



USAID
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INTEGRATING MICRO- AND SMALL SCALE ENTERPRISES INTO PRODUCTIVE MARKETS

A DISCUSSION PAPER

microREPORT #29

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DISCLAIMER

The authors' views expressed in this publication do not necessarily reflect the view of the United States Agency for International Development or the United States Government.

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This paper is intended to provide a basis for discussion on how enterprise development practitioners can turn knowledge into practice. This paper does not attempt to be an exhaustive review of the literature, though a much more exhaustive review was conducted by way of background review. Before relieving all other parties who contributed to this paper, I would like to thank them for their contributions. These include, Vikas Choudhary and Adina Saperstein, who reviewed hundreds of documents and summarized them in a form accessible to many who will not find time to read them all in their entirety, and Banu Akin, who developed a document review platform that allowed a large number of reviewers to provide comments and input into the review process. I want to thank Jeanne Downing, Cognizant Technical Officer (CTO) for the AMAP BDS project, for her tireless ability to identify ‘must reads’ and forwarding them on to me and our review team. Mike Field of the Microenterprise Office made useful contributions, but, like all the others mentioned above, should not be held at all responsible for any errors shortcomings or weaknesses of this draft—for those I claim sole responsibility.

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ABBREVIATIONS

ACDI/VOCA	Formerly Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance
AMAP	Accelerated Microenterprise Advancement Project
BDS	Business Development Services
BSR	Business for Social Responsibility
CSR	Corporate Social Responsibility
CTO	Cognizant Technical Officer
DFID	United Kingdom Department for International Development
MSE	Micro and Small Enterprise
NGO	Non-Government Organization
USAID	United States Agency for International Development

1. INTRODUCTION

Since the early, 1990's a number of initiatives have come to dominate the economic growth agenda of many donors and public agencies. These initiatives arose as a response to, or an interpretation of, the increasing effects of market globalization on the economies of developing countries. Analyses that only looked at domestic markets were no longer adequate to understanding the dynamics that affected the incomes and livelihoods of poor households almost anywhere in the world. With the increase in globalization, resource-driven comparative advantage diminished in importance, while competitive advantage, created by private and public stakeholders, rose. And with it rose the importance of theories that could help us understand and manipulate the dynamics affecting economic growth—including competitiveness, value chain analysis, and economic cluster theory. As a result of increased globalization and a shift in jobs from developed to developing economies, ethical issues emerged. These were largely in response to labor and environmental concerns. Since then, competitiveness initiatives, value chain analysis, and cluster development approaches have proven to be quite effective at increasing micro, small, and medium enterprise productivity and competitiveness into global markets, as well as national and local markets.

The emphasis has been on economic growth and the role that competitiveness plays in sustainable growth. At the same time, there has been a surge in research and papers, underscoring that not all growth lead to poverty reduction. The World Bank, USAID, DFID, and others have sought to define “pro-poor growth strategies” and the extent to which micro and small enterprise (MSE) development, for example, is correlated with poverty reduction.

At the same time, the enterprise development field shifted towards more sustainable and more cost-effective approaches to delivering a range of critical business services (BDS) to MSEs. This shift evolved into the Market Development Paradigm, a set of guiding principles for donor and practitioner support of improved BDS delivery to MSEs. The Market Development Paradigm's emphasis on private sector providers, and the recognition that many MSEs were unable to pay for services, led many practitioners to look at the existing firms operating in value chains as actual and potential service providers of embedded services. This, in turn, led to the recognition that microenterprises are equally as dependent on, and affected by, global markets as are larger firms. The logical next step was to better understand how the theories, tools, and approaches for economic growth could be harnessed, adapted, modified, or used outright to develop more effective programs in support of MSEs, and to understand the conditions under which MSEs contribute to increased efficiency and productivity of global, national, and local value chains.

The USAID Accelerated Microenterprise Advancement Project (AMAP) BDS and the Knowledge & Practice activity of which this paper is part represent the frontier of a dynamic process that seeks to deepen the reach and impact of tools developed over the last decade. AMAP BDS's vision is to “create wealth in poor communities and promote economic growth through sustainable linkages between large numbers of MSEs and lead firms in productive value chains.” The objective of the research that will be carried out over the next three years is to learn more effective and productive tools and strategies for designing and implementing programs that enable MSEs to “develop their businesses and contribute to and benefit from their participation in competitive markets.”

