



COMPONENT A: RESEARCH ON CLIENTS AND MARKETS AMAP BDS KNOWLEDGE AND PRACTICE TASK ORDER RESEARCH HYPOTHESES – JULY 2006

The Clients and Markets research seeks to promote economic growth with poverty reduction by increasing opportunities for beneficial participation of MSEs in value chains. These hypotheses are designed to improve our understanding of how firm owners respond to the interaction of governance, risk, profits, information, transaction costs, and social capital. The hypotheses—which focus on vertical relationships, horizontal relationships, and upgrading—provide a framework for the Clients and Markets research agenda and are continually refined through field and desk studies.

The purpose of testing these hypotheses is to generate information for improving the effectiveness of interventions. The first three hypotheses focus on leverage points for enhancing vertical cooperation and coordination in order to create win-win relationships between MSEs and lead firms. The next three focus on factors affecting horizontal cooperation and coordination in order to improve the effectiveness of MSE groups. The last three focus on understanding the incentives and constraints to MSE upgrading, in order to intervene in ways that encourage MSE owners to upgrade their businesses and enhance their contributions to value chain productivity and competitiveness.

VERTICAL RELATIONSHIPS

1. *Risk in vertical relationships can be reduced by strengthening governance.*

The risk to each firm that the counterpart firm in a vertical relationship will fail to meet its agreements (i.e., the risk of commitment failure) can be reduced by strengthening governance through alternative means, including

- a. the development of linking social capital,
- b. the development of stronger network types of governance,
- c. increasing the formality of contracts, and
- d. strengthening the legal enforcement of contracts.

2. *Trust in vertical relationships can be increased by improving information.*

Trust between firms in vertical relationships can be increased by improving the information that firms have about each other in several ways, including

- a. building information over time about the trustworthiness of counterpart firms through a series of increasingly larger “riskable steps”,

- b. increasing the face-to-face interaction between representatives of counterpart firms,
- c. increasing transparency about distribution of rents in the value chain, and
- d. increasing transparency about risks faced by firms in the value chain.

3. *Lead firms will be more willing to form vertical relationships with MSEs if the transaction costs can be reduced.*

Transaction costs are a major constraint to lead firms forming vertical relationships with MSEs, but the transaction costs that lead firms incur in working with large numbers of dispersed MSEs (i.e., the costs of communication, knowledge sharing, contract management, production coordination, etc.) can be reduced through the use of

- a. commercial intermediation (i.e., private intermediaries),
- b. organizational arrangements to coordinate MSE activities, and
- c. cost-effective information and communication technology (ICT).

HORIZONTAL RELATIONSHIPS

4. *MSE owners will be more willing to form horizontal relationships if the transaction costs can be reduced.*

Transaction costs, especially the opportunity cost of time, are a major constraint to MSE owners forming horizontal relationships. There are several ways that these transaction costs can be reduced, including the use of

- a. alternative organizational structures,
- b. cost-effective information and communication technology (ICT), and
- c. measures to improve trust (see hypothesis 5 below).

5. *Trust in horizontal relationships can be increased through organizational innovation and improvements in human capital.*

Lack of trust can be a rational but critical barrier to the formation of horizontal relationships between MSEs. Trust in horizontal relationships can be improved by reducing the scope for opportunistic and fraudulent behavior in several ways, including through

- a. organizational innovations that limit the power of leaders (e.g., rotating group leadership, member input to decisions, transparency),
- b. formalized record keeping,
- c. training in leadership and group management skills, and
- d. increased human capital among all group members (i.e., literacy, numeracy, language skills, market knowledge).

6. *Social capital plays an important role in influencing horizontal relationships between MSEs.*

Social capital can have both positive and negative effects on the formation of horizontal relationships between MSEs:

- a. in-born social capital reduces the transaction costs of forming horizontal relationships because firm owners are more likely to trust each other and less likely to behave opportunistically and
- b. high levels of bonding social capital can reduce investments in acquired forms of capital, including both bridging social capital and physical capital.

FIRM-LEVEL UPGRADING BY MSEs

7. MSE owners base their upgrading decisions on their assessments of the risk-adjusted returns to upgrading.

MSE owners make their upgrading decisions based on their estimates of risk-adjusted returns, which include expected returns (profits), variability of returns (risk), impacts on future opportunities (sustainability), and their individual resources and objectives (household economic portfolio). MSE owners will be less likely to upgrade their businesses if

- a. there is no price premium for the upgraded product,
- b. they must invest in assets with a high degree of asset specificity and they lack credible assurances of repeated future transactions,
- c. they have relatively low household incomes and assets and the downside variability of returns includes negative or very low profits,
- d. they lack access to required investment capital.

8. Upgrading can be encouraged by strengthening the linkages between firms.

Vertical and horizontal linkages between firms help to improve the risk-adjusted returns to upgrading. MSE owners will be more likely to upgrade if

- a. they have higher levels of acquired social capital (networking),
- b. they are linked to lead firms through network types of governance structures rather than only through market-type linkages.
- c. they observe successful upgrading among MSE owners with whom they share bonding social capital.

9. Lack of information is a critical barrier to upgrading.

MSE owners in developing countries often lack the information that would allow them to understand the possible advantages to upgrading. MSE owners will be less likely to upgrade if

- a. they lack basic awareness of the existence of upgrading opportunities,
- b. they lack the information needed to calculate risk-adjusted returns, and
- c. the transaction costs to gathering upgrading information are high.