

**Donor approaches
to supporting
pro-poor value chains**

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Donor Committee for Enterprise Development
Working Group on Linkages and Value Chains

by

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Introduction

Donor organizations increasingly focus on value chain promotion as a key element of their private sector development strategies. This new trend is based on the following widely shared assumptions:

1. Economic growth is good for the poor. Even though the poor do not always benefit proportionally from growth, and income gaps often widen during growth phases, income levels of the poor are strongly correlated with GDP growth.
2. High rates of economic growth can only be sustained if the national economy, or at least substantial sectors of the economy, are internationally competitive. Given the increasing openness to trade and foreign direct investment, even domestic markets in developing countries become ever more exposed to global competition. Developing countries thus need to face the challenges of globalization. Competing with international enterprises is a challenge not only for export sectors but for any producer of tradable goods or services.
3. Global integration is increasingly taking place through structured exchange relations. Traditional arms-length trade, where producers sell spontaneously to unknown buyers, is clearly diminishing. Most trade is now based on coordinated forms where one or more actors in the value chain have the capacity to define quantities, product and process standards, terms of delivery and the like as preconditions their trading partners have to fulfil. Therefore it is important to understand how these relationships are coordinated, what the rules of the game are, who takes the relevant decisions and what these imply for the distribution of rents and the inclusion or exclusion of subordinate trading partners. In developing countries, exporters to the OECD were the first to be confronted with these changes. Recently, however, the new sourcing patterns start to penetrate even their domestic markets.
4. The question is thus not *if*, but *how* to integrate in value chains in a way that allows for incorporation of a growing number of the workforce and increasing levels of productivity and incomes. This calls for a balanced approach which takes both competitiveness and equity issues into account.

Given the growing relevance of value chains for private sector development there is a need for developing country governments and donor agencies to better understand the dynamics of value chain integration, to assess its risks and opportunities especially for poor persons in developing countries and design appropriate strategies for socially inclusive competitiveness strategies.

The present study has been commissioned by the Donor Committee for Enterprise Development, with financial support provided by UNIDO and FAO. The Donor Committee provides a forum in which member agencies can exchange information about their programmes, and the lessons learned through those programmes. Given the increasing awareness about value chain

issues the Committee launched a Working Group on Linkages and Value Chains with the aim of reaching an agreement among the member agencies on approaches to operationalise value chain strategies for pro-poor growth.

This study serves several purposes, namely

- to discuss the analytical foundations of the concept, help to clarify terminology and discuss areas of overlap as well as conceptual distinctions between “value chain” and “linkage” approaches and related concepts in the field of private sector development;
- to examine the implications of the increasing coordination and globalization of value chains for pro-poor growth in developing countries;
- to identify strategies and interventions for value chain development in ways that contribute to economic growth and poverty reduction; and
- to identify questions for further discussion among the donor agencies involved.

To this aim a review of academic literature as well as unpublished agency reports has been carried out and a number of donor agencies and academic institutions have been consulted, either in person or by telephone or email. The author is grateful for the great enthusiasm with which all agencies have cooperated and contributed even unpublished strategy documents and project reports.

In addition to this report the author is preparing an overview of the diversity of policy approaches and practical experiences of the core members of the Donor Committee’s Working Group on Linkages and Value Chains with the aim of comparing agency objectives and illustrate specific strengths and proven policy instruments. Hopefully this will serve as a basis for further cooperation within the Donor Committee.

This report consists of seven chapters. Chapter 1 discusses the analytical foundations of the value chain concept and shows how it relates to other theoretical concepts and strategies for the support of enterprise development. Thereby it helps to clarify terminology, identify areas of overlap with similar, and often complementary, approaches and elucidate conceptual differences. Chapter 2 examines the relevance of the value-chain concept for pro-poor growth, identifying opportunities and threats for developing countries and pointing to the multiple trade-offs between policy objectives. Chapter 3 then elaborates on the interests of different stakeholders involved in value chain activities and analyzes to what extent interests coincide or diverge. In chapter 4 different methodologies for value chain analysis and procedures to design intervention strategies are presented. Comprehensive planning approaches are contrasted with less meticulous participatory tools and grant schemes which encourage private sector-led solutions. Chapter 5 presents an overview of the major policy options to influence value chains in the desired way. It distinguishes between *general private sector development policies* and their potential impact on the structure and development impact of value chains and *specific value chain policies* aimed at building linkages and improving their development impact. Subsequently, chapter 6 discusses the issue of impact assessment. The last part makes

out relevant problems and trade-offs with regard to value chain development and identifies areas for future discussion among the members of the Donor Committee (chapter 7).

1 Analytical foundations and different connotations of the value chain concept

Firms generally do not become competitive on their own, that is, without a supportive environment of related suppliers and service providers as well as customers which are both reliable and demanding. All firms are more or less embedded in networks of firms that provide externalities such as easy access to information, material inputs, specialized business services and a skilled workforce. The more developed these complementary networks are, the more can individual enterprise specialize in certain core capabilities, which in turn tend to raise the competitiveness of the network which the firm is embedded in.

Value chains are one of the most important elements of these networks or production systems. Value chains can be defined as “the full range of activities that are required to bring a product from its conception to its end use. These include design, production, marketing, distribution, and support to get the product to the final user. The activities that comprise a value chain may be contained within a single firm or may embrace many firms. They can be limited to a single country or stretch across national boundaries.”¹ If firms specialise in a certain stage of the value chain and establish linkages with input providers (upstream) and processors or distributors (downstream), this is usually referred to as vertical linkages. At the same time, firms tend to be embedded in horizontal linkages, i.e. cooperative relationships with other firms at the same stage of the value chain. Moreover, firms are connected with non-firm organizations, e.g. employer’s associations, trade unions, NGOs, universities and government agencies. Many of these relationships do not directly influence the process of value addition and should therefore be distinguished from vertical value chain links.

Scholars from different disciplines - management sciences, innovation theory, economic geography, industrial economics and sociology, transaction cost theory, etc – have tried to conceptualize the way firms are embedded in their local environment. The focus here is on *business* linkages (in contrast to non-economic forms of societal embeddedness) and especially on *value chain* linkages (as opposed to horizontal linkages). Nevertheless it is important to keep in mind that the configuration of value chains is very much dependent on peculiarities of its broader economic, social and cultural environment.

The number of different approaches to explain the relationships of firms and their respective value chains or production systems has increased considerably since the 1970s when firms started to outsource massively and the boundaries between firms and their business environment became more and more blurred. Value chains are an important analytical element in all

¹ Downing et al. (forthcoming), p. 9.

these approaches. However, these differ with regard to their disciplinary focus. Some for example aim at improving logistics from a management perspective, while others are primarily concerned with the impact on specific locations, and again others place emphasis on technological learning. Some authors make use of similar notions, such as supply chains, production chains, or commodity chains. Although this may at times express slightly different foci the notions are largely overlapping and there is no consensus regarding their specific contents. The following overview discusses the most important concepts related to the basic idea of value chains highlighting their specific connotations and disciplinary roots.

1.1 The management sciences perspective

Value chains (or “supply chains” which is more commonly used in the business management literature) are a core concept in management sciences.² Four main bodies of literature within this discipline have been central to our understanding of the functioning of value chains:

First, the *strategic management* literature brought forward the distinction between core and non-core competencies³ and explored the rationale behind make-or-buy choices. Firms need to calculate the costs and benefits of in-house production versus outsourcing.⁴ Such calculations require a dynamic perspective that takes future situations and learning trajectories into account, e.g. the risk of losing competences which may become relevant in the future. In addition, outsourcing implies risks and raises the costs of exchanging via markets. The strategic management literature therefore strongly draws on transaction cost economics⁵ and basic operational economics,⁶ including considerations of scale and scope economies. Closely related to the debate on make-or-buy decisions is the concept of boundaries of firms. As firms increasingly trade products and services across the boundary of the firm, new forms of non-market coordination between core firms and associated producers emerge in order to make standards and procedures compatible and reduce transaction costs.⁷

Second, the *supply chain management* literature has developed this debate further, linking the make-or-buy debate to issues of locational choice and logistics. Supply chain research thus not only provides criteria to decide which business processes are appropriate for outsourcing, but also what should be sourced from which locations and vendors. Moreover, it helps to “unbundled” the value chain distinguishing different types of sourcing relationships for dif-

² See Petersen (2005) for an overview.

³ Prahalad / Hamel (1990).

⁴ See e.g. Quinn / Hilmer (1994); Mahoney (1992).

⁵ Williamson (1985).

⁶ Stiegler (1951).

⁷ These management science debates also spurred a discussion in industrial sociology, e.g. giving rise to the notion of “embedded firms”: Granovetter (1985) and Grabher (1993).

ferent processes and introducing concepts of modular sourcing,⁸ where certain privileged vendors supply pre-assembled modules, thus giving rise to different tiers of suppliers. Logistics concepts such as Just in Time Delivery and Efficient Consumer Response emerged from this strand of management research.

Third, a more specialized body of literature deals with *offshoring* as a specific form of cross-border outsourcing. Starting with the apparel industry in the early 1970s,⁹ offshoring became relevant for developing countries which offered substantially lower labour costs. Subsequently offshoring spread out to many other sectors and regions, to the extent that by 2001, “about 90 % of all consumer electronics sold in the United States were produced offshore, as were 80-85 % of footwear, toys, luggage and handbags, watches, clocks, games, and television sets, 70 % of bicycles, 60 % of computers, and 57 % of apparel.”¹⁰ The business processes to be outsourced across the globe increasingly also include complex knowledge-intensive activities. Recently, even offshoring of R&D to a small number of more advanced developing countries is gaining importance.¹¹ Academic research on offshoring builds on the make-or-buy debate and discusses criteria which facilitate or hinder the unbundling and international dislocation of production processes, e.g. to what extent certain processes are divisible, codable and tradable.¹² In addition it raises questions about competitiveness factors determining the ability of host countries to attract such foreign direct investment.

Forth, *Porter's value chain concept*¹³ has put these management science debates in a broader perspective. According to his empirical studies most competitive advantages of nations cannot be explained by factor cost differentials, as neoclassical theory suggested. Especially in more advanced countries, where basic factor endowments tend to be relatively similar, sustainable competitive advantages rather build on a range of location-specific conditions. These include Linkages with related and supporting industries – i.e. value chain integration – play a very important role because they allow firms to build on external economies. In addition, Porter's analyses emphasize the importance of local competition and specific demand conditions. Fierce rivalry with strong competitors as well as extraordinarily challenging home markets (either due to especially demanding consumers or government regulations forcing firms to raise standards) both drive innovation and create competitive advantages vis-à-vis other countries. Porter thus strongly underpins the argument that competitiveness at the firm level decisively depends on its local embeddedness. While management sciences have always dealt with firm strategy and inter-firm linkages, it is Porter's merit to have attracted attention to additional location-specific factors such as local demand patterns and rivalry.

⁸ See Sanchez / Mahoney (1996).

⁹ Fröbel/ Heinrichs/ Kreye (1980).

¹⁰ USITC, cited in Gereffi/ Sturgeon (2004), p. 1.

¹¹ UNCTAD (2005).

¹² Gassmann (1997).

¹³ E.g. Porter (1990).

1.2 Linkage and chain concepts in development studies¹⁴

Whereas the management science literature focuses on the individual firm as the main unit of analysis, value chain and linkages concepts are concerned with explaining the whole process of value creation from primary processing to consumption. Some of the most important theoretical work sets off from a development studies perspective and therefore addresses issues of industrialization strategy, income distribution, spillovers, and entry barriers.

Among the most influential sources of the value chain concept are Perroux and Hirschman. Perroux proposed the notion of growth poles, which are large industries that generate external economies for other, related industries. Industries with strong interactions and externalities have the ability to induce local growth poles (and, thereby, spatially polarized development) and are therefore termed “propulsive”.¹⁵ A few years later Hirschman’s developed his linkage approach.¹⁶ According to this approach investment in a (especially manufacturing) firm produces demand effects that induce subsequent investments (backward linkages) by input suppliers (e.g. in agricultural raw materials, intermediate goods). Often, the output of the manufacturer can, in turn, be used as an input into another industrial activity. Thus, subsequent investments are also stimulated on the output side (forward linkages).

Hirschman’s and Perroux’ work strongly influenced industrial and regional policies in the 1960s and 70s when governments promoted heavy industries, e.g. steel and petrochemical plants, in order to trigger the development of forward linkages with processing industries. Underlying this strategy was the argument that heavy industries usually require economies of scale which can not be achieved given the limited size of domestic markets in many countries. The existence of such industries however would induce economic growth in downstream activities and thus create the necessary markets. Industrialization could accordingly be triggered by public investments in heavy industries. Likewise, import substitution policies in developing countries built on Hirschman’s ideas as they protected domestic production of consumer products as a way of creating a critical market size for the later development of *backward linkages* with suppliers of intermediate and capital goods.

Transnational Corporations (TNCs) have been a favourite object of research on linkages, with a strong focus on backward linkages with local SMEs.¹⁷ Especially UNCTAD has a 40 year long tradition of research into the way TNCs are embedded in developing country’s economies.¹⁸ In this work it is remarkable how the perception of the TNC’s role in developing

¹⁴ See Stamm (2004) for an overview of different origins of the value chain approach as well as Raikes / Jensen / Ponte (2000) for an excellent comparison of the *filière* and the global commodity chain approach.

¹⁵ Perroux (1955).

¹⁶ See Hirschman (1958), especially pp. 100-119.

¹⁷ See e.g. Dunning (1992); Dicken (1998); Halbach (1985); Moran (1999).

¹⁸ Frederiksson (2003).

countries has changed over time. Whereas in previous decades TNCs were regularly blamed to abuse of monopolistic power and outcompete local companies, to date there is considerable agreement that the positive effects of foreign direct investment far outweigh these negative consequences. According to Dunning, the findings of a large number of studies over the past decades "are virtually unanimous that the presence of foreign-owned firms has helped raise the standards and productivity of many domestic suppliers, and that this has often had beneficial spillover effects on the rest of their operations."¹⁹ More recently, a number of scholars have explicitly studied policies for promoting local business linkages with TNCs and enhancing technological spillovers.²⁰ The most comprehensive work to date has been presented in UNCTAD's World Investment Report 2001.

Important contributions to the understanding of value chains also emanate from the **filière approach**.²¹ This approach was developed by French researchers who studied vertical integration in agriculture. It was soon applied to export commodity production of cotton, rubber, coffee, and cocoa in France's former African colonies. Most research was done by agricultural scientists interested in increasing the efficiency of these value chains by improving the functioning of public marketing institutions and reducing transaction costs involved in dealing with farmers. According to Raikes, Jensen and Ponte, "its main objective has been to map out actual commodity flows and to identify agents and activities within a filière, which is viewed as a physical flow-chart of commodities and transformations."²² The filière-approach emphasized the measurement of input-output relations, prices and value added at different stages of the production chain – which was relatively easy to do in fairly homogeneous commodities which were mainly regulated by State marketing boards. Furthermore the method was applied to identify

“strategic junctures, from which the entire production and distribution chain can be dominated. The intention is to find those in the group of actors who not only determine their own action in the filière, but also thus powerfully influence the ability or even the need of other actors in the filière to act.”²³

Most of the work on filières was rather technical, focusing on physical flows and prices. One group of researchers however – the “anthropological tradition within filière works”²⁴ – also addressed issues of power distribution and entry barriers for small farmers.