This paper is an effort to contribute to our understanding of how the above mentioned tools can be used to support MSEs' benefits from and contributions to industry productivity. The objective of the paper is to explore both the theoretical literature and private sector experience with a *micro matter* lens. This document does not attempt to summarize all that has been written in competitiveness, value chain analysis, and cluster analysis. Rather it attempts to summarize the literature and actual experience for specific lessons as to how the theory can better inform practice, and how the tools of economic development can be better harnessed and, where necessary, adapted to assist the poor.

This paper is divided into three sections. Each section summarizes both the literature and expertise from various sources. Section 2 summarizes the value chain literature; section 3 summarizes parts of the literature on economic clusters with emphasis on MSEs; and section 4 summarizes literature in the Corporate Social Responsibility (CSR) and Ethical Supply Chain Management field, again through the *micro matter* lens.

It will be useful for the reader to note that this paper is a draft. Its purpose is to serve as a basis for discussion at an AMAP BDS Component C Workshop. Comments and feedback are invited. Strong dissent is also appreciated. Both will improve the quality of this product as it evolves.

2. VALUE CHAIN APPROACHES

A number of key questions emerge in reviewing the value chain literature from the perspective of the very small firm. These include: (1) identification of the kinds of industries and the stages of evolution of an industry, functions, and activities in which MSEs can participate, contribute, and benefit, i.e., an understanding of where there are opportunities for MSEs within value chains; (2) an understanding of the conditions and/or services that contribute to successful MSE participation in value chains; (3) an understanding of how learning is transmitted within value chains so as to help firms be competitive; and (4) the issue of how profits are generated and distributed within value chains, how much power MSEs in value chains have, and constraints to increased MSE participation. The literature and project review focuses on the following specific questions:

- In what kinds of industries, functions within industries, stages of evolution of an industry are there opportunities for MSEs to participate, contribute and benefit from growth?
- What are the obstacles to greater MSE participation in value chains?
- What are the disadvantages of MSEs participating in productive value chains?
- What is the impact of upgrading value chains on their MSE participants?
- How can micro- and small-scale enterprises earn more within existing value chains?
- What factors determine how profits are distributed within value chains; under what conditions can MSEs access greater profits?

In which industries, functions within industries, stages of evolution of an industry and/or activities do MSEs contribute to and benefit from economic growth?

What are the disadvantages of, and obstacles to, MSE participation in productive value chains?

The literature discusses two risks. The first risk—experienced by MSEs—is that MSEs will become ‘captive’ firms to a single buyer. The second—created by MSEs but faced by buyers considering whether to subcontract with MSEs—is the risk of non-compliance of subcontracts resulting in insufficient quality or quantity of product.

As microenterprises move into more integrated chains, there is a risk of becoming ‘captive’ enterprises, a situation in which microenterprises become dependent on a single firm for access to inputs and a market for their products. Several questions arise on this issue. How real is the risk of MSEs becoming ‘captive’ firms in global value chains and can this risk be reduced? Do the services provided by lead firms—whether information, inputs, or financial services—contribute to dependency on the part of subcontracting MSEs or do these services contribute to increased MSE incomes, which increase household options? Can donor efforts to reduce the captive firm risk actually diminish the services and income opportunities available to MSEs?

Facilitating linkages through subcontracting or outsourcing with multiple lead firms is one strategy to weaken subcontractor dependency on a single buyer (Knopp, 2002), but increasing competition among lead firms often leads to a decrease in services that the lead firms are willing and able to provide to MSEs. Multiple buyers in the market often reduce the chance that a lead firm will be able to recover the costs of delivering embedded services. This is because alternate buyers create cost competition reducing margins that buyers could use for providing services, while increasing the risk that MSEs will sell their product to another buyer at a higher price. Liberalization of the cotton industry in Tanzania resulted in an increase in the number of buyers, but a significant decrease in the provision of inputs on credit. Donor strategies to promote competition among service providers in value chains may, in some instances, result in a decrease of services to targeted enterprises (Langmead, 2003; Nylandsted Larsen, 2003).

