policy makers.

2. A theoretical framework for analysing supply channels

The role of supply chain management, emergence of new types of contracts, contractual failures and quality issues in the CEEC agri-food sectors have become increasingly important fields for research (Gow and Swinnen, 1998, 2001; Beckmann and Boger, 2001; Lehota et al., 2001). Empirical studies on the CEECs have described agricultural producers as having weak bargaining positions (Mihaylova et al., 1996; Gorton et al., 1998; Beckmann and Boger, 2001; Fertő and Szabó, 2001). However, agri-food processors have also suffered severely from disrupted supply channels and in many cases their institutional response has failed (Gow and Swinnen, 1998, 2001).

Failure in procurement markets has attracted attention because of its relationship to issues of efficiency, food safety, consumer protection and producer welfare (Gorton, 1997; Jackson and Swinnen, 1995; Swinnen and Gow, 1999). Insights provided by the New Institutional Economics literature on transaction costs, principal-agent problems and property rights (Williamson, 1975, 1979, 1985; Jensen and Meckling, 1976; Fama, 1980; Eisenhardt, 1989) provide a grounding to explain problems of governance in the supply chain. Thus, as the break-up of the integrated supply channels was paralleled with dramatic changes in the business environment and exchange mechanisms, TCT has been adopted to theorise (a) why spot markets fail and (b) the choice of alternative institutional arrangements to procure raw materials.

2.1. Determinants of transaction costs

Transaction costs are incurred ex ante and ex post to the completion of a contract, where ex ante costs include search costs of discovering price variations and costs incurred in negotiating and delineating agreements. Ex post costs of contracting include the costs of quality monitoring and enforcement and renegotiations and maladaptation costs (Williamson, 1985).

TCT is based on four concepts: (a) the existence of bounded rationality and incomplete information, (b) the potential for opportunistic behaviour by partners, (c) uncertainty and (d) restricted numbers involved in the bargaining process. Bounded rationality arises since individuals are limited in their knowledge, foresight and skills to collect and process information and solve complex problems (Simon, 1957; March and Simon, 1958; Cyert and March, 1963). The concept of asymmetric information was developed by Arrow (1975), who claimed that transactions between upstream and downstream firms are subject to incomplete, imperfect and asymmetric information. He assumes that downstream firms have limited information on raw material prices and therefore their ability to make efficient decisions is impaired. Klein et al. (1978) define opportunistic behaviour as the unanticipated nonfulfilment of specified contractual obligations. Ex ante opportunism, describes a situation in which asymmetric information exists between buyers and sellers and the opportunistic seller will be apt to selectively reveal information. The seller could deliberately distort or provide false information when specifications are difficult to verify prior to purchase (Akerlof, 1970). Ex post opportunism, occurs due to the complexity of monitoring a partner's performance and arises when one party engages in activities such as shirking, cost cutting or debasing quality (Masten, 1996). Asymmetric information may generate possibilities for opportunistic behaviour that can lead to hold-up problems "in which each party to a contract worries about being forced to accept disadvantageous terms later, after it has sunk an investment, or worries that its investment may be devalued by the actions of others" (Milgrom and Roberts, 1992). *Uncertainty* in supply channels is related to random acts of nature, lack of knowledge concerning the future decision-making patterns of economic agents, government policies and unpredictable changes in consumer behaviour.

2.2. Matching transaction characteristics with governance structures

Processors face a decision in the choice of supply channel where this decision involves consideration of the efficiency of internal organisation versus different vertical arrangements or open market purchasing where trade-offs between these forms are governed by three characteristics of transactions. These characteristics are: the frequency with which exchanges take place, uncertainty and the degree of specificity of assets involved in transactions.

The criterion for organising transactions takes two parts—production cost minimisation and minimising on transaction costs so that an organisation can achieve a competitive edge. It also contains a consideration of how effectively processors can respond to price and production quality characteristics communicated with consumers. With regard to economising on transaction costs, asset specificity is seen as crucial in the choice of a supply channel (Williamson, 1985). It refers to the