¹⁹ Dunning (1992), p. 456.

²⁰ Battat/ Frank/ Shen (1996); Altenburg (2000).

²¹ See Lauret (1983) as well as Raikes / Jensen / Ponte (2000) and Stamm (2004) for critical overviews.

²² Raikes / Jensen / Ponte (2000), p. 15.

²³ Lenz (1993), p. 26.

²⁴ Raikes / Jensen / Ponte (2000), p. 16.

Gereffi and several other researchers developed these ideas further. Gereffi coined the **global value chain** concept (although he used the term “global commodity chains” in earlier studies) on the basis of empirical studies of globalised production of different industrial sectors, including garments, footwear, and automobiles.²⁵ In addition to the traditional notions of the input-output structure of chains and their spatial distribution, the innovative contribution of his work is its focus on the *governance structure* of value chains. Certain key actors, the lead firms or “governors of value chains”, have the capability and power to define and impose the parameters of contracts and subcontracts in their supply chain. For example, they can set chain-wide product and process standards, quantities and conditions of delivery. This power may be based on ownership of well-established brand names, proprietary technology, or the exclusive information about different product markets which enables the firm to act as a system integrator.

These specific competences of the dominant lead firms give them a competitive advantage which is difficult to emulate and therefore allows for above-average rates of profits (or producer rents). The subordinate supply chain partners tend to be in a much weaker bargaining position because their products are usually more easy to manufacture (i.e. barriers to entry for new competitors are low), and lead firm can therefore easily swap suppliers, or at least threaten to do so, in order to squeeze their partner’s profits and appropriate a larger share of the total gains of the value chain. Moreover, lead firms may set standards as a means to exclude non-certified competitors. Thereby lead firms define, or at least influence, entry barriers for newcomers. It is Gereffi’s merit to have drawn attention to these issues of uneven power relations, barriers to entry, and rents.

The degree of influence over the value chain depends on the type of value chain organization. In institutional economics, the distinction is usually made between markets, networks and hierarchies. In *markets*, products are traded in repeat anonymous transactions, and partners can be easily exchanged. Markets tend to work well if products are homogeneous, with little specific information attached to them, and if the business and legal environment facilitates transactions. contracts can easily be enforced. *Hierarchies* are at the other end of the spectrum, where production is vertically integrated in a single firm, and the management exercise control over the whole production process. Firms may opt for in-house production if they want to keep control over core technologies, if processes are difficult to codify, or if contract enforcement is unpredictable. The global value chain concept insists that most value chains are of the intermediate, network-type, i.e. without ownership control, but different non-market coordinating mechanisms. In most industries, such network-type arrangements offer the optimal combination of gaining from specialization *and* maintaining sufficient control over the production process.

²⁵ Gereffi /Korceniewicz (1994).

According to the density of coordination and degree of power asymmetry, Gereffi, Humphrey and Sturgeon distinguish three types of network-based governance between markets and hierarchies, thus adding up to five types of governance of global value chains (see box 1).

Box 1: Types of governance in value chains

Gereffi et al. build on the well-known distinction in organization theory among markets, networks, and hierarchies. Between the two extremes of “markets” and “hierarchies”, they distinguish three intermediate forms of “networked” governance:

1. Markets. Market linkages do not have to be completely transitory, as is typical of spot markets; they can persist over time, with repeat transactions. The essential point is that the costs of switching to new partners are low for both parties.
2. Modular value chains. Typically, suppliers in modular value chains make products to customer’s specifications, which may be more or less detailed. However, when providing “turn-key-services”, suppliers take full responsibility for competencies surrounding process technology, use generic machinery that limits transaction-specific investments, and make capital outlays for components and materials on behalf on customers.
3. Relations value chains. In these networks we see complex interactions between buyers and sellers, which often cerates mutual dependence and high levels of asset specificity. This may be managed through reputations, or family and ethnic ties. Many authors have highlighted the role for spatial proximity in supporting relational value chain linkages, but trust and reputation might well function in spatially dispersed networks where relationships are built-up over time or are based on dispersed family and social groups (see for example, Menkhoff 1992).
4. Captive value chains. In these networks, small suppliers are transactionally dependent on much larger buyers. Suppliers face significant switching costs and are, therefore, “captive”. Such networks are frequently characterized by a high degree of monitoring and control by lead firms.
5. Hierarchy. This governance form is characterized by vertical integration. The dominant form of governance is managerial control, flowing from managers to subordinates, or from headquarters to subsidiaries and affiliates.

Source: Gereffi, Humphrey, Sturgeon (2003), p. 5

Another element introduced by Gereffi is the distinction between buyer vs. producer-driven chains. Buyer-driven chains have low barriers to entry in production (e.g. garments, shoes, toys). In these industries, ownership of brand reputation or market access through retail systems is the strategic asset that is difficult to replicate and therefore allows to appropriate rents. International brand name and retailing companies (“buyers”) therefore define the “rules of the game” in the respective industries and appropriate the largest share of the gains from the respective production. Producer-driven chains, in contrast, are characterized by high-technology and capital-intensive production facilities, e.g. in the automotive industry. Here, manufacturers are the governors of value chains, and routine activities are outsourced to networks of suppliers and distributors whose profits are being squeezed by the core manufacturers.

This distinction is helpful insofar it exemplifies the sector-specificity of governance patterns. However, it is somewhat rigid and simplistic. Empirical research shows that power distribution is not so clearly distributed and continuously renegotiated (e.g. some auto parts suppliers

nowadays have a stronger bargaining power than the car manufacturers). Furthermore, governance patterns tend to vary within the same product category, depending on the scarcity of specific capacities in different locations and market segments.

1.3 Subsector and industry level analysis

In addition to the linkage and chain concepts presented above, a number of similar and overlapping concepts have been developed which focus on specific subsectors or industries as the main unit of analysis. There are several terms for these approaches (e.g. subsector, agrifood system, or industry level analysis), and authors use the terms differently, so that no generally accepted definitions are available. Some of these concepts have a narrower focus than value chain analysis while others are almost identical (although they may use their own terminology) or adopt an even broader systemic perspective.

Subsector analysis has already been developed in the 1960s and goes back to the agricultural marketing field of agricultural economics.²⁶ Since then it has been applied widely especially in the analysis of agricultural commodity chains, for example by the World Bank, USAID, and the FAO. However, it has later also been applied to SME development in non-commodity sectors.²⁷ Its definition is largely identical with that of value chains:

“A subsector is a vertically linked chain of production, marketing and transformation activities that move an agricultural commodity from the field to final distribution to consumers. Value is added as commodities move and are productively transformed across subsector stages, which are each separate industries. (...) This approach places heavy emphasis on how a commodity subsector is organized (structure), which can influence how participants in the subsector behave (conduct), and ultimately how the subsector performs in the aggregate.”²⁸

Key concepts of the value chain approach are almost identically used in subsector analysis. For example, subsector analysis also highlights the importance of “coordination” of subsector participants through mechanisms other than markets and underlines the role of lead firms as coordinators:

Subsector analysts pay more attention to agribusiness firms that actively coordinate marketing systems, such as producer/exporters, wholesale traders, processors and exporters. Key firms in any of these industries can serve as channel captains who play a large role in organizing a subsector, structuring exchange relationships, and using their strategic vantage point (and market power) within the

²⁶ Shaffer (1973); Haggblade / Gamsler (1991); Holtzman (2002).

²⁷ Boomgaard / Davies / Haggblade / Mead (1992).

²⁸ Holtzman (2002), p. v

subsector to bring about positive changes that lead to improved system performance.”²⁹

Subsector analysis (and related concepts, like the notion of **agrifood systems**)³⁰ thus largely overlaps with value chain analysis. Some subsector work however seems to adopt a slightly broader systemic perspective, looking explicitly at the respective commodity subsector as a whole and delving into issues which are not at the centre of value chain analysis, such as the impact of changes in food consumption patterns and the links between food production and rural livelihood.

Industry level analysis is another related branch of research.³¹ Its key concern is to uncover “the many industry specific policy and enforcement issues which, collectively, have been found to be the most important constraints to economic growth.” Findings are largely based on detailed industry studies which the McKinsey Global Institute carried out for 28 sectors in developed and developing countries. These studies focus on *industries* – such as garment assembly or beer brewing – rather than the respective *vertical chains* (such as the cotton–textile–garment–retail chain). In contrast to value chain analysis, industry level studies would thus not place emphasis on the inter-firm relations between suppliers and customers, the coordination of these relationships, the knowledge flows between chain actors, and the distribution of gains and risks between enterprise at different stages of the value-adding process. However, most industry studies would also somehow address upstream and downstream operations as relevant framework conditions for the core industry’s competitiveness. Industry level and value chain analysis thus have an overlapping focus, but differ with regard to the scope of their analysis.

Industry level analyses rather focus on impediments to growth which are *external to the chain*. These include

- industry specific policy issues, such as specific licensing and ownership restrictions, trade barriers and pricing regulations;
- land market issues, including (unsecured) property rights, restrictions on land for foreigners, user charges on utilities, restrictive zoning laws, etc.;
- unequal enforcement of policies among formal and informal enterprises, which distorts competition in several ways.

It argues that many constraints to private investment and economic growth lie in inadequate “micro-policies”, and that in-depth analyses of specific industries are needed to detect particu-

²⁹ Ibid.

³⁰ According to Baker (2006), agrifood systems “comprise the individuals, enterprises, institutions, activities, services and relationships which develop and deliver inputs, produce primary commodities, and handle, process, transport, market and distribute food and other agricultural products to consumers.”

³¹ E.g. Palmade (2005).

lar constraints at the industry level, where causality links can be conclusively determined.³² Despite the analytical focus on specific industries the tool is also used for deriving country wide reform priorities - by summing up the results from industry value chain analysis from across a representative sample of industries.

The focus on barriers to investment and policy distortions reflects a liberal, market-friendly orientation. Whereas much of the value chain work in development studies deals with the mechanisms by which private value chain governance erects entry barriers, industry-level studies are mainly concerned with policy-based market distortions. Its aim is to reduce inadequate government interference in markets, establish a level playing field for all enterprises and to increase competition which is considered to be the most effective capital allocation mechanism and the main driver of productivity growth.

Based on subsector and industry level analysis the World Bank's Foreign Investment Advisory Service (FIAS) developed its own methodology for value chain analysis.³³ The FIAS approach starts by measuring production time and costs at different stages of the value chain, such as input costs, transactions costs, and derived metrics such as value added and productivity. FIAS then benchmarks these metrics against international competitors which allows to establish where in the whole value chain the most relevant performance gaps lie and to prioritize policy interventions accordingly. The next step is to explain the performance gaps by getting at underlying government policy and market failures. In line with FIAS' mandate, the main goal is to detect policy and market failures rather than pro-active strengthening of individual firms or groups of firms. In fact, the approach is quite critical about any effort to pick specific sectors.

1.4 Other network concepts

The **Global Production Network** (GPN) approach, developed independently by Ernst et al.³⁴ and several scholars at the University of Manchester,³⁵ builds upon Gereffi's global value chain concept but incorporates several additional elements. In particular, Henderson et al. criticize that "the metaphor of a chain gives the impression of an essentially linear process of activities ... rather than one in which the flows of materials, semi-finished products, design, production, financial, and marketing services are organized vertically, horizontally, and diagonally in complex and dynamic configurations." Moreover, they argue that the chain metaphor is inadequate to conceptualize how inter-firm networks are embedded in societies which display considerable social and institutional variation, how firms and individuals in a chain

³² Ibid., p. 22.

³³ Subramanian (2006).

³⁴ Ernst (1999); Ernst / Kim (2001).

³⁵ Henderson et al. (2002).

are influenced by overall power relations and sociocultural patterns, and how knowledge is being produced by, and circulates among, producers, consumers and intermediaries in complex multidirectional rather than unidirectional ways. According to Coe, „different societies exhibit significant social and institutional variation, (and) ... these leave a distinctive imprint on the elements of production networks that are located in particular national territories.” Similar to the cluster approach, the GPN draws our attention to additional influential factors which are not necessarily directly involved in the sequence of the value-adding process.

The **National Innovation Systems (NIS)**³⁶ concept is another framework to describe the embeddedness of firms in networks. Two distinctive characteristics of the concept are noteworthy. First, its focus on innovation rather than production; and second, the emphasis on national rather than global systems.

A NIS is a network system of actors (firms, organizations, government agencies, consumers, etc.) that interact with each other in ways which enhance the innovation performance of a national economy. The main idea of the concept of innovation systems is that overall performance depends not only on how each individual actor performs but also on how these actors work together in knowledge generation, acquisition, and use. It conceptualizes the interaction between three different levels: the internal organization of firms; inter-firm relationships; and relationships between institutions and firms. Especially deepened division of labour in value chains often accelerates of the accumulation of knowledge. In addition to inter-firm relations, the concept points to the relevance of institutional linkages. Knowledge-providing institutions such as universities, schools, training systems, research labs, databases, training systems etc. are very important elements of an NIS. Furthermore, institutions are needed to support the *transfer* of knowledge through telecommunication networks, libraries, databases, linkage programs, technology transfer centers, etc. And, finally, institutions play an important role in *reducing uncertainty* in the political, legal and economic environment.

Compared to the linkage and chain concepts the NIS approach takes a more comprehensive look at the dynamics of innovation and learning. Although the value chain literature frequently mentions different sources of knowledge-flows in chain relations³⁷ and deals with different categories of value chain upgrading,³⁸ the institutions underlying knowledge flows and technological learning are rarely analyzed systematically. For example, the incentives of value chain partners to share or hold back knowledge are hardly ever considered in value chain studies. Moreover, knowledge-creating and -transferring institutions *outside* the value chain (such as research institutions) are usually disregarded.

³⁶ E.g. Lundvall (1992).

³⁷ E.g. Downing et al. (forthcoming) mentions that buyers and suppliers of capital goods frequently generate and transfer knowledge to the benefit of other value chain firms.

³⁸ Schmitz (2000, p. 7 f.) distinguishes four types of upgrading strategies: process upgrading, product upgrading, functional upgrading, and inter-sectoral upgrading.