It also possible that the captive firm dilemma is less of a problem for MSEs than it is for larger firms. While a MSE may become a ‘captive’ firm in a vertically integrated market for one household activity, that same household will be engaged in alternative activities (Liedholm and Mead 1987; Cohen, no date). The multiple enterprise strategy is common in the poultry subsector in the U.S. and Indonesia, where a very small number of large firms who subcontract with a large number of small firms control the entire production process from input supply to retailing microenterprises (ACDI/VOCA, 2003). There is also evidence of buyers’ initiatives to avoid the captive enterprise phenomena because it increases failure risk for their subcontractors. In Kenya, some horticultural exporters who subcontract with smallholders require that the smallholder not commit more than 25-30% of her land, labor, and capital to the contracted crop (F-PEAK, 2003; Bernard, 2003). In the automobile industry and surgical instruments industries, most interviewed subcontractors supply multiple clients.

Contract compliance remains a major constraint to firms who could subcontract with larger numbers of small-scale producers. The cost of ensuring product quality and quantity compliance with subcontractors is a major disincentive for subcontracting in both agriculture and garment industries. Quality controls are such a critical function that many buyers are unwilling to shed this function to intermediaries. The costs of ensuring product quality compliance can be reduced if MSEs organize into producer groups, coops, and associations. However, these groups often have difficulty shifting from advocating on behalf of their members to policing for product quality (Langmead, 2003; ACDIVOCA, 2003; Knopp, 2002; Dolan and Humphrey, 2000)

The high costs of ensuring compliance or quality controls are driving a decline in subcontracting to very small firms in the horticulture industry (Dolan and Humphrey, 2000). The same phenomena can be observed in the garment industry (Schullstrom, 2003). Rising Corporate Social Responsibility (CSR) concerns in the garment industry and the high cost of ensuring CSR compliance with small and household enterprises is forcing many buyer-driven value chains to eliminate subcontracting with MSEs (Schullstrom, 2003).

Under what conditions can micro and small scale enterprises access greater rents within existing value chains?

In a competitive setting, four strategies are available to increase rents (profits) for any participant with the chain (Kaplinsky, 2000). These are:

1. Increase the efficiency of firm-level internal operations so that they are significantly better than their rivals;
2. Develop inter-firm linkages that generate greater transaction-cost savings than those of rivals;
3. Introduce product branding, new products, and improved versions of existing products faster than rivals;
4. Change the mix of activities conducted within the firm, shedding existing or adopting new activities (e.g. moving from production to assembly and marketing).

The greatest returns are derived from strategies 3 and 4 (Kaplinsky, 2000). Because rents are highest from these functions, poor producers often face substantial barriers to entry, as small firms run up against asymmetries of power from governance relationships within the value chain (Kaplinsky, 2000; Schmitz and McCormick, 2002). Many of the power asymmetries in value chains are due to high transaction costs and diseconomies of scale associated with contracting with MSEs (Bazan and Schmitz, 1997; Farinelli and Mytelka, 2000).

The biggest single constraint to increased incomes for MSEs is the challenge in creating ***collective efficiencies*** (Berry, Rodriguez, and Sandee, 2002) through group formation. Group formation requires a concerted investment by multiple stakeholders in overcoming the obstacles to inter-firm cooperation.

Although there have been many successes in building the capacity of smallholder groups in multiple value chains through cooperative, association, and group development, many challenges remain. Often the strongest groups of small enterprises tend to provide both social and economic services. The social function of smallholder groups finds itself in conflict

with the enterprise functions, particularly when one of the groups' functions is to police members' products for quality control (Woolcock, 2001; Narayan, 1997). There appear to be significant cultural variations in the propensity of MSEs to organize themselves in groups and in the performance of those groups (Nakamura, Vertinsky and Zeitsma, 1997).

What factors determine how profits are distributed within value chains?

Since MSEs predominate at the production and initial assembly levels of value chains, the question above can be restated as *what determines whether and how profits¹ reach down to the production and initial assembly levels of value chains?* The biggest determinants of the distribution of profits within value chains are chain governance and barriers to entry (Kaplinsky, 2000; Rabbellotti and Schmitz 1999; Knorringa and Schmitz, 2000).

Chain governance varies considerably by the broad category of value chain under consideration. Buyer-driven chains are characterized by large firms specialized in marketing, in which the buyer controls the operation of the chain. Garments, athletic shoes, and commodity foods are buyer-driven chains in which chain governance rests in the hands of a small number of industry-branded name leaders. Generally, MSEs have little power in buyer-driven chains. There are a few noticeable exceptions to this trend. Starbucks coffee is the leader of a buyer-driven chain in which the product's value is linked to the uniqueness and quality of the product, a factor controlled by the producers. Part of the success of Starbucks' story is that, through inter-firm cooperation between a lead buyer and producer groups, more of the production, post-harvest, and quality control functions were passed to farmers groups. Starbucks benefited by being able to sell a 'story' to the consumer, adding value to their product (Ponte, 2002; Fitter and Kaplinsky, 2001).

Several lessons and questions emerge from the coffee example. Added value (rents) in the global value chain can be transferred to producers by (a) facilitating the establishment of farmer groups, (b) facilitating direct linkages between these groups and lead buyers, (c) developing a system of standards and grades similar to that used by the wine industry, and (d) adopting local regulations to support pricing by established grades (Ponte, 2002). It is worthwhile to note that most of the small-scale specialty coffee producers are only able to sell a small percentage of their product into the specialty coffee market (Specialty Coffee Growers Association, 1999).

Producers have more power in value chains where the product is characterized by a high degree of labor specialization and product differentiation. Custom leather shoes, surgical instruments, and differentiated agricultural products are industries in which chain governance and market power is held at least in part by producers and manufacturers. In these value chains, branding strategies are dependent on producer-level decisions.

Where a product is differentiable in a market, branding is a strategy to increase profits at the producer level. Branding at this level often requires a high degree of inter-firm cooperation, though returns from these activities do reach MSE producers (Berry, Rodriguez, and Sandee,

¹ Profits assumed as income in excess of all operating costs including a minimum wage for all labor and depreciation of any plan and equipment is used interchangeably with the term rents in much of the literature.

2002). Some degree of producer-level branding can even occur in buyer-driven chains. In value chains where quality drives value, such as specialty coffee, graded vanilla and cocoa, buyers tend to invest more in producers and producers command higher margins (Knorringa and Schmitz, 2000, ACDI/VOCA, 2005). Product differentiation and branding strategies at the producer level require strong producer groups and associations that are able to control for quality and tax members for product control and branding activities.

Some value chains provide income and employment for large numbers of the poor, even though very little real profits or rents reach down to the producer level.

There are value chains that provide considerable opportunity for MSE participation through subcontracting, even though MSEs exert very little governance over the chain. There are a few commodities where MSEs have a comparative advantage in subcontracting into value chains, including buyer-driven global chains. MSE comparative advantage in value chains is different in agriculture and manufacturing (Staley and Morse, 1964). In agriculture, MSEs' roles remain strong in commodities whose production or handling is labor intensive, or where risk of disease or crop loss due to weather increases with field size (Dolan and Humphrey, 2000; Panlibuton, 2005).

In the garment and apparel industry, subcontracting with MSEs is greater when demand is seasonal because MSEs' multi-enterprise strategies facilitate more rapid entry and exit. Conversely, there is less demand for MSEs to subcontract when production is highly labor intensive, as in piece work sewing, and where the per-unit capital costs are low but total capital costs are high, as in the case of plants which either have to purchase thousands of sewing machines or subcontract with hundreds of MSEs with dozens of machines per firm (Schullstrom, 2003).

What is the impact of upgrading value chains on their MSE participants?

Upgrading, the process of increasing the capacity, productivity, and/or efficiency of a chain, does not consistently benefit small-scale participants. In primary commodity value chains where international traders play the driving governance role, the upgrading of a few larger scale producers has resulted in the marginalization of many smaller firms (Gibbon, 2001). From an external (donor) investment perspective, the positive implications of dedicating resources to upgrading key firms may be offset by the negative implications for both equity and poverty alleviation.

Upgrading appears to create opportunities for MSEs when, as a result of upgrading, lead firms begin to specialize away from production and towards marketing or processing. If, as a result of upgrading, lead firms' demand for the product of MSEs increases, MSE participants gain, and the negative externalities of upgrading are minimized.

Upgrading is not always directed at lead firms. Loose or weak chains, where buyers source through multiple intermediaries (as in horticulture), provide opportunities for small firms to differentiate their products or services through upgrading and inter-firm cooperation (Humphrey and Schmitz, 2002; Knorringa and Schmitz, 2000). Buyers in chains who specialize in marketing and retail branding are more likely to shed production, assembly, and quality control functions to trusted suppliers. This creates opportunities for MSEs to upgrade by as-

suming additional market functions through upgrading and inter-firm cooperation (Humphrey and Schmitz, 2002).

2.1 Summary

The driving constraint to increased MSE participation and access to profits in value chains is their level of organization. The relative cost-effectiveness of different approaches to MSE group formation and strengthening has not adequately been addressed.