The NIS focus on *national* systems reflects the fact that national economies differ with regard to the structure of their production systems and institutional setups.³⁹ The success of an NIS thus depends on a variety of nation-specific factors such as market conditions, managerial and technological competences of enterprises, public infrastructure and regulations, norms and values, and the intensity and effectiveness of interaction between knowledge-using and knowledge-producing entities. It is because of these particularities that innovation activities differ among countries. Yet as nation-states become more open to cross-border trade and investment relations, NIS increasingly become subject to external influences. Transnational corporations in particular shape local production systems to a much greater extent than they did a few decades ago. Moreover, nation-states increasingly act in accordance with international agreements, and even some research and technology organizations exercise influence beyond national boundaries. On the whole, although the degree of nation-specific similarities justifies the analysis of *national* systems, NIS should always be viewed as open systems. In this regard the global value chain concept has made an important contribution to widening the research perspective.

1.5 Systemic competitiveness

The concept of systemic competitiveness was developed in the 1990s by the German Development Institute.⁴⁰ Like the network approaches it argues that competitiveness of firms is dependent on the quality of inter-firm relations and national systems of norms, rules and institutions that define economic incentives. It proposes a heuristic framework to analyze the political and economic determinants of successful industrial development which distinguishes between four levels:

1. The microlevel of the firm and inter-firm networks. It is assumed that microlevel competitiveness is to a great extent based on interaction. Learning-by-interacting, and feedback loops along the value chain, are a key element in firms' innovation processes.
2. At the mesolevel, specific, targeted policies and institutions are crucial to establish dynamic competitive advantages.
3. The macrolevel of generic economic conditions, e.g. a stable and predictable macroeconomic framework and an enabling business climate are equally important.
4. The metalevel refers to underlying socio-cultural structures which include e.g. development-oriented cultural values which are shared by a large part of the society; a basic consensus on the necessity of industrial development and a competitive integration into the world market, and the ability of social actors to jointly formulate visions and strategies and to implement policies.

³⁹ OECD (1999), p. 21.

⁴⁰ Esser et al. (1994).

The concept considers inter-firm networks as a key element of systemic competitiveness, but calls attention to the need to take the overall business framework and underlying socio-cultural norms and rules into account. It has been influential especially in German development policy where “multi-level approaches” are pursued to coordinate interventions at the firm, institutional capacity building, and political advisory levels.

1.6 The cluster concept: focusing on the spatial dimension

Value chains, or important parts of them, are often spatially concentrated. Automobile manufacturers for example persuade their strategically important suppliers to locate in the proximity of their assembly plants with a view to reducing delivery times and risks; in the electronics and the garment industry, clustering of suppliers often occurs in locations with a cheap supply of workers and specific infrastructure facilities. As pools of labour with sector-specific skills evolve, spatial concentration is further enhanced.

Clusters are characterized by sector specialization and geographic concentration. Extensive research on enterprise clusters has shown that clustered firms often perform better than spatially dispersed firms. This is due to the fact that geographic proximity facilitates what Schmitz call “collective efficiency”⁴¹ emanating from

- forward and backward linkages between firms inside the clusters;
- intensive information exchange between firms, institutions, and individuals in the cluster, which gives rise to a creative milieu;
- the existence of a local pool of skilled labour and the attraction of buyers;
- joint action (e.g. joint purchases or marketing efforts);
- the existence of a diversified institutional infrastructure supporting the specific activities of the cluster;
- a sociocultural identity made up of common values and the embeddedness of local actors in a local milieu which facilitates trust.⁴²

The cluster concept thus also highlights the embeddedness of firms in complex inter-firm relations. The cluster concept emphasizes geographic proximity, and it draws the attention to additional elements which are usually not addressed in value chain analysis, e.g. the role of local socio-cultural milieus with shared values, the relevance of local labour pools, formal and informal mechanisms of knowledge transfer as well as the dynamics of joint action of firms at the same stage of the value chain.

⁴¹ Schmitz (1995).

⁴² Altenburg / Meyer-Stamer (1999), p. 1694.

Combing both concepts thus helps us to better understand two interrelated sources of technological learning and upgrading opportunities: those transferred through buyer-supplier relations and those stemming from other elements of the local milieu.⁴³ Research shows that clustered firms tend to increase their extra-regional sales and purchases. In other words, global value chain integration gains importance whereas cluster coherence has a tendency to erode.⁴⁴ Nevertheless certain agglomeration economies persist which limit dislocation and stabilize local business networks.⁴⁵

This has important implications for policymaking. The trend towards increasing local integration into global value chains, especially the growing role of global buyers, obliges policymakers to reorient local economic development and cluster initiatives towards linkage building with external markets. In fact, both academic research on clustering in developing countries and practical cluster promotion in the past tended to exaggerate local interactions and understate the relevance of external agents as facilitators of market access and innovation. On the other hand, it may be promising to combine linkage building with lead firms with policies for local economic development and SME networking which help mobilizing local synergies.

1.7 Synthesis: Strengths and limitations of the value chain approach

As the previous overview has shown, the value chain approach is not a fully coherent theory but a research tradition with a number of different ramifications. As Henderson et al state, “although the approaches often overlap with one another they derive from different intellectual domains and, therefore, carry with them different kinds of intellectual ‘baggage’.” Some proponents place emphasis on horizontal, others on vertical linkages; some highlight the role of spatial proximity and regional synergies, others the knowledge flows and power relations between buyers and suppliers. None of the concepts is all-encompassing.

However, recent value chain work, most notably that of Gereffi, Sturgeon, Kaplinsky, Humphrey and Schmitz, has converged towards a consensus on a number of analytical elements which enrich the analyses of private sector development and its development impact:

1. The value chain approach takes a different view on international trade. While orthodox trade theory puts the endowments of production factors at the centre of its analysis and assumes trade relations to be based on arms-length market-based transactions, the value chain approach focuses its attention on the organisation of international trade and shows how production and trade are, to a varying degree, coordinated and shaped by lead firms. This gives rise to different patterns of industrial organisation.

⁴³ See e.g. Pietrobelli/ Rabellotti (2004); Humphrey/ Schmitz (2000).

⁴⁴ Schmitz/ Knorringa (2000); Schmitz (2004).

⁴⁵ See Markusen (1996).

2. The value chain concept helps to understand competitive challenges. As buyer-supplier relations are increasingly arranged through quasi-hierarchical relationships and product flows systematized by all kinds of standards and agreements, the performance of industries becomes more dependent on the quality of value chain relationships. Breaking down value chains in different stages and analyzing their performance enables entrepreneurs and policymakers alike to systematically identify competitive disadvantages and define points of leverage for action. In the automotive industry, for example, manufacturers realized quite early that, once a first round of factory automation had increased the efficiency of assembly plants, additional gains could mainly be achieved by restructuring their supply chains. Competitiveness of car manufacturers hence increasingly depended on improvements outside their own firms, and they consequently focused their attention on reducing costs and delivery times and raising quality standards of their suppliers and distributors. In the same vein, policymakers can dissect value chains and benchmark each of its components in order to identify bottlenecks where improvements are most effective.
3. Reflecting the experience that government and donor-driven interventions have often had little impact, a new generation of private sector development programmes emphasises the need to work through private change agents. Value chain analysis enables policymakers to recognize the most powerful change agents and their likely – positive or negative – impact on the competitiveness and inclusiveness of value chains. The concept shows how some firms define and enforce standards, thereby raising or lowering entry barriers for small and weak economic actors, and how their position of power influences the distribution of profits and risks among participating firms. Development agencies may now seek to influence these private change agents in the pursuit of inclusive and sustainable value chain strategies.
4. The approach shows that power relations are crucial. The power relations between different actors determine how economic gains and risks are distributed among chain actors and to what extent dominant firms are able to set and enforce standards with the aim of raising entry barriers for competitors and to achieve market foreclosure. The concept of “governance of value chains” implies that “there are key actors in the chain who take responsibility for the inter-firm division of labour, and for the capacities of particular participants to upgrade their activities.”⁴⁶
5. The value chain approach helps to understand the dynamics of value creation at different stages of the value chain, including the role of entry barriers and innovation rents. Identifying where the bulk of the value accrues and the highest profitability can be achieved, and understanding how firms deliberately erect entry barriers to escape from price competition are necessary to find appropriate upgrading strategies.

⁴⁶ Kaplinsky (2000).

6. The approach draws attention to issues of knowledge creation, transfer, and appropriation. It points to critical questions of how knowledge flows along value chains, e.g. how information on market trends is passed back from retailers to primary producers, how firms learn and upgrade in chains, how they “unlearn” certain capabilities as they specialize, what kind of knowledge technology proprietors transfer and how they disclose their core competencies. Moreover it has developed a typology of upgrading strategies which firms can adopt.⁴⁷ However, this is a field where substantial further research is required.
7. The value chain concept adopts a global perspective, recognizing that trade, the coordination of productive activities, and technology transfer are increasingly organized across borders. This implies that researchers and policymakers need to take key stakeholders into account that may be located far away from the country or region they are interested in.⁴⁸ This constitutes a major advancement of academic cluster studies and related aid projects of local economic development which had in the past often adopted a rather inward-looking perspective, neglecting the important role of global buyers, international trade relations, foreign investment, and the rules and regulations shaping their behaviour.

Other academic concepts place even more emphasis on the observation that value chains are embedded in broader relationships. These include the regulatory framework, social norms and values, specific consumer preferences, horizontal inter-firm relations, and so on. Any strategy for private sector development will need to take the full range of systemic factors into account. This is why some scholars prefer more comprehensive systemic concepts. While most proponents of the value chain approach clearly acknowledge the need to conceptualize value chains as part of a broader set of factors which shape competitiveness, there is an implicit risk of adopting a too simplistic perspective. In particular,

1. some studies depict value chains as simple linear non-ramified flows, whereas in the real world chains furcate and band together again, and many firms form part of several overlapping chains;
2. the stylized dichotomous concept of either buyer-driven or producer-driven value chains tends to ascribe all power to one “governor” of the chain, whereas in reality different degrees of power or powerlessness are usually found along any given chain, and power constellations continuously change over time. For example, Gibbon and Ponte observe that some lead firms encourage first-tier suppliers to absorb coordinating functions in the value chain.⁴⁹ In some cases first-tier suppliers (e.g. large autoparts manufacturers) have become so powerful that they, rather than their customers, im-

⁴⁷ This differentiates process, product, functional and chain upgrading. See Kaplinsky /Morris, p. 38.

⁴⁸ Humphrey (2005).

⁴⁹ Gibbon/ Ponte (2005), p. 204.

pose conditions. In other instances leading buyers are in a weak bargaining position when certain products are in short supply;

3. some decisive determinants of a sector's competitiveness and development impact, e.g. government regulation or the availability of specific infrastructure and skills, tend to be neglected if value chains are conceptualized as rather autonomous units. Especially the FIAS approach however places strong emphasis on these factors in the firms' external environment;
4. contemporary value chain research as well as related development projects are somewhat biased towards *global* chains. Hence they sometimes disregard the co-existence of other, local or regional, chains that may provide viable alternatives especially for poor, small and rural producers. The relevance of some characteristics of global value chains, such as increasing demands on quality, product and process certification, traceability, economies of scale, etc. may therefore be overstated.

The embeddedness of value chains in the overall policy framework, in a territorial context and specific socio-cultural patterns is of great relevance for the design of policies. Almost any type of national policy or donor programme in the field of private sector development somehow directly or indirectly influences value chains. This is the case, for example, of policies aimed at improving overall investment conditions, attracting foreign investment, providing better business services, or increasing the competitiveness of national SMEs (and hence their "value chain readiness"). This makes it impossible to establish a clearly delimited set of "value chain policies." Conversely, adopting a value chain perspective is often useful to understand the impact of generic private sector policies.

2 The relevance of the value chain concept for pro-poor growth

The previous discussion has shown that structured exchange relations increasingly dominate international trade as well as domestic value chains. Production by order of a dominant lead firm is becoming the dominant trade pattern. In such supplier relations product and process standards, terms of delivery and other parameters are usually defined in advance and compliance is enforced by the lead firm. The opportunities of firms to access markets, to pocket economic rents and to upgrade towards more sophisticated and better remunerated activities therefore increasingly depend on the characteristics of the value chain and the power relations vis-à-vis the lead firm. Therefore it is important to understand how these relationships are coordinated, what the rules of the game are, who takes the relevant decisions and what these imply for the inclusion or exclusion of subordinate trading partners, their opportunities for technological learning and the distribution of rents and risks. Value chain analysis helps to recognize barriers to entry, to assess risks and opportunities related to different value chains and to identify appropriate strategies for value chain integration which make it possible to achieve pro-poor growth. This chapter briefly describes the most important recent trends in

global value chain formation and analyzes the associated threats and opportunities for pro-poor development.

2.1 New trends in value chain formation

Increasing globalization is changing the business environment of SMEs and agricultural producers in developing countries in different ways. These have been analyzed in detail elsewhere. For the purpose of this study, however, it is worth summarizing some developments which impact on the structure of value chains before discussing their likely positive or negative implications for pro-poor growth:⁵⁰

- Liberalization of global markets increases competitive pressure and enhances the role of economies of scale. This has furthered concentration processes, e.g. in manufacturing and retailing.
- Increased international competition reduces returns to firms that fail to innovate and distinguish their product. Continuous product changes and branding strategies therefore gain importance as a market differentiation and upgrading strategy.
- International competition also rewards reliable and timely delivery. Error-free production, smooth supply chain logistics and short time-to-market thus become increasingly important for the success of companies.
- Greater consumer awareness has given rise to higher and more differentiated consumer standards.
- New transportation, information, and communication technologies have driven down the cost of accessing information and trading products and facilitate the spatial division of value chains. This has implications for the choice of locations for different phases of the production process. Nations and their firms can more easily specialize by subsector or even activity within an industry. Lead firms divide the activities associated with their industry into ever more differentiated segments and locate their affiliates at the optimal location anywhere in the world, respectively source from independent suppliers at the optimal locations.
- Some firms increasingly dominate their business partners upstream and downstream in the value chain, imposing their own rules and acting as gatekeepers to the market. Their dominance arises from specific capabilities, mostly the capabilities to innovate, to create brands, or to coordinate the whole production process. Their privileged position implies a shift in power that usually translates into increasing rents.

Given these trends, the sourcing and outsourcing strategies of large industrial and commercial corporations as well as their efforts to define and enforce more demanding standards are be-

⁵⁰ See Downing et al. (forthcoming) for a more detailed discussion.

coming key determinants for the integration of developing countries and their firms into the world economy. Access to OECD markets increasingly depends on their ability to enter into global production networks of lead firms. This entails both threats and opportunities.

2.2 Threats for pro-poor development

A first threat results from the fact that those large corporations that are able to create powerful brand images, influence fashion trends, set and enforce standards and coordinate comprehensive logistics networks rarely originate from developing countries. With the exception of some emerging TNCs from newly industrialized Asian countries,⁵¹ lead firms are almost exclusively based and embedded in OECD countries. If lead firms become more important as innovators, coordinators and governors of global production networks, and subordinated companies become standard-takers which are excluded from important processes involved in creating intangible values, this process will shift power, and probably value added, away from developing countries.