There are other questions for which the research suggests some answers, but where more empirical work is needed. These include an assessment of the impact of MSE participation in more productive value chains. Are there characteristics of groups of MSEs that are somehow marginalized relative to value chains? What are the characteristics of these groups? What role does gender, endemic disease, or geographic isolation play?

3. CLUSTER-BASED APPROACHES TO MSE DEVELOPMENT

In the donor world of enterprise development, cluster approaches and value chain approaches to creating wealth are often viewed as distinct. Advocates of cluster-based approaches argue for the need to invest in building strong networks of participatory approaches including public and private stakeholders. Advocates of value chain approaches have focused on the importance of vertical linkages as a means of facilitating the delivery of critical services through private players with little or no external subsidy. These services can be intangible, such as information on markets, design, branding strategies, as well as tangibles, such as inputs, credit and, of course, the product transaction. Critics of cluster-based approaches cite high costs of building clusters without clear and consistent measures of returns. Critics of value chain approaches emphasize that, without minimal collective efficiencies and coordination between private and public stakeholders, markets either cannot work efficiently or certain groups will be unable to participate in them.

In the research world, the distinction between the two approaches is less clear. Researchers have written extensively about both clusters and value chains. The concept of collective efficiency links both value chain and cluster work. In reviewing the literature on cluster and value chain approaches, the distinctions fade.

But donors, as stewards of public funds, must make decisions about how, when, and where these funds are allocated, and practitioners must focus their efforts. Since the two approaches are linked, the questions arise of where to focus, when to focus, and how attributes about particular clusters can help us design and implement better programs. The remainder of this section summarizes the literature that provides insight into the above questions from a microenterprise perspective. As a result, more attention is given to the concept of collective efficiency, group formation, and the importance of subcontracting. A short summary of differences between rural and urban clusters is mentioned.

Clusters deconstructed

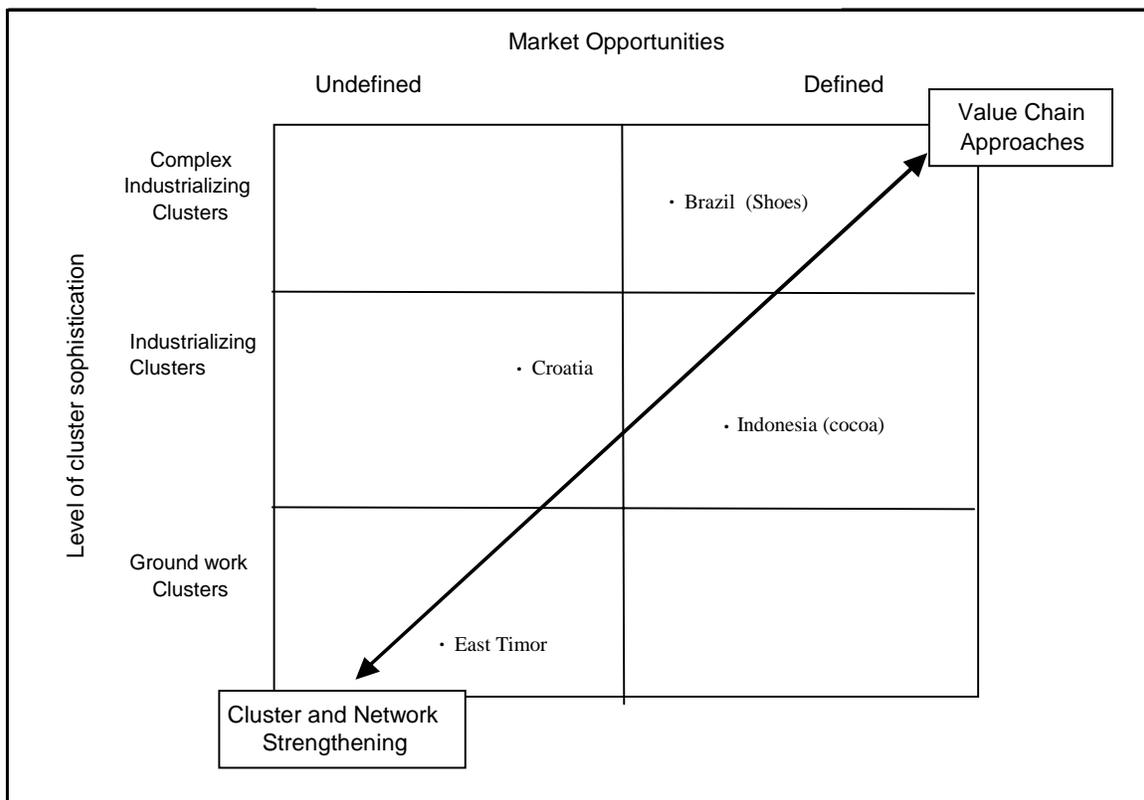
A recent review of cluster-based competitiveness projects identified a set of guiding principles (The Mitchell Group, 2003). Some of these principles are closely aligned with the theoretical foundations of the competitiveness literature and reflect a number of observations from the cluster and value chain literature. This suggests a close alignment between the theory and practice, at least with economic growth programs. This also suggests that the gap between theory and practice may be greater in the microenterprise field. First and foremost among these principles is the idea that individual firms cannot become and remain competitive in global markets on their own. Building competitiveness involves sustained change among firms both vertically and horizontally (Berry, Rodriguez, and Sandee, 2002; Schmitz, 1995).

Deconstructing the term *cluster* into components that are more useful for policy and intervention design is important. Current definitions and theories of clusters are often competing. One author summarizes the cluster literature as “a patchy constellation of ideas ranging from important economic theories to banal and misleading” (Martin and Sunley, 2001). For the purposes of this review, clusters are defined as geographic concentrations of horizontally

and vertically linked firms, suppliers, service providers, and associated institutions operating in a single field.

Dorothy McCormick deconstructs clusters into three categories—*groundwork clusters*, *industrializing clusters*, and *complex industrializing clusters*—according to the level of industrialization of the economy in which they are located, as well as by market opportunities (McCormick, 1999). This exercise seems useful, as much of the debate about cluster-based approaches seems to focus on whether they are appropriate in a particular setting. According to McCormick, *groundwork clusters* lay the foundation for industrialization by building a productive environment that paves the way for the emergence of collective efficiency through local and generally low-income markets. Signs of emerging collective efficiency and greater degree of labor specialization and differentiation characterize *industrializing clusters*. Local market linkages with emerging linkages to more distant and demanding markets characterize industrializing clusters. The third group, *complex industrial clusters*, is characterized by a high degree of differentiation and specialization, catering to high value national and global markets. Audretsch and Feldman (1996) support McCormick in arguing that adaptation and innovation in clusters is dependent on industry and cluster life cycle.

Figure 1: Framework for BDS design



McCormick argues further that in economies with small markets and excess labor, the cluster advantages of collective efficiency and knowledge transfer may not be relevant because weak markets, weak institutions, and excess labor constitute barriers that cancel out the benefits of clustering. These economies could be characterized as pre-groundwork clusters. Deconstructing clusters into more precise categories is a useful way for donors to determine an appropriate course of action. Figure 1 above provides an illustration.

Donors and practitioners need to make decisions about how to allocate scarce resources while maximizing growth and incomes. This is particularly true for the microenterprise field and its greater scrutiny on sustainability and cost effectiveness of resource use. Value chain interventions, characterized by the facilitation of vertical exchanges, are attractive because they can be improved upon at very low cost. Building networks and group formation, on the other hand, often requires longer and more substantial initial subsidies. Where and how a donor focuses resources is, in part, a function of the development of clusters and markets already in place. Figure 1 suggests a simple framework for program design based on McCormick's categorization of clusters.

Horizontal and vertical cooperation among enterprises contribute to *collective efficiency*—the competitive advantage derived from local external economies and joint action (Berry, 1997). Micro- and small-scale firms must link with other firms in order to maintain market share and increase share of rents.

The term *clustering* has emerged as the set of linkage possibilities available to firms. Clustering encompasses all the relationships, both vertical and horizontal, which can reduce the costs of accessing information, reduce the risks of modifying and assembling products, and reduce the time needed to get a new product to market (Lundvall, 1988; Farinelli and Mytelka, 2000). Horizontal coordination between firms of similar size performing like functions in a sector yield collective efficiencies in terms of reduced transaction costs and accelerated innovation, through more rapid problem solving and greater market access through economies of scale (Bazan and Schmitz, 1997). *Agglomeration*, another benefit of clustering, is the creation of positive externalities by bringing together skilled labor, infrastructure, access to research and public institutions (Morgan and Sayer, 1988; Farinelli and Mytelka, 2000). Agglomeration benefits tend to arise only in urban clusters.