Second, the growing importance of knowledge-intensive, intangible factors (including design and branding) may enlarge imbalances between developing and developed countries as well as within these countries. Successful product innovations and branding strategies tend to shift rents and bargaining power to the innovator or brand owner. In poor countries and regions only very few differentiated industrial clusters or “knowledge hubs” exist that are able to provide strategic complementary service support for knowledge-intensive production.

Third, increasing scale requirements and market consolidation raise entry barriers for smaller firms and reduce the number of markets where they can sell their products. Small, less efficient firms will often be crowded out or face the challenge to specialize in areas with lower scale requirements and specific comparative advantages.

Fourth, as lead firms (but also governments and consumer organizations) impose more rigid standards even for the subordinate functions of the value-adding process, barriers to entry again tend to rise. Firms in developing countries have to meet ever higher and more costly minimum technological standards. To give a few examples, additional investments are required to establish software for electronic data interchange and traceability systems; to meet higher standards in terms of (depending on sector) hygiene, safety, electromagnetic compatibility etc., suppliers have to bear the costs of compliance with social, environmental, hygiene and other standards plus the necessary certification procedures and customer audits. Crowding out of smaller, less competitive suppliers and locations is likely to occur.

⁵¹ For the emergence of Asian TNCs, see Aggarwal (2000) and Lall (1998); Altenburg et al. (2004) describe how a Thai-based TNC dominates the characteristics of the shrimp farming industry in several countries.

Fifth, since most firms in developing countries are standard-takers, they have less bargaining power vis-à-vis lead firms. This is likely to lead to shifting margins from suppliers to lead firms. This problem is aggravated by the fact that cheap labor and natural resources are mostly in abundant supply, creating pressure to bring prices down, while innovation rents may be obtained for the knowledge- and network-based capabilities of lead firms which are very specific and thus difficult to be reproduced by newcomers.

2.3 Opportunities for pro-poor development

As TNCs systematically subdivide their functions, reorganize their internal corporate structures, concentrate on core competencies, and outsource marginal tasks and functions, new opportunities present themselves to developing countries which fulfil the minimum conditions for performing these tasks at lower costs. In Enright's words, the spatial dislocation of production processes according to the specific requirements of each stage of production "is actually good news for developing countries, because today an economy does not have to be able to do everything in a production chain or an industry in order to participate. The key is finding the specialization, finding the niche, finding the activity in which the nation can compete, and creating links into the world economy sufficient to participate."⁵² New ICT technologies for example enable developing country firms to acquire contracts in new areas such as back-office services.

Moreover, since lead firms are ever more interested in assuring smooth, error-free production flows and compliance with all sorts of standards, more knowledge transfer is required. Even though we have mentioned increasing entry barriers as a *risk*, they constitute an *opportunity* as well. If lead firms want to exploit factor cost advantages in less developed countries or regions, where "advanced" production factors⁵³ such as testing facilities, standardization and certification bodies, consultancy firms etc. are in short supply, the lead firms are likely to put more effort into the transfer of technology. Empirical evidence shows a variety of relevant learning processes among Third World suppliers in global production networks.⁵⁴ For example, the dissemination of business concepts and standards such as ISO 9000, ISO 14000, "good manufacturing practice" (GMP) and "good agricultural practice" (GAP) among firms catering to international customers has largely been triggered by a combination of pressure and support from international lead firms.⁵⁵ Successful adoption of such standards is an im-

⁵² Enright (2006), p. 4.

⁵³ According to Porter (1990, p. 77 f.) *advanced factors* are those production factors which are not "inherited" by a nation, but must be created over time.

⁵⁴ E.g. UNCTAD (2001).

⁵⁵ Nadvi (1999), p. 1606ff., provides a detailed description of GMP adoption among Pakistan's exporters of surgical instruments.

portant means of industrial upgrading, one that in part protects firms from lower-cost competitors who are not able to comply with these standards.

Although the development literature often paints a stylized picture in which trade takes place between factor-cost-based developing country locations and knowledge-based OECD locations, this dichotomy obviously does not hold in reality. Investment decisions in the real world have to bear in mind a number of different production factors that entail different economies of scale, externalities, and transaction costs, and this means that in selecting locations it is necessary to take into account a variety of different elasticities and trade-offs.⁵⁶ In order to exploit factor-cost advantages or gain access to product markets of developing countries, investors usually have to put up with certain deficiencies of the local production system. This is why some, especially larger, firms are willing to invest in creating and deepening local linkages.⁵⁷ Every single investment in this direction helps the respective location to move up the technological ladder.⁵⁸

2.4 The complexity of trade-offs

All in all, the enhanced role of lead firms has far-reaching consequences for the poor in developing countries, involving both threats and opportunities. Empirical evidence suggests that threats are much greater and opportunities more limited were the competitiveness of the domestic business sectors lags far behind international standards. However, defining the net effects of changes in value chain organization is not an easy undertaking because these tend to create both winners and losers. For example,

- shifting from in-house production to external suppliers may reduce relatively well paid wage labour in the lead firm and increase lower quality jobs in supplier firms;
- inducing foreign firms to adopt local small-scale suppliers may be favourable for local technological learning but lessen the efficiency of the supply chain;
- holding back concentration and internationalization in the retailing business may protect small enterprises but lead to higher consumer prices;
- interventions aimed at increasing social or environmental standards in a given industry may lead to the exclusion of poor informal suppliers;
- increasing environmental and social standards may raise costs and jeopardise competitiveness vis-à-vis competitors with lower standards.

⁵⁶ Storper (2000), pp. 252ff.

⁵⁷ UNCTAD (2001), p. 140, based on different sources.

⁵⁸ Rasiah's (1994) study of Penang's electronics industry describes one of the most convincing cases.

The following box 2 exemplifies how structural change in a particular sector may have highly differentiated effects on wages, job quality, competitiveness, distributional and environmental issues, etc. This is a challenge for value chain analysis as well as for policy impact assessment, especially as many of the relevant parameters are difficult to measure and attribute to a specific policy. Furthermore, due to the diversity of outcomes it is very complicated to assess the counterfactual (what would have happened without intervention). Still, value chain analysis provides a framework that allows policymakers to get a better understanding of complex interdependencies within economic subsectors and to anticipate changes.

Box 2: Socio-economic impacts of a transition from traditional retail organization to supermarket supply chains (hypothetical)		
Area of impact	Expected development impact	Assessment (pos./ neg.)
Direct employment in retailing	Decreasing due to concentration, crowding out of mom-and-pop stores	-
Indirect employment effects in supplier firms	Decreasing due to concentration	-
Employment effect on competitors	Crowding out of mom-and-pop stores	-
Wage levels of employees	Increasing due to higher productivity	+
Income level of suppliers	Decreasing margins as oligopolistic buyers exert pressure on prices, but higher income for <u>some</u> suppliers due to increasing turnover and productivity gains	- / +
Income disparities	Increasing concentration among retailers and suppliers, crowding out effects	-
Stability of supplier's income	more stable sourcing patterns (for those remaining)	+
Learning opportunities	Different, partly new opportunities for suppliers with regard to quality, logistics, franchises etc., partly deskilling of workforce	+ / -
Labour standards	more formalized, but increasing pressure to increase labour productivity	+ / -
Equality of opportunities for women	Depends on labour market; concentration processes likely to crowd out informal producers which are more often female-headed	- (?)
Environmental standards	Better enforcement of standards throughout the chain	+
International competitiveness of domestic retail sector	Increasing	+
Foreign exchange balance	Increasing imports of luxury goods or even basic products if local suppliers lack economies of scale	-
Consumer prices	Lower retail margins and higher productivity lead to declining consumer prices	+
Own compilation		

3 The political economy of value chains: Understanding the rationale of lead firms, suppliers, host country governments, and donor agencies

Given the strong interrelations between different forms of value chain organization and their impact on pro-poor growth there is a strong case for government or donor intervention. Governments may either limit their role to improving the business environment for private sector transactions and providing generic services, or they may adopt a more active role as facilitators and promoters of specific value chains. Likewise, donors have to decide to what extent they are willing to engage in specific and selective value chain interventions.

If governments or donors agencies decide to engage actively in support of value chains different partner constellations are possible. Support may for example be focused on local farmers or micro-entrepreneurs within marginalized populations, on SMEs or the organizations of such small-scale producers, with the primary aim of strengthening their “value chain-readiness”. However, the public sector may also create incentives for, or build alliances with, lead firms in order to encourage them to integrate more local suppliers or to enhance technology transfer. Others options include strengthening value chain linkages indirectly via business service providers or promoting multi-stakeholder alliances with all relevant value chain partners. In any case, the specific, and sometimes conflicting, interests of different actors need to be taken into account. The analysis of stakeholder interests also reveals sector-specific differences in the behaviour of value chain actors.

Prima facie we may assume that there is a great deal of congruency of interests because all parties are interested in upgrading the local institutional and business environment. As noted above, gaining competitive advantages is increasingly a matter of coordinating and governing a corporation's upstream and downstream relationships more efficiently than its competitors do. Consequently, the competitiveness of firms depends on factors lying beyond the boundary of the company and include the production system in which the firm is embedded. If lead firms “can procure inputs locally, particularly in host economies in which labour costs are low, they can lower production costs (some service inputs, for example, may be very expensive to import). If they can subcontract directly to local suppliers, they can increase their specialization and flexibility, and adapt technologies and products better and faster to local conditions. Technologically advanced suppliers can provide affiliates with access to a pool of external technological and skill resources, feeding into their own innovative efforts.”⁵⁹ In short, having efficient complementary firms close by helps lead firms to sustain their competitiveness.

At this point a caveat is necessary: Although firms become increasingly reliant on linkages with value-chain partners and providers of complementary services, these linkages may not involve *local* firms. Instead, lead firms may import the overwhelming share of their supplies, and even if they source locally, their partners may be other foreign affiliates which may con-

⁵⁹ UNCTAD (2001), p. 129

strain technological spillovers into the region and hamper local accumulation of capital.⁶⁰ By and large, nevertheless, the level of development of the local business community and institutions is an important factor for the locational choices of firms. Firms will prefer those locations where all relevant input factors are available at a low cost, where transaction costs are low and the general business environment is supportive. In fact, empirical evidence proves that lead firms are, to a certain extent, willing to invest in the quality of local clusters.

Furthermore, lead firms may improve their profile as good corporate citizens if they show commitment with the social development of their host country or region. Especially consumer pressure on brand-name products is a strong motive for engaging in Corporate Social Responsibility programmes that benefit local suppliers or improve working conditions.

All this is in line with the public interest of the host country (or region) in enhancing locational spillovers and upgrading local competitiveness. Local policy-makers and most stakeholders welcome spillovers from lead firms, especially the generation of employment and technological skills. Moreover, local stakeholders have an interest in local linkages because they help to embed investment in local business networks and make them less footloose.

However, even if lead firms, guided by their “enlightened self-interest,” contribute to the upgrading of their local business environment, this is not likely to lead to the most efficient outcome in terms of public welfare. Additional public support and regulation may be required where companies underinvest in local capabilities because they are unable to privately appropriate the returns, and in some cases public interests even conflict with the lead firm’s interests. Two aspects of market failure are likely to occur:

1. *Public goods and externalities:* As we have already argued, a diversified and competitive local network of supporting firms and institutions benefits both the large investors that build on these networks and the local population. However, for any individual corporation, building and upgrading all the complementary structures required – e.g. research facilities, human capital, specialized suppliers – would usually be too costly. Moreover, unless supplier relations are captive, it is often not feasible to exclude other (nonpaying) firms from using the relevant structures. This creates an incentive for free-riders and leads to situations where the public good “supportive enterprise structure” is likely to be under-supplied. Finally, firms may refrain from investing in complementary firms in order to avoid boosting their own competitors. Modern supplier relations or joint ventures increasingly involve sharing of relevant tacit knowledge about technologies and customers. This may imply leakage of strategic information and ultimately enable some of the supported firms to copy products that are core competencies of the lead firm. Hence private-sector technology providers, while interested in enhancing the efficiency of their value-chain partners, will seek to keep their own strategic assets secret and limit knowledge transfer or even suppress learning processes that might endanger their own knowledge edge in the

⁶⁰ Ibid., p. 133.

area of their core competencies. Where business partners have access to critical knowledge, lead firms will try to prevent them from cooperating with competitors. In the same vein, companies often try to externalize risks and costs. For example, they may take advantage of information asymmetries to shift the risks of fluctuating markets to their suppliers, or they may externalize environmental costs.

2. *Noncompetitive markets*: Firms have an interest in establishing monopolies in order to obtain rents. Lead firms are defined by their ability to set and enforce standards, to coordinate and control large production networks, and to advance product innovations. All this raises barriers to entry and hence lowers the degree of competition. If lead firms gain too much control of the market, they may prevent competitors from serving the market and completely subordinate and exploit their supply-chain partners.

Wherever firms seek to suppress technology transfer, to externalize social costs or to restrict competition, this creates a conflict of interests with governments and other local stakeholders. Further conflicts may arise with regard to the distribution of gains along the chain. Lead firms often try to diversify their supply base in order to weaken the bargaining power of suppliers and to be able to appropriate a larger share of value added. If they succeed in doing so, they restrict capital formation in local firms and may even drive local firms into bankruptcy. If local suppliers anticipate this opportunistic behavior, they may refrain from making technologically desirable specific investments. Both cases lead to underinvestment in the development of local clusters.

The public sector in a given location should aim at increasing allocative efficiency of resources. The allocation of resources is efficient when it is not possible to improve the situation of any economic agent without penalizing another one. Policy-makers must therefore try to find an adequate balance between supporting lead firms in their efforts to upgrade the local business environment and pursuing public interests that are not fully congruent with those of the lead firm, e.g. to capture larger rents for local producers and consumers. This a constant source of tensions in public-private partnerships.

Finding the right balance becomes even more difficult when we consider that production networks compete against each other. Countries or industrial locations have an interest in increasing the competitiveness of those production networks which concentrate a considerable portion of value added within their boundaries. Take the example of a lead firm cutting costs at the expense of the margins of its local subsidiary or suppliers. While this obviously curtails local incomes in the short run, it may increase the competitiveness of the lead firm's production network, increase its market share and spur future investments. Local industrialists hence have to consider whether to support such cost-cutting measures or not. If local stakeholders strongly advocate their interests, lead firms may consider moving (or at least threaten to move) to another location (although in practice high sunk costs often prevent firms from doing so).

All this presupposes a large measure of both *strategic competence* and *willingness to cooperate* on the part of key representatives of an industrial location. These are quite heroic assumptions.

With regard to *strategic competence*, we have seen that competitive success is increasingly dependent on systemic conditions, and this implies that it is impossible to have all the relevant information. Contemporary concepts of industrial policy seek to reduce this problem by involving a large number of informed stakeholders in the planning process, as well as by designing planning procedures based on regular performance measurement and feedback loops to readapt targets and policy instruments. Even so, it is by no means clear whether the cost of collecting and processing all the relevant information and of implementing policies to increase locational spillovers will be lower than the benefits of such correction of assumed market failures.⁶¹

Even if policy-makers or other key representatives of the location had the informational means needed to take the right decisions, there can be no presumption that they will always be *willing* to serve only the public interest. First of all, local stakeholder interests are heterogeneous, and local policy-makers obtain their legitimacy from representing different interest groups. The following points illustrate the diversity of specific stakeholder interests:

1. *Lead firms* may put pressure on the host country government to cut taxes and exempt them from certain requirements (e.g. mandatory national equity shares, compulsory contributions to skills development funds); if they fear competition they may lobby against the deregulation of markets;
2. Even within the *local business community* we may assume that interests diverge considerably. For example, some firms (especially less efficient competitors) may be threatened by new business models, while others (complementary specialist firms) may expect new business opportunities. Although these interest groups are usually less powerful than lead firms, they sometimes “have sufficient autonomy to develop and exercise their own strategies for upgrading, and they have the possibility of combining with other lesser firms to improve their collective situation within the network.”⁶²
3. *Civil society organizations* advocate a broad range of interests, e.g. environmental concerns, labor issues, and business interests. Some of them are conflicting, e.g. the interests of trade unions and business associations.

Governments represent these and other interests. The outcome of the policy process depends on patterns of how legitimacy is created in a specific government, and this again may differ between local, provincial, and national governments (which in turn are superposed by regional and global institutions). Government institutions provide an arena in which interest groups with different degrees of power vie to influence policy. As certain interest groups are better organized and more powerful than others, the outcome of this struggle will usually be

⁶¹ Chang (1996), p. 25.

⁶² Henderson et al. (2002), p. 21.

biased towards them.⁶³ It is likely that lead firms will be among the powerful actors, unless they are foreign and see themselves up against strongly nationalist governments. Therefore the possibility that individual interest groups will use their political connections to garner special favours, i.e. to pocket rents at the expense of consumers or taxpayers, is a real one.

Summing up, the optimal development of production networks may require some public action to design strategies to maximize local value added by increasing complementary local capabilities and embedding lead firms in the local business environment, to improve the distribution of gains in favour of the host country and to avoid competition-distorting behaviour and rent-seeking. This, however, requires considerable strategic competence and development orientation on the part of local decision-makers – neither of which can be taken for granted.

4 Value chain analysis and definition of intervention strategies

As we have seen, trade-offs between different development objectives are manifold, and the structure of value chains depends on a continuous negotiation processes among stakeholders with heterogeneous interests. Policy interventions thus impact on complex socio-economic systems and may therefore have highly differentiated outcomes including many indirect and unintended side-effects. To make things even more complicated, time horizons matter. Even if it were possible to record all the necessary data, to ponder the multiple trade-offs and identify the *currently* most desirable version of value chain organization this may not be the most sustainable one. For example, it may be desirable in the short run to avoid labour-saving automation and crowding out of inefficient small-scale suppliers. In the long run, however, it may prove even worse to have avoided this kind of structural adjustment leaving the respective sector fully unprepared for trade and investment liberalization shocks at a later stage. The timing and sequencing of reforms should therefore also be taken into account.

Before designing and implementing policies or support programmes governments and donors should therefore have a thorough understanding of the structure of value chains, about ongoing processes of structural change, alternative development trajectories and their likely socio-economic impact. They need to acknowledge potential trade-offs, prioritize objectives and decide to what extent they are willing to accept certain non-intended effects. For example, the ILO may favour decent working conditions over the objective of including additional small-scale producers, whereas other donors may define market access for poor informal producers as their priority even if this may imply acceptance of poor employment conditions.

The crucial question, however, is how governments and donors gain the necessary comprehensive knowledge about value chain processes and translate this into practical policy interventions. A review of the literature on value chain analysis suggests to distinguish three styl-

⁶³ Chang (1996), pp. 19f.

ized donor approaches to tackle with this problem (although governments and aid agencies may apply hybrid models):

1. A “comprehensive planning approach” based on detailed analytical value chain mapping and market analysis preceding interventions;
2. Participatory workshop-centred tools for value chain analysis with less academic rigour and stakeholder workshops as a key element;
3. Incentives for private sector-driven projects whereby donors leave the conception and implementation of initiatives to corporate value chain leaders.

4.1 Comprehensive planning approach

Some agencies have designed comprehensive tools and guidebooks aimed to analyze value chains. These include different methodologies to map the physical flow of commodities along the chain, output values at different stages of value chains, export market potentials, the regional spread of value chains, inter-firm cooperation, production efficiency, etc. Most tools and guidebooks refer to the pioneering works of Kaplinsky/ Morris and McCormick/ Schmitz⁶⁴ which were developed for the purpose of academic research. On this basis USAID developed its *Participatory Value Chain Analysis* (PVCA) and GTZ its *ValueLinks* methodology. Both recommend quite extensive studies-based procedures for the design of value chain programmes (see box 3). The World Bank, FAO, ILO and other agencies have commissioned similar comprehensive value chain analysis in order to define entry points for policy interventions. Some agencies (most clearly the PVCA, ValueLinks and ILO approaches) emphasize the need for stakeholder participation in defining upgrading strategies. Nevertheless, the strong emphasis on extensive upfront studies and the detailed planning procedures laid out in the guidebooks call for a strong coordinating role of agencies.

Box 3: The “comprehensive planning approach”: Methodologies for value chain analysis compared

USAID applies a methodology developed by Mayoux called Participatory Value Chain Analysis, PVCA). It comprises five steps:

- 1) Selecting industries with the greatest development potential;
- 2) Conducting a value chain analysis of factors influencing competitiveness
- 3) Developing a participatory competitiveness strategy.
- 4) Developing an implementation action plan,
- 5) Establishing a performance monitoring and impact assessment system.

All these steps are based on ambitious analytical work. This includes data collection on end markets, changes in demand, enabling environment (local, national, and global), inter-firm linkages (vertical

⁶⁴ Kaplinsky/ Morris (2000); McCormick/ Schmitz (2002).

and horizontal), supporting markets, employment and multiplier effects, regional and global competitors, and cross-cutting development issues (health, gender equity, environmental issues). On the basis of such data, assessments are made with regard to the competitiveness potential and appropriate upgrading strategies.

GTZ has prepared a preliminary manual (Springer-Heinze: “Info-cadena. Instruments to foster value chains”) and is currently finalizing a refined version called the ValueLinks methodology. ValueLinks consists of 10 modules. The sequence of the first four modules is similar (1. Selecting a value chain for promotion; 2. Analyzing a value chain; 3. Determining the chain upgrading strategy; 4. Facilitating the chain development process), and the methodology also concludes with a module on “Impact Monitoring” (module 10). The modules in between are dedicated to five “key intervention areas” (5. Strengthening private business linkages, 6. Strengthening service capacity, 7. Value chain financing, 8. Social, ecological and product quality; 9. Sectoral economic policies and market regulation). Hence the two methodologies overlap with regard to the analytical part and impact assessment, whereas the GTZ document also provides a “toolbox” for practical value chain interventions.

FAO's Agricultural Policy Support Service unit has developed operational guidelines for what it calls commodity supply chain analysis for pro-poor rural growth. The methodology starts with an overall analysis of the host countries economy, its most important agricultural sectors, global demand for their commodities and sub-sector performance. It proceeds with appraising rural poverty and identifying main discriminating factors based on very comprehensive farm level surveys. On this basis, then main pro-poor commodities and sub-sectors are identified. Finally, detailed chain analysis of the main 2-3 “growth-engine pro-poor sub-sectors” are carried out. These including very complete analyses of production, distribution, and marketing of the respective commodity. Conceptually the methodology is rooted in the *filière* tradition. The unit has developed a complex software for data processing and has carried out a number of comprehensive case studies applying its methodology. In addition FAO has commissioned the Institute of Development Studies in Brighton to develop a mapping tool for live-stock markets.

A fourth manual is being prepared by the **ILO**. Again, the document distinguishes five modules for the design of value chain upgrading strategies (1. Project set-up, 2. Research and analysis, 3. Finding upgrading solutions, 4. Implementation, 5. Impact assessment and project closure). The implementation part has a specific emphasis on social dialogue, according to the ILO's mandate.

FIAS is preparing another manual for value chain analysis. In a similar way, the analysis comprises industry trends, price trends, competition levels, links to global value chains, technological trends, global policy trends, factor costs, transaction costs, productivity and value added at different stages of the value chain. FIAS however strongly emphasizes benchmarking of production costs at different stages of the chain and uses the results for a data-based policy dialogue, especially to sensitize policymakers to introduce reforms which bring down the costs of public utilities.

Sources: Mayoux (2003); Downing et al. (forthcoming); Springer-Heinze (forthcoming); FAO (2004); Herr et al. (forthcoming); Humphrey/ Napier (2005); Subramanian (2006).

The academic merit of value chain analysis is beyond doubt. Given the complexity of value chain relations, and the fact that very different patterns of value chain organizations coexist, each with very specific outcomes in terms of competitiveness and social inclusion, it is very important to have a good understanding of processes and underlying causalities. In practice, however, it is impossible to fully comprehend all the opportunities and threats of value chain processes on the basis of a few weeks or months of consultancy work. While it is relatively easy to describe physical resource flows and different marketing channels, calculate the number of producers at different stages of production, and gather other general sector-wide information, such data tells us relatively little about what the best available upgrading options are, how gains and risks are being distributed, and which policies are likely to sustain competi-

tiveness in the long-term. The following observations underline this argument and show that policy decisions are complex and need to take context-specific factors into account:

- Although market prices may be obtained for homogeneous commodities, most markets are highly segmented, with strongly diverging prices and profitability in different niche markets.
- Even if gross output values can be determined for different chain links, it will be almost impossible to measure the profitability of each activity – for obvious reasons firms will usually not share this information. Mapping the distribution of rents in the chain and drawing conclusions for upgrading strategies is therefore not a realistic undertaking.
- Make-or-buy decisions, and thus the structure of value chains, depend on industry-specific technicalities. Key variables are the complexity of transactions, the possibility to codify and transmit the necessary information, and the capability of potential suppliers to deal with these issues in a way that is more efficient than in-house production. Effective proxies of these variables are not yet available and would require a comprehensive understanding of industry-specific technical processes.⁶⁵
- Even within the same industry lead firms behave differently. Their competitive strategies reflect specific values, different time-horizons of planning, etc. Comparative studies on TNC sourcing behaviour, for example, reveal very different patterns according to the nationality of ownership.⁶⁶ Moreover, some lead firms take Corporate Social Responsibility more serious than others. As a result, their attitudes towards suppliers are different, resulting in differences with regard to knowledge flows and learning opportunities for local suppliers.
- In the global economy different chains compete with each other. Policy interventions aimed at inducing changes in one particular chain thus affect its position vis-à-vis competing chains. If policies for example increase the margins for SME suppliers or the labour standards in the chain, this may result in declining market shares (unless these changes also result in increased productivity). Such indirect effects may even thwart the original policy goals.
- Analysis of current market situations may tell little about future trends. Although there is a role for governments and donors to bridge information gaps and provide market information, it is often problematic to induce SMEs or farmers in developing countries to make specific investments on the basis of such analysis. Identifying market opportunities is usually a core competence of private enterprises, and it may therefore be more appropriate for development agencies to facilitate access to exporters, processors, trade fairs or intermediaries rather than assessing and signalling business opportunities.

⁶⁵ Gereffi/ Humphrey/ Sturgeon (2003), p. 17.

⁶⁶ E.g. Moran (1999).

In sum, while value chain analysis is very helpful to get an overall picture of the structure, the incentives and the performance of economic subsystems and to identify opportunities and risks, policymakers should keep the limitations of ex-ante studies in mind. Value chains are complex interdependent social and economic systems, and consequently there will always be an element of uncertainty in identifying the best possible upgrading strategies.

4.2 Participatory workshop-centred tools for value chain analysis

Alternative instruments build less on extensive previous research and more on mobilising the knowledge of stakeholders. Two rather similar instruments have been developed recently and applied to a great number of local clusters and value chains throughout the developing world: ITC has developed its SHAPE format and Mesopartner, a private consulting firm in Germany, Participatory Appraisal of Competitive Advantage (PACA). Similar to the comprehensive planning approach, both start with a review of available studies, but this is done relatively quickly (e.g. four weeks to assess markets and the sector environment in the case of SHAPE and usually less in the case of PACA) whereas much emphasis is placed on activating business leaders and government agencies to take part in the process. Stakeholder workshops are a centrepiece of both instruments (see box 4 for details).

Box 4: Participatory workshop-centred tools for value chain analysis: SHAPE and PACA

SHAPE brings sector stakeholders together in a series of workshops where they combine practical planning techniques with market information and their own experience to diagnose their sector's performance, identify market opportunities, new market approaches and ways to add value to their products or services, and define a strategy and implementation plans to achieve their objectives.

SHAPE is composed of a 5-Step structured thinking process including (a) 2-4 weeks of preparation; (b) 4 weeks to assess markets and the sector's business environment. An in-country support team, supported by ITC, collects and evaluates data and presents it to stakeholders; (c) a two-days stakeholder workshop to discuss data, policy options and draft an action plan; (d) 4-6 weeks to examine strategy options in-depth, engage implementing partners and agree on resources, progress measures etc.; (e) a second 2-day workshop to finalize the strategy plus another 4-6 weeks to organize its implementation and oversight.

The activities are kept on track by a "sponsor" aided by a small support team that is headed by a local coordinator. The sponsor should be a person who can mobilise business leaders and government agency chiefs to take part in the process. ITC.

The **PACA** process is similar. In many cases it seems to be less ambitious with regard to data collection and evaluation, which makes it even less time-consuming and more suitable for small local clusters or regional value chains - although the format may be adjusted to the size and diversity of the locality. PACA proceeds in a pragmatic way with limited diagnostic efforts. A review of existing reports and internet sources combined with action-research at the local level will usually be sufficient.

PACA starts with a kick-off workshop involving local stakeholders, followed by a series of interviews with local players (firms, business associations, supporting institutions, local government, and others), and mini-workshops with groups of local actors. This could take between one and two weeks. The diagnostic and the proposals are elaborated and presented immediately thereafter. The presentation

includes a moderated discussion with local stakeholders. After the initial diagnostic, external consultants are ready to conduct a planning workshop with local actors. Local actors assume responsibility for the implementation of agreed activities. External consultants are in a position to offer, on a limited scale, subsequent support.

Sources: SHAPE Brochure 5.2; <http://www.paca-online.org/more.html>; Meyer-Stamer (2004).

4.3 Incentives for private sector-driven projects

Some agencies have adopted a fundamentally different approach. Rather than pursuing an agency-driven strategy they offer cost-sharing grant schemes for enterprises which engage in developmental activities. Enterprises are encouraged to present ideas for own development initiatives which bring enhanced competitiveness and generate clear benefits for the poor. The enterprises are expected to implement the project, contribute a significant (usually more than 50%) share of the project costs and take on the risk of failure. Co-funding is provided if the proposal meets certain criteria. Proposed activities must go beyond the usual business activities of the firm. This aspect of *additionality* is crucial to avoid using taxpayer's money to support activities that the enterprise would have carried out anyhow.