The level of cluster organization determines resilience to external shocks. The greater the inter-firm cooperation, both vertically and horizontally, the better cluster members are able to move into new chains. Cluster resilience depends on the enabling environment as much as on the behavior of firms within the cluster (Berry, 1997).

Subcontracting, the principal contractual means by which MSEs participate in value chains, is highly dependent on the level of collective organization of smallholder groups. The transaction costs of contracting with individual MSEs are too high for most buyers to consider. Often, the main prerequisite for a dense subcontracting system is better performance on the part of potential subcontractors. Some of the problems MSE groups face in subcontracting have been discussed above in the value chain section.

The challenges to creating or increasing collective efficiency (discussed in the value chain section above) are many. Failures at building sustainable strong groups able to subcontract and negotiate for services on their own may exceed the successes.

Leadership

Intuitive, but inadequately explored, is the role of leaders in clusters. From a programmatic perspective, many projects regarded as apparent successes failed after the end of the project due to the lack of clear leadership of partner associations. This literature review cites a number of associations of horizontally and vertically linked firms including Hortico Zimbabwe, the Kenya Flower Council, and the East African Coffee Growers Association. The apparent African bias is not deliberate; every country has its examples.

Leadership in vertical relationships is a lesser issue because the buyer generally operates as the leader, providing information and services for a product. Rather it is in horizontal coordination that leadership—or the lack thereof—is a greater challenge. Members of horizontally linked groups are frequently owners of their own businesses. Thus, management and leadership resources drawn to strengthen the group or association are drawn from the individual's own enterprise. In addition, there are always asymmetries of information and management skill within groups. Group members with greater skill and access to information may be unwilling to share this with other members (Meyer-Stamer 2001). Lack of strong leadership, complicated by the inability of many small groups to pay for dynamic and motivated management and staff, remains a driving constraint to achieving the collective efficiencies mentioned above.

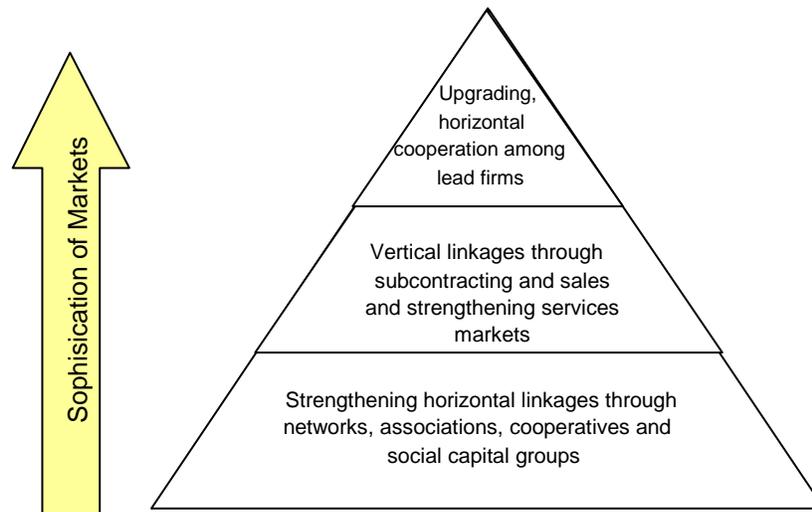
Differences between Rural and Urban Clusters

There appear to be significant differences in the dynamics of rural and urban clusters (Oyelaran-Oyeyinka, 2001). In urban clusters, we see higher levels of innovation, resulting from greater inter-firm interaction. Urban clusters grow more rapidly, bringing in new players, including research institutions and public institutions able to bring about enabling environment changes. Exchange of information and transactions in urban clusters occurs across unrelated firms. Innovation appears greater in clusters with looser social ties, a characteristic of urban clusters (Oyelaran-Oyeyinka, 2001; Granovetter, 1983)

Market systems in developing countries are often weaker in rural areas. Communities with very weak markets are often heavily dependent on familial and strong social networks to meet their daily needs and to offset risks (Oyelaran-Oyeyinka, 2001). Social networks based on leadership and ethnicity are characterized by stronger ties. Networks where shared kinship or ethnicity are absent are characterized by weak ties.