Beyond this co-funding, development agencies are either not involved, or their role is limited to certain complementary services. Thus the private partners are "in the driver's seat" and accountable for the delivery of agreed services. Some of the funded activities are related to value chain development – e.g. support for local farmers and SME suppliers or introduction of fair trade and eco-labelling systems – while others are not – e.g. community development and training activities.

Encouraging private companies to engage in supplier development and technology transfer programmes has a number of advantages. Private lead firms are the ones who buy their suppliers products. They know best what markets require, where potential suppliers need to improve performance, and which candidates are most likely to succeed. If they are committed to supplier development, their suppliers sales are practically secured. Moreover, they are the ones who define entry barriers and set standards. If they encourage new business partners to engage in their supply chain, or if they introduce new standards, it is clear to all partners that these will be the rules of the game. Donor agencies in contrast may not know exactly what a specific supply chain requires, and their recommendations may therefore be less credible. Furthermore, cost-sharing grant schemes do not select specific sectors and value chains. As funds are accessible to all enterprises who present convincing development concepts they are less distorting than selective donor interventions.

However, the funds do not solve the problem of incomplete information. Above all it is not possible to clearly segregate the limits of a companies' business interests from additional altruistic concerns. Public relations and CSR activities often fall somewhere in between both categories. Often companies apply for co-funding of activities which are in their enlightened self-interest but which they would not have tackled in the short term. Donors thus may trigger additional spillovers from private investments, or at least accelerate delivery, but they also

incur the risk of inefficient employment or even deliberate misuse of funds. Consequently this modality of service delivery does not supersede the need to gain a comprehensive knowledge of sector- and value chain-specific processes.

The most prominent programmes are the German Public Private Partnerships programme, with more than 1700 supported projects, USAID's Global Development Alliances (including some multi-million dollar projects with TNCs and charitable private foundations) and DFID's Business Linkage Challenge Fund (see annex 2). Some of the funds (e.g. the Dutch and the Danish funds) are tied to business linkages with companies from the donor's home country, while others support linkages regardless of nationality, i.e. also including linkages among developing country partners. Box 5

Box 5: Examples of pro-poor value chain projects funded by the PPP facility and implemented by GTZ

The export company *Target Agricultures* trains 320 farmers in organic production (dried pineapple & papaya) in Sri Lanka and commits itself to accept their produce for export.

Fair organizer *BioFach* trains and organizes organic food producers and creates a Centre of Excellence in Brazil.

DaimlerChrysler supports smallholder production of natural fibers for auto seats, creates a processing cooperative in the Philippines and supports the development of alternative fibre products.

Fruta del Pacifico trains 600 farmers in ecological banana production and helps to set up a farmers cooperative in Ecuador.

Deichmann introduces social and environmental standards in Indian supply chain for shoe production.

Seda & Fibras establishes silk production in Paraguay, including the forestation of mulberry trees and family-based cocoon production, targeting 2000 families.

Kraft Foods introduces a national quality standard for coffee production in Peru, trains advisers and helps to set up a national certification system.

Cosmetics producer *Wala* introduces organic rose production in Romania, trains 250-300 farmers, commits to fix purchasing prices and helps to build up an organic farmers association and a certification system.

Unilever Bestfoods rehabilitates out-dated state-owned tomato processing plant in Ghana, transfers ownership to farmer families and commits to pre-established prices for tomato products.

A *Flower Importers Association* introduces a flower label program which establishes and certifies social and environmental standards in flower production in Zimbabwe and Kenya.

Source: GTZ

4.4 Synthesis: Combining approaches

It has become clear that each of the above approaches has its strengths and limitations. The 'comprehensive planning approach' may provide the most complete picture of the structure and potentials of a value chain, but it is rather costly and tends to be donor- rather than private sector-driven; the participatory, workshop-centred methodology is appropriate to draw on

stakeholder experiences, it is more flexible and less costly, but provides less systematic information; the alternative of extending incentives for private company-driven projects is the least bureaucratic option as it actively involves private change agents and ‘governors’ of value chains in the identification and implementation of appropriate interventions, but it implies a certain risk of subsidizing private gains rather than public goods, it may restrict the participation of other stakeholders, and it makes independent performance measurement difficult.

Of course, elements of all three approaches may be combined in practice. In many situations it is convenient to apply different elements, i.e. to carry out upfront value chain analysis, use participatory procedures to cross-check information and discuss proper strategies with different stakeholders, and to employ incentives aimed to ensure an active supportive role of key actors in the private sector. Cooperating with individual (lead) firms and other interest groups, (multi-stakeholder alliances), such as business associations, farmer’s and worker’s organizations, and international NGOs is often a promising way to ensure private engagement without distorting markets and privatizing gains.

5 Policies and support programmes to support pro-poor value chains

It has been argued in chapter 1 that value chains are always embedded in a broader context of production systems and affected by a great number of general policies which shape the legal investment conditions, transaction costs, the availability of production factors, etc. These overall conditions strongly influence the behaviour of economic actors, e.g. their make-or-buy decisions, their willingness to source locally or abroad, the decisions of SMEs to sell through anonymous markets or to regular buyers, their ability and willingness to invest and grow or to deliberately stay small, etc. In contrast to general private sector policies, other policies and support programmes are directly related to value chains, e.g. matching programmes to link value chain partners, targeted measures to upgrade suppliers, to mobilize finance specifically for supply chain activities or to foster knowledge flows along the chain, the promotion of chain-specific standards and certification procedures, etc. The following chapter is organized along this distinction between *unspecific* private sector policies and supporting activities with an impact on value chains and *specific* value chain policies and programmes. Chapter 5.1. deals with the first issue, giving a brief overview of **general private sector development policies and support programmes** and their potential impact on the structure and development impact of value chains. Chapter 5.2. then analyzes **specific value chain support activities** in more detail.

However it is important to draw attention to the importance of a coherent policy approach for supporting pro-poor value chains. General and specific policies and support measures interact in a number of ways and tend to have differentiated impacts both on competitiveness and social inclusion. Hence it is crucial to take the interfaces between different interventions into account, e.g. between investment promotion, human capital policies, technology policy, delivery of financial and non-financial business services to SMEs, competition policy, etc.

Comparing two regions with a similar FDI stock in Malaysia, Rasiah has shown that it was not so much the sheer availability of policy instruments but rather their “systemic coordination” that explained their different ability to build value chain linkages and enhance technological spillovers.⁶⁷ Moreover, it is important that policymakers are firmly and explicitly committed to linkage promotion as a policy priority and clearly signal this to both implementing policy agencies and targeted private sector groups.⁶⁸ Highly visible integrated linkage or value chain programmes seem to have more impact than uncoordinated bundles of institutional activities.⁶⁹ Donor agencies may contribute to enhancing this policy integration.

5.1 General policies and support programmes with an impact on the structure and development impact of value chains

Almost any private sector policy and economic programme somehow impacts on value chains, their competitiveness and their influence on the livelihoods of the poor. The following paragraphs highlight some of the effects of general economic policies on value chains.

1. Creating an enabling environment for the private sector. Both developing country governments and donor agencies increasingly acknowledge the influence the business environment has on the dynamism of the private sector and its ability to create employment and income opportunities for the poor.⁷⁰ If, for example, property rights are not guaranteed or contracts cannot be enforced due to deficiencies in the legal system, entrepreneurs will reduce inter-firm transactions as far as possible. If, in contrast, investors are reasonably protected and courts work comparatively well, it is less risky to outsource production. Furthermore, unnecessary bureaucratic procedures and high administrative costs for the registration of small business may exclude the poor from doing business or induce them to stay informal which makes it difficult to take up business linkages with formal sector enterprises. Policy interventions aimed at making the business environment more reliable, more transparent and less bureaucratic may therefore contribute largely to value chain integration.

Value chain analysis can be employed to identify concrete policy constraints that affect competitiveness at the subsector level and assess their relative importance. The methodology developed by FIAS (see chapter 1.3) allows policymakers to disaggregate production costs at different stages of the value-adding process and benchmark them against international competitors. This helps to identify binding constraints and establish priorities for public and private action. The focus on concrete value chains directs the attention to micro-policy issues,

⁶⁷ Rasiah (forthcoming).

⁶⁸ Robbins (forthcoming).

⁶⁹ Examples are the linkages programmes in Singapore and Ireland (Battat/ Frank/ Shen 1996).

⁷⁰ White (2004); World Bank (2005).

such as inadequate subsector regulations or lack of specific skills, which otherwise would “never make it to the radar screen of reformers.”⁷¹

2. Trade and investment policies and export promotion programmes. Trade and investment policies, including trade-related capacity building, export promotion and the like, affect the linkages between domestic and foreign markets. The level of import tariffs and bureaucratic non-tariff trade barriers, the treatment of foreign investors, the quality of export promotion programmes, the competitiveness of ports and airports as well as the road and rail system therefore all strongly impact on the degree of integration in international value chains.

Firstly, trade and investment policies largely determine to what extent developing countries benefit from offshoring. Enterprises in industrialized countries tend to move activities offshore when operating cost differentials are sufficiently great to offset tariff, transport and other transaction costs. Hence it is not only *operating costs* that have an effect on offshoring decisions but the *cost of trading* as well. In order to become competitive, any location interested in attracting international offshoring investment needs to keep both costs low. To put it differently: countries can afford relatively higher wage levels if they have a competitive edge in tariffs and the trading infrastructure.

Secondly, export promotion may facilitate the integration of developing country firms in global supply chains. These include market intelligence, export financing and guarantee schemes for SMEs, subsidies for trade fairs and trade delegations, and many other traditional export promotion activities. Some interventions are explicitly designed to promote subcontractors, e.g. indirect exporter financing schemes, whereas others aim at helping firms to upgrade into higher-value activities, e.g. grants for financing the promotion of brands overseas.

Thirdly, trade and investment policies also affect the competitiveness of local enterprises and value chains vis-à-vis imports and market-seeking foreign investment. In recent years, cheap imports especially of light manufactures such as garments and shoes have ruined local industries in many developing countries around the world. Likewise, the global expansion of large retail chains is expected to impact severely on local value chains. Although protectionist trade policies tend to hold back innovations and productivity growth, there is a strong case for careful timing and sequencing of liberalization. Especially in very disadvantaged least developed countries safeguards may be required to protect economic activities which are highly important for the livelihood of the poor.

3. Tax policy. In most developing countries only large corporations pay taxes whereas a huge proportion of the small and micro-enterprises evades taxation. Firms that are not registered with the revenue authorities however usually do not qualify for regular supply chain relations. Broadening the tax base while keeping taxes for micro and small firms low is therefore an important step to legalize informal firms and make them eligible as supply chain partners.

⁷¹ Palmade (2005), p. 6.

Moreover, tax systems are often based on sales taxes which are levied on the basis of total turnover rather than value-added taxes because administration of the former is easier. Sales taxes however act as a disadvantage to inter-firm specialization because they do not allow for deduction of taxes which already been paid at the previous stage of the value chain. Value-added taxes are thus more conducive to inter-firm specialization.

4. Policies and programmes for skills development and innovation. The most important constraint for vertical business linkages, especially with large-scale processors, wholesalers and exporters, is the generally low capacity of local SMEs to produce at a competitive cost, supply reliably and comply with standards. Strengthening the supply capacity of local SMEs is therefore probably in most cases the key challenge for value chain initiatives in developing countries. This requires the development of skills in different fields, ranging from technical skills in production processes to management competences. In the first place certain skill levels are required to overcome the basic entry barriers of value chains. In addition continuous advancement of skills is essential to upgrade in the value chain and capture economic rents. Beyond a certain stage of technological sophistication upgrading furthermore requires innovation capabilities. In addition to its own publicly financed skills development and innovation programmes governments may create tax incentives for firms to invest more in skills development and innovation.

5. Financial and non-financial business services. Difficult access to finance is another major growth constraints for SMEs in developing countries. Integration in modern value chains often requires substantial investments to acquire new production technologies and logistics systems, to increase economies of scale, to invest in human capital, or to certify newly required standards. The cost and availability of capital to small enterprises is therefore a decisive determinant of linkage formation. In addition to finance, the modernization of SMEs entails incorporation of external know-how and thus the availability of providers of non-financial business with specialized competencies in different fields. Activities aimed at strengthening such service supply thus help to make SMEs partnership-ready and thereby indirectly impact on value chains.

6. Support of local economic development. Local economic development and cluster initiatives are among the most popular government and donor activities in the field of private sector development. The main purpose is to increase the competitiveness and inclusiveness of enterprise networks in a given locality. Most initiatives place their emphasis on *horizontal linkages* and collective action among firms of the same stage of production and within the same territory. While vertical linkages (within the region and beyond) are usually addressed, they are not the main concern. By enhancing the competitiveness of local business networks, however, cluster initiatives make them more attractive for extra-regional business partners. At the same time policymakers need to recognize potential conflicts of interests between local communities and lead firms in value chains (see chapter 3).

7. Marketing. End-market demand is generally exogenous but can sometimes be influenced through branding and product differentiation. Governments and donors may help to introduce

brands or quality labels (“certified organic product”, “free of child labour”, “fair trade”) that add value to the product of targeted enterprises and industries. Thereby they improve the capacity of firms or industries to differentiate themselves from competitors and to develop a profile which increases the willingness of consumers to pay a higher price. For example, USAID’s competitiveness project in Sri Lanka helped the gem industry establish a niche market for the “Ceylon sapphire.”⁷²

5.2 Specific supporting activities for pro-poor value chains

Specific activities for pro-poor value chains include all those interventions that intervene directly at one or more stages of the value chain and affect the modes of interaction (governance structures) within the respective value chains. The following subchapter classifies and portrays some of the most common government and donor interventions in this field.

5.2.1 Awareness raising and matching

Lack of market transparency hampers the formation of business linkages. This applies in particular to SMEs who are often not familiar with the requirements of regular supplier relationships and may not have a good overview of potential buyers. But also large firms, especially foreign investors, are sometimes not aware of potential local supplies. As a result they may fall back on imported inputs even if a similar domestic product is available. Three instruments can promote matching between potential customers and suppliers:

1. *Information and motivation events for suppliers* aim at providing SMEs with information on advantages and potentials of subcontracting for their respective firm and on possible government promotion schemes. In addition to such events SMEs may sometimes visit potential customers that present their supplier strategies. The SMEs thus get an insight in the advantages and disadvantages of subcontracting. At the same time such events stimulate first contacts between customers and suppliers and lower communication barriers.
2. *Subcontracting exchange schemes* (SES) offer lists of potential suppliers to interested customers. To this end, the staff of the exchange office visit potential suppliers and evaluate their products and processes so as to give valid information to customers. Some SES aim at an integrated promotion scheme including service provision for SMEs, facilitation of joint bids, and incentives for customers to engage in knowledge transfer.

⁷² Downing et al. (forthcoming).

3. *Supplier fairs and exhibitions*, i.e. reverse fairs, give customers the opportunity to exhibit products they would like to source locally.

All these instruments help to make markets more transparent and set up first contacts between customers and suppliers. Empirical evidence however shows that matching events are usually not sufficient to build lasting linkages. As a rule, potential SME suppliers in developing countries have too many internal problems to be able to guarantee regular supply at favourable costs at once. Nevertheless matchmaking may be a good starting point for integrated supplier development programmes. For example, the participation of potential customers in matching events provides an opportunities to disclose weaknesses of suppliers which may the be addressed by providing specific support. Such integrated approaches have proven to be most successful if lead firms actively engage in support for selected future suppliers.⁷³

5.2.2 Supporting spillovers from lead firms

Lead firms contribute to local enterprise development in many ways, both deliberately and unintentionally. These may include the facilitation of markets access, coaching and mentoring, funding of supplier development projects, the introduction of standards or brands which enhance the competitiveness of its supply chain as a whole, or the creation of new enterprises by former employees.⁷⁴ Donors may encourage lead firms to extend such support either towards their established partners or to other local SMEs. The following donor activities seem to be especially appropriate:

1. Several donor agencies have set up co-financed grant schemes for private sector-led initiatives (see annex 2). Such schemes support spillover activities (e.g. extended training programmes for suppliers and capacity building for government officials) which are mainly implemented and at least partly paid for by private companies (in most cases value chain leaders). In order to qualify for public co-funding their impact must go beyond what is considered to be in the private partner's own interest. Co-financed initiatives with private sector lead firms have a number of advantages: Lead firms have established market access; their internal production efficiency in implementing supplier development initiatives is usually higher than that of public agencies; their involvement leverages additional capital for development initiatives; complementarities between public and private actors may create productivity gains; and, last but not least, such cooperation may contribute to mutual appreciation and learning with regard to value chain development. However, some risks are involved in such alliances, especially if objectives and cost-sharing agreements are not well defined, and

⁷³ See Ruíz Durán (forthcoming) for Mexican matchmaking initiatives.

⁷⁴ UNCTAD (2004) provides a comprehensive list of potential spillovers from Transnational Corporations.

if companies employ public resources for their private objectives rather than the agreed public good.⁷⁵

2. Tax and financial incentives may be offered to induce TNCs to source locally and upgrade their suppliers or to make subcontracting more attractive to local suppliers. Some countries use exemptions from corporate income or value-added taxes to encourage investors to develop local linkages or enhance technology transfer. In some countries, expenditure incurred in the training of employees, product development and testing, and factory auditing to ensure the quality of vendors' products, are allowed as a deduction in the computation of income tax. Donors and international organizations may help to benchmark such policies, identify the most beneficial tax and financial incentive schemes for value chain development and assist in their implementation.
3. The Corporate Social Responsibility movement among TNCs may be an especially promising gateway for encouraging spillovers from lead firms. In South Africa, for example, the government recommended that all industry sectors should adopt an "Empowerment Charter" and announced that it might link this to certain political benefits. In the past few years many large corporations seek to negotiate such "Charters" and make time-bound commitments to address issues including the shareholding of local operations, local participation in management and technical staff, and relationships with suppliers and distributors. For example, as a result of the charter-related processes, companies such as Microsoft are seeking to increase the number of black-owned and managed service providers and retailers of its products.⁷⁶ Likewise, DaimlerChrysler set up a programme to support black-owned supplier industries. Donor programmes may campaign for such CSR supply chain initiatives, organize stakeholder support and encourage TNCs to extend such initiatives beyond their first level suppliers.

5.2.3 Access to value chain finance

Difficulties to access credit are among the most important constraints for SME development. Value chain integration may facilitate access to credit through two mechanisms:⁷⁷

1. Directly, by receiving credit from business partners in the value chain, such as buyers or input providers. Direct credit occurs especially often in agriculture, where seed and fertilizer companies advance inputs (thus supplying credit in-kind) or traders or agro-processors provide loans and often take payment in the form of produce. Credit supply by buyers is especially frequent in outgrower schemes, where relationships between

⁷⁵ See Altenburg (2005) for a detailed discussion.

⁷⁶ Robbins (forthcoming).

⁷⁷ USAID (2005), p. 2.

farmers and buyers are captive and loans can be tied to purchase agreements. . In manufacturing, machinery producers often supply credit (or leasing arrangements) for the acquisition of their products.

2. Indirectly, by making the firm creditworthy to financial institutions, e.g. because secure sales channels are accepted as collateral.

Public programmes can help to improve both direct and indirect value chain finance. Support agencies may, for instance, provide soft credit lines and credit guarantees to development banks in order to stimulate linkages. The Small Industry Development Bank of India (SIDBI) has established several SME funds and credit guarantee schemes especially targeted to support technological upgrading of SMEs in promising growth sectors and to enable them to acquire the status of preferred partners of transnational corporations. The South African Department of Trade and Industry has rolled out a cash grant programme for black owned or managed SMEs which covers 80 % of the cost involved in business development services that are deemed necessary for meeting the requirements of becoming an approved industry supplier.⁷⁸ Donor agencies may also promote outgrower schemes as a form of improved value chain coordination, thereby facilitating direct credit supply from buyers (direct value chain finance).⁷⁹

Moreover, they may contribute to developing financial products which support value chain integration (indirect value chain finance). The following kinds of financial products seem especially suitable to improve access of suppliers to bank loans:

1. Factoring. Serious problems arise for many suppliers if their customers pay large orders weeks or even months after delivery. This is customary where buyers have sufficient market power. For the suppliers it often creates severe liquidity problems and may force them to solicit costly short-term credits. To alleviate this problem, financial institutions in some countries offer factoring schemes whereby the buyer upon receipt of the merchandise issues a document which the bank accepts as collateral and disburses the respective amount of money, thus helping SMEs to bridge the time between delivery and debt settlement. The bank then claims the credit back from the buyer.
2. Warehouse receipts. Such receipts are issued to depositors of commodities by secure warehouses. Banks accept the deposited inventory for collateral. This instrument is especially suitable in the case of commodities with clearly specified standards and grades and transparent markets.⁸⁰

⁷⁸ Robbins (forthcoming), p. 31.

⁷⁹ See Stamm et al. (2006) for the promotion of outgrower schemes in Sri Lanka.

⁸⁰ See Fries/ Akin (2004) for a detailed discussion of value chain finance, especially trader credit, outgrower schemes and warehouse receipts.

Supporting this kind of financial products to the benefit of suppliers may be complemented with legal provisions to avoid abusive behaviour by powerful buyers. India for example has legislated an “Interest on Delayed Payments to Small Scale and Ancillary Industrial Undertakings Act” to ensure that large companies make prompt payments to their small suppliers. The practical usefulness of this legislation however is doubtful as small firms are often reluctant to pursue cases against major buyers fearing strained relationships with the latter.⁸¹

5.2.4 Promotion of inclusive standards

In recent years a great number of standards have been created and implemented at a worldwide scale.⁸² Many of them are being enforced throughout the whole value chain and consequently affect the welfare of producers and consumers in developing countries in different ways. Standards are documented agreements containing technical specifications to ensure that materials, products, processes and services are fit for their purpose. They address a range of issues including quality management procedures and product properties as well as social, environmental, health and safety concerns.

Whereas in the past most standards were set by government agencies or intergovernmental bodies, there is now a marked trend towards much more differentiated private standards developed and enforced by industry organizations, individual lead firms, and NGOs. Standards are more and more often enforced through value chain relations given that the final producer or distributor of the respective product is held accountable for compliance and thus takes a strong interest in assuring compliance at previous stages of the value-adding process.

Standards are used for different purposes. These range from assurance of trade and government requirements (e.g. with regard to safety and health) to altruistic motives (e.g. protecting poor people or vulnerable ecosystems) and commercial interests of companies to develop and protect specific high-value labels. This variety of voluntary and compulsory standards and underlying purposes is reflected in the diversity of government and donor programmes to cope with standards. Activities include

- promoting standards and labels as a means of adding value. Labels that certify fair trade conditions, organic production or regional provenance may increase the consumer’s willingness to pay higher prices. As barriers to entry to such labels are relatively modest, donors see such labels as one of the most promising strategies for pro-poor value chain development. This includes support for producers, sensitization of consumers, and capacity building for national certification systems. Increasingly donor cooperate closely with firms which provide market access or develop private labels;

⁸¹ Narain (2005), pp. 47, 53. Similar attempts to limit payment delays through legislation, e.g. by the Korean and French governments, encountered the same problem.

⁸² Nadvi/ Wältring (2003); FAO (2003); Burger/ Mayer (2003).

- information and sensitization of target groups and support for poor producers with regard to compliance;
- participation in the standard-setting process in order to make developmental concerns heard. Donors may assist in setting up inclusive low-cost certification systems and promote group certification.

Governments and donors need to be aware that promotion of standards may have undesired side-effects. Especially, very demanding standards, which may be desirable from the consumer's perspective, may create an unbearable burden for poor producers and exclude them from the market. Donors should therefore be careful in supporting initiatives that raise standards, especially if these are mandatory. Likewise it is problematic to include standard compliance in the conditionality of development agencies. Although mandatory standards may be justified in certain cases of universally agreed basic principles (such as restrictions on child labour), enforcement should always be handled carefully.

Most donor agencies are dealing with standards issues. The topic ranks especially high on the agenda of the ILO (labour standards) and the FAO (Good Agricultural Practices). Furthermore, the promotion of certified organic farming through capacity building, marketing support and assistance in the development of accredited certification procedures is a primary concern of many donor agencies. In German development cooperation alone, several hundred public-private partnership projects and some of the most prominent value chain projects in technical cooperation deal with organic standards. Also, initiatives to improve labour standards in global value chains (especially in light industries such as garment, footwear, and toys) play an increasing role across all donor agencies.

5.2.5 Franchise development⁸³

Distributional and after-sales services are among the activities most frequently transferred to independent companies, e.g. automobile dealers, gas stations, restaurant chains, travel agencies, drug stores, and courier services. Outsourcing these activities implies considerable advantages for the brand-name company, mainly that it may rapidly cover extensive markets while minimizing risks and investment in distribution channels. On the other hand, brand owners are obviously keen to maintain high and homogeneous standards in their downstream activities. Brand owners therefore often opt for outsourcing plus providing comprehensive training for their distributors. The local distributor thus benefits from the use of an established brand name, a proven business concept and the transfer of knowledge from the brand owner. This greatly reduces the risk of failure for the local SME. The main disadvantages of such linkages consist in the fact that the local marketing partner remains highly dependent on the brand owner. In some cases, furthermore, the local SME is forced to pay substantial fees and royalties for using the partner's brand name and business concept.

⁸³ See Altenburg (2000) and Henriques and Nelson (1997) for a more detailed discussion.

In most cases franchises develop at the initiative of the entrepreneurs and do not require government action or even donor interventions. In some countries, private-sector franchise associations exist which provide services to the national franchising community. Nonetheless, some countries and international organizations have adopted programs to encourage franchising as an instrument for developing business linkages. The government of Singapore, for instance, has formed a Franchise Development Centre and a Franchise Development Assistance Scheme. Malaysia's Ministry of Entrepreneur Development has created a Franchise/ Vendor Division. In other countries multilateral (e.g. the ILO in Indonesia) and bilateral (e.g. USAID in South Africa and Russia) donors support the development of indigenous franchise systems. Measures to support franchising include organizing events for building awareness of the potential benefits of franchising; reviewing the existing legal requirements regulating the franchising business; facilitating contacts between international franchisers and potential local franchisees; encouraging and supporting the establishment of national franchising associations; providing consultancy and training for potential franchisees during the initial phases of establishment of contacts, negotiation of contracts and setup of the new enterprise; helping to develop indigenous "SME-to-SME" franchises; and providing finance.

Impact assessment

Impact assessment is important to ensure that objectives are met and to enable donor agencies to learn and to improve their programs continuously. This requires, in the first place, clearly defined objectives and corresponding performance indicators. Many value chain initiatives seem to pursue relatively broadly defined objectives ("increase competitiveness", "upgrading of SMEs") which need to be further operationalised.

As stated previously, value chain initiatives influence complex socio-economic systems. This makes impact assessment very difficult. Three main challenges need to be addressed:⁸⁴

1. The problem of trade-offs and unintended side-effects. As shown in chapter 2.4, interventions in value chains may have manifold and highly differentiated effects on wages, job quality, competitiveness, distributional and environmental issues, etc. What's more, these effects are closely interlinked, i.e. improvements in one field may cause deterioration in another one.
2. The attribution gap and the problem of counterfactual. Especially in multi-actor socio-economic systems with complex power relations it is difficult to analytically isolate the impact of single interventions. Moreover, as all value chains are unique, and many of them undergo rapid structural changes, trying to appraise how the value chain would have evolved without interventions is a futile undertaking.

⁸⁴ Partly based on White (2004), pp. 48ff.

3. Timeframes matter. For example, it may be an ephemeral success to have increased the number of persons employed and/or raised their wages if this undermines competitiveness and eventually leads to stagnation or even bankruptcy of a whole chain or sub-sector. Programme evaluations would therefore need to weigh up (measurable) short-term effects and (hardly predictable and attributable) long-term impacts. As White states, “long timeframes enhance the problem of attribution, described above, as other contributors to changes in the business environment have time to take effect.”⁸⁵

Although several donor documents on value chains address the issue of monitoring and impact assessment, they do so in a rather general and normative way. None of the existing manuals and guidebooks systematically addresses the above problems and provides a satisfactory approach for dealing with them. USAID however has commissioned an ambitious research project to develop methodologies for measuring the impact of its private sector development programmes on economic growth and poverty. The project is expected to deliver a conceptual framework to understand causalities and translate this into a practical methodology for programme evaluations.

Specific problems arise with regard to monitoring and evaluations of co-financed grant schemes to support business-led activities. In the previous chapters it has been argued that the success of linkage programme crucially depends on the engagement and ownership of lead firms. Co-financed linkage funds put this consequently into action, leaving implementation of agreed measures to the corporate partners. For good reasons, however, companies are sometimes reluctant to accept rigorous external reviews: firstly, a major share of the resources employed are voluntary corporate contributions. Companies usually see these contributions as a means to improve their corporate image. Consequently it is rather unlikely to mobilize such contributions if independent evaluations are compulsory and companies exposed to potentially critical public reports; secondly, they cannot be expected to disclose certain strategic business information e.g. regarding future investments. Still, companies and donor agencies must be held accountable for the use of public development funds. None of the existing co-funding schemes has yet been able to resolve this problem in a satisfactory manner.

6 Critical trade-offs and unresolved issues

This last part identifies and discusses relevant problems and trade-offs with regard to value chain development and identifies areas for future discussion among the members of the Donor Committee.

1. The structure of value chains and their poverty-alleviating effects depend on a broad range of factors and can be influenced through a diversity of policies and support pro-

⁸⁵ *ibid.*

grammes. It is therefore not easy to draw up the boundaries and define a clear subset of “value chain policies”. The Working Group on Linkages and Value Chains will therefore need to define its scope of action as well as its way for dealing with the general policies which impact on chain building.

2. During the last years donor programmes for private sector development have shifted from directly targeted selective interventions towards more generic interventions aimed at improving the investment climate and the development of markets for business development services. In contrast, most donor approaches for supporting value chains are strongly selective with regard to sectors and target groups, often have a relatively micro-level focus on individual value chains and producer groups of limited size, and require a strong market interference by facilitators. To what extent is this consistent with previous work by the Donor Committee that emphasized non-selective policies for improving the business environment and market-led solutions? Where is the borderline between public goods which justify donor (or host country government) intervention and private goods? To what extent should donors get engaged in “engineering” value chains? Or should they rather limit their role to improving the overall policy environment and strengthening providers of specific value chain services (e.g. value chain mapping; risk management; matching grants)?
3. Value chains are interdependent social systems with complex coordination mechanisms and often strongly asymmetric power relations. Interventions in such systems tend to have very differentiated and partly unintended impacts. This has led agencies to adopt ever more comprehensive mapping and planning procedures involving substantial overhead costs. What can be done to simplify analyses and strategy formulation without risking to adopt inappropriate interventions? How can impacts – including unintended effects – be measured?
4. Value chain analysis is helpful to depict basic actor constellations and resource flows. The most relevant value chain parameters however – such as entry barriers, technological upgrading, or distribution of rents – are difficult to operationalise (especially as markets continuously change) and data are not readily available. The challenge remains to develop proxies and analytical tools to assess these categories.
5. The study distinguishes three stylized types of interventions. What is the best approach under which circumstances? It has been argued that government and agency-driven approaches may have limited impact if they fail to assign an active role to value chain leaders, whereas co-financed grant schemes are a proven tool to achieve this but involve certain risks and tend to impact on the firm and its respective value chain only rather than on sector-wide institutions and policy reforms. This raises the question of how co-financed grant schemes and technical cooperation may be combined in order to exploit the advantages of both approaches.
6. In an increasingly globalised world producers face increasingly harsh international competition from low-cost countries like China. Many scholars argue that “those who call for an end to what they call a ‘race to the bottom’ are simply holding out false

hope to those who cannot compete and providing excuses for those who put off the tough decisions necessary to survive in today's economy."⁸⁶ In response to this situation many lead firms exert pressure for cost reduction within their supply chains and squeeze the margins of their suppliers. This may be inevitable to sustain or improve the competitive position of the whole supply chain, but it may imply crowding out of inefficient producers, laying off workers, concentration of incomes, etc. How should donor agencies deal with such trade-offs? Analytically, how can the long term effects be assessed?

7. Likewise there is a trade-off between the objectives of increasing standards (decent work, SA 8000, environmental and food safety standards) and involving poor producers. Higher standards inevitably imply compliance costs which raise entry barriers and penalize small-scale production. Moreover they may render the whole supply chain less competitive as long as other providers manage to avoid compliance. Hence donors need to weigh up short-term and long-term objectives as well as differing interests of consumers, small producers, employed workers and labour-seeking persons in the informal sector, etc. What is the right balance?
8. Value chain analysis and related donor programmes are biased towards global value chains and export-oriented enterprises in developing countries. Many studies address the related entry barriers, but few explore the remaining alternatives for those who fail to meet the necessary minimum standards. Is the frequent presumption correct that those who fail to comply with the standards of global value chains are bound to be marginalized? To what extent can we expect that other (e.g. local, regional, rural) markets continue to absorb the same or similar products, where presumably lower prices are offset by the absence of compliance challenges and costs?⁸⁷ Should governments and donors redirect their support towards those alternative channels, and what would be the appropriate instruments?

Value chain analysis is a powerful tool for understanding the determinants of competitiveness, and significant progress has recently been made in disaggregating some of its key concepts. However, many policy implications still remain unclear. The present report hopefully helps to structure the future debate in the Donor Committee for Enterprise Development and to advance the search for the most appropriate policies to support competitive and socially inclusive value chains in developing countries.

⁸⁶ Enright (2005). This is being questioned especially by the ILO which argues that higher standards ultimately help to embark on a "high road to competitiveness."

⁸⁷ See Jaffee/ Henson (2005), p. 99.

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Annex 1: List of agencies and persons consulted

Agency	Person consulted	Mode
ACDI/ CIDA	Christine Johnson	Email
GTZ	Helmut Albert* Sabine Becker Rainer Engels Annemarie Matthess Andreas Springer-Heinze	Personal interview Personal interview Personal interview Telephone interview Personal interview
IFAD	Edward Heinemann Henning Pedersen Jens Sorensen	Personal interview Personal interview Personal interview
ILO	Nicolai Rogovsky Matthias Herr	Personal interview Personal interview
ITC	Ian Sayers	Personal interview
FAO	Doyle Baker Wilfried Baudoin Lorenzo Giovanni Bellú Louis Bockel Carlos Arthur da Silva David Hallam Alison Hodder Ron Kopicki Eric Kueneman Prabhu Pingali Andrew Speedy Florence Tartanac Grímur Valdimarsson Gavin Wall	Personal interview Personal interview
SDC	Andreas Gerrets	Email
UNCTAD	Fulvia Farinelli Jaques Ferrière Christiane Stepanek-Allan Mike Pfister	Personal interview Personal interview Personal interview Personal interview
UNIDO	Kai Bethke* Michele Clara Zeynep Taluy* Gabriele Ott*	Personal interview Personal interview Personal interview Personal interview
USAID	Barbara Addy* Jeanne Downing Douglas Ostrov	Personal interview Email Email
Others		
Mesopartners	Jörg Meyer-Stamer	Personal interview
SBP South Africa	Corin Mitchell	Personal interview
IDS	Hubert Schmitz John Humphrey*	Personal interview Personal interview
GDI	Andreas Stamm	Personal interview

* Recent interview before this study was commissioned.

Annex 2: An overview of leading multilateral and bilateral donor initiatives for public-private partnerships

The following overview has been compiled on the basis of website information and other official documents, in some cases complemented by interview data and other sources. The brief descriptions have not been endorsed by the organizations named.

UNDP: Growing Sustainable Business (GSB)

The objective of the Growing Sustainable Business initiative (GSB) is to facilitate business-led enterprise solutions to poverty in advancement of the Millennium Development Goals. This includes in particular promoting employment creation, business linkages, local economic development, growth of SMEs, and improvements of the enabling environment for private investments.

Investments should not only be pro-poor in design and meet the demand of local populations, they should also be commercially viable. The GSB facilitates “enterprise solutions” under which profit and incentives justify real investment and where financial sustainability is embedded in the design. GSB investments should be related to the reported and audited measures of a company’s business activities. Emphasis placed on developing new business models for the poor.

Participating companies are expected to develop investments on the basis of consultation and partnership with civil society, governments, and other development actors. The initiative leverages UNDP’s unique capacity to create a neutral “space” at country level where information can be shared, issues raised, and appropriate local partners brought together to solve a specific problem. The GSB is a very recent initiative, at present it is active in Ethiopia, Madagascar, and Tanzania, and it is under consideration in some additional countries.

<http://www.undp.org/business/gsb/about.htm>

UNIDO’s Business Partnership Programme

In UNIDO’s client countries, transnational corporations (TNCs) often actively support SMEs through their global vendor and supplier development programs. UNIDO and the international business community can use partnerships to exploit the synergies between their respective activities, with positive development impacts. As potential partners, UNIDO targets TNCs that basically share the organization’s inclusive approach to development: a willingness to integrate economic, social, and environmental dimensions in their business strategies and to cooperate with other players in the development process.

UNIDO has developed the Business Partnership Programme to serve as a model for economically viable and sustainable technical assistance that focuses on the quality, efficiency, and international competitiveness of SMEs. Within the industry targeted, the approach seeks to achieve: technological and managerial learning effects, improved domestic resource use in production, increased productive employment and incomes.

A project under the program will address problems of SMEs in specific industries in an integrated way, emphasizing the more advanced SMEs. In value chains, the focus will be on second- and third-tier suppliers - fourth-tier suppliers are likely to need a different type of support, such as small business credit schemes or advisory services, and first-tier suppliers will be strong enough not to need international assistance. Wherever economically and technically feasible, SMEs should avoid being locked into a captive relationship with a single TNC. In UNIDO’s partnership projects, SMEs with more than one large business partner are normally chosen.

<http://www.unido.org>

Germany: Federal Ministry for Economic Cooperation and Development (BMZ) – Public Private Partnership (PPP) facility

In 1999 Germany's Ministry for Economic Cooperation and Development (BMZ) established a "PPP facility" to support private sector initiatives with positive expected development impact. BMZ assigned three implementing agencies (GTZ, DEG and SEQUA) the task of implementing the program. To date, about 1.700 PPP projects have been implemented in 70 countries, covering almost all areas of development cooperation; e.g. they support health-related investments, promote social and environmental standards in supply chains, clean technologies, training and capacity building, export promotion for smallholders and SMEs.

All German PPP projects need to be in line with the aims of German development policy. Support from the public partner will only be provided if the private partner(s) can not be expected to carry out the project with his/their own resources, i.e. when public goods are provided. Cost-sharing arrangements vary, depending on the expected development impact and the extent to which improvements may be appropriated by the participating firms. However, the private partners are expected to contribute at least 50% of the project cost, and projects are expected to be commercially viable. As a rule, BMZ contributions should not exceed 200.000 euros per project.

<http://www.bmz.de/themen/Handlungsfelder/ppp/>

USA: USAID's Global Development Alliance (GDA)

The Global Development Alliance (GDA) is USAID's commitment to changing the way USAID implements its assistance mandate. GDA mobilizes the ideas, efforts, and resources of governments, businesses, and civil society by forging public-private alliances to stimulate economic growth, develop businesses and workforces, address health and environmental issues, and expand access to education and technology. It extends USAID's reach and effectiveness in meeting development objectives by combining its strengths with the resources and capabilities of other prominent actors.

Alliances mobilize significant USAID and partner resources to arrive at solutions only available through pooled efforts. The resources united are as diverse as the alliances themselves and include technology and intellectual property rights, market creation, best practices, policy influence, in-country networks, and expertise in development programs ranging from international trade to biodiversity protection. Together, the combination of complementary assets has encouraged innovative approaches, more effective problem solving, and deeper impact. Importantly, public-private sector dialogue almost always leads to a better understanding of the challenge.

In the first two years GDA supported 224 partnerships with a total of 500 million US\$. In contrast to all other programs, charity and other non-profit organizations play an important role in funding the projects, and projects need not necessarily be commercially viable. Most activities take place in Africa.

http://www.usaid.gov/our_work/global_partnerships/gda/index.html

United Kingdom: DFID's Business Linkages Challenge Fund (BLCF)

The BLCF started in 2001 as a cost-sharing grant scheme, i.e. it gives grants to enterprises to achieve DFID's objective of developing commercially sustainable business linkages that bring benefits to the poor. It is a way of working in partnership with the private sector towards the goal of poverty eradication. The Fund encourages and supports the formation of business linkages by enterprises in developing countries with each other and/or with international partners.

The linkages must lead to enhanced competitiveness and generate clear benefits for the poor. The linkages involve an investment of resources by all members of the linkage – skills, technology, information, facilities, supplies, and access to markets. The linkages, in turn, bring benefits to all members and to poor people. Bidding is competitive and grants are allocated according to the degree to which bids meet BLCF criteria and objectives.

Funding comes from the UK government's Department for International Development (DFID). The BLCF offers grants of between £50,000 and £1,000,000 (larger grants may be considered in some cases if they are expected to make a special contribution to achieving the BLCF's objectives). The Fund operates in 20 countries, with a focus on Africa and the Caribbean. At least one partner must come from one of the 20 countries (which include Britain), but participation of British enterprises is not compulsory. The Fund is administered by a consultancy company (Deloitte & Touche).

<http://www.challengefunds.org/whatisblcf.htm>

The Netherlands: Dutch Ministry of Economic Affairs, Agency for International Business and Cooperation (EVD) – Programme for Co-operation with Emerging Markets (PSOM)

The Netherlands Minister for Development Co-operation has identified the private sector as the engine of economic growth and job creation. The Ministry has therefore initiated the Programme for Co-operation with Emerging Markets (PSOM) in order to share some of the initial financial risks that companies face when investing in new products and/or technologies in emerging markets in developing countries. The dual purpose of the PSOM is a) to promote lasting investment and/or trade relationships between Dutch and local companies and b) to contribute to the alleviation of poverty in the developing countries through transfer of knowledge and technology, as well as strengthening and diversifying the local private sector.

PSOM co-finances pilot projects, which are to catalyse long term investments and/or a lasting trade relation between the parties. PSOM funds are made available to consortia of Dutch companies and companies of the host country interested to undertake such an investment and trade project. The Dutch partner should be the leading partner and will be the main contractor. A typical PSOM-project involves a mix of technical assistance, hardware supply and installation, marketing, demonstration and training. PSOM projects usually try out – on a pilot scale- a new line of production or production technology to see whether it is commercially feasible in the country concerned and whether (export) quality standards can be attained. Investors are expected to observe a high standard of corporate social responsibility. PSOM aims at some 60 investments per year in 16 countries.

Projects creating substantial local employment, transferring knowledge, making extensive use of local SMEs in the supply chain, operating in geographically disadvantaged regions, generating income for a substantial group of beneficiaries and/or contributing in other ways substantially to poverty alleviation will receive priority in the selection process.

http://www.evd.nl/start.asp?pagina=/Internationalprogrammes/ProgrammaInt_psm.asp?land=psm

Denmark: Ministry of Foreign Affairs of Denmark, DANIDA's Private Sector Development Programme

Danida's Private Sector Development Programme (PSD) aims at developing the private sector in a range of program countries by supporting the establishment of long-term and mutually committing partnerships between Danish companies and companies in developing countries. A business cooperation might well prove to be a shortcut to attracting Danish technology and investment. By using busi-

ness linkages as an instrument for economic growth, the PSD Programme seeks to improve living conditions for the people in the countries selected.

The PSD Programme makes it easier to create long-term business linkages between companies in Denmark and companies in the program countries. The PSD Programme makes funds available to support a number of elements within the activities involved in the cooperation. The business-to-business cooperation must be commercially based, and the joint partners are expected to assume all of the risks involved. The PSD Programme acts solely as a facilitator and does not function as the implementer of individual cooperation projects. To qualify for support, a partnership must have a long-term perspective and comply with Danida's development objectives. The PSD Programme is open to all sectors of business and industry, as long as it is fair to assume that the proposed business cooperation will have a genuine development impact.

<http://www.um.dk/en/menu/DevelopmentPolicy/BusinessCooperation/PrivateSectorDevelopmentProgrammes/>

Source: Altenburg, Tilman, The private sector and development agencies: How to form successful alliances. Critical issues and lessons learned from leading donor programs. Paper presented at the 10th International Business Forum 2005, 13 September 2005, New York