The *Strength of Weak Ties* (Granovetter, 1973) provides insights into the operation of networks and in the dynamics of communities shifting from social capital to economic capital formation. Weak ties link members of different small groups, enlarging the network of opportunities. Strong ties, characterized by kinship, are concentrated and exclusive and tend to be poor sources of information. The ethnic foods markets in many countries are dependent upon weak ties. Members of similar groups or nationalities have access to information that outsiders lack. This information enables them to operate more efficiently in certain markets. Thus, Eastern Europeans dominate Eastern European markets, West Africans and Indians are key wholesalers in the African and Caribbean markets.

Figure 2: Resource Allocation Pyramid



3.1 Summary

The review of the cluster literature stresses the importance of collective efficiency and inter-firm cooperation. Practitioners and donors are well aware of the challenges to building stronger networks, investing in collective efficiencies, and strengthening inter-firm cooperation, regardless of the level of the value chain. Cluster-based research provides a theoretical and an empirical rationale for investment in strengthening networks and building groups. This is particularly important for MSEs because of the diseconomies of scale that their size creates. For MSE advocates, network building and the strengthening of groups must be the foundation of an approach that seeks to generate wealth by linking them into value chains. The share of donor resources devoted to capacity building, versus linking MSEs to lead firms within value chains, will depend on the sophistication of available markets and the evolution of local clusters (see Figure 2). This framework may also be useful for allocating resources to particularly marginalized groups.

4. CORPORATE SOCIAL RESPONSIBILITY APPROACHES

Emerging private sector awareness of environmental and fair labor issues by leaders of buyer-driven value chains has created a new field of practice called Corporate Social Responsibility (CSR). CSR arose from the private sector in response to environmental and consumer advocates and in anticipation of—and in response to—stricter regulatory environments in the global marketplace.

The role of CSR is increasing in the business community. The case for CSR goes beyond consumers' willingness to pay a premium for goods and services meeting CSR standards. This is due, in part, to the risk that consumers will shift their spending away from noncompliant firms, as was the case with Nike (Baron, 2001). Consumer and environmental groups have been successful at creating pressure for extractive industry companies (petroleum and mining) and pharmaceutical companies to adopt CSR policies, though there are no customer premiums attached to CSR investments for these firms.

There is little evidence to suggest that many customers will pay a premium for CSR (Smith, 2003; Schullstrom, 2003). This is particularly true for products whose attributes change rapidly in response to consumer preference, such as apparel and accessories (Smith, 2003). The Cooperative Bank's Ethical Purchasing Index indicates that the combined UK share of ethical products (fair trade products) over seven food and non-food products is approximately 1.5%. That said, in highly competitive markets, CSR might be a basis for product differentiation. A number of large international buyers as well as smaller 'gourmet' brands have begun differentiating their product as an ethical product.

Both national and international associations promote CSR (Businesses for Social Responsibility, 2002). Currently, many developed countries have their own CSR body. The U.S., for example, has Business for Social Responsibility (BSR) www.bsr.org. Such groups may provide a forum through which equity and externality issues can be raised.

Because the CSR field includes ethical and equity issues, and because ethical and fair trade advocates are trying to shape the CSR agenda, CSR has potential to be a positive force in favor of greater MSE participation in, and benefit from, productive value chains. However, the evidence to date is mixed. CSR subscribers, including Starbucks, have formed backward linkages down to the producer level and have developed product lines that emphasize fair trade aspects, as well as product quality components managed by the small scale producers. On the other hand, many CSR policies have served to marginalize MSEs from markets in which they used to compete.

Does CSR help or hurt MSE participation in value chains?

This question is the focus of the CSR literature review. Like with the concept of clusters, it is useful to deconstruct the CSR field. One CSR advocate has identified an evolutionary process in CSR, characterized by four levels of corporate responsibility behavior (Swift and Zadek, 2002). These are:

- **Legal compliance:** firm(s) abide by regulations covering taxation, health and safety, worker rights, and environmental regulations;
- **1st Generation:** Low-level business case philanthropy, short-term vision, often viewed as extraction compensation to affected communities;
- **2nd Generation:** Strategic Corporate Responsibility for both Product and Process, responsible governance, long-term sustainability; and
- **3rd Generation:** Reshaping competitive advantage around CSR objectives, multi-stakeholder partnerships, institution building. Corporate responsibility advocacy and public policy.

CSR activities by mining and petroleum companies are in their early stages, classified under this model as the Legal Compliance and 1st Generation phase of CSR. In some cases, CSR is limited to locally dispersed investments with little strategic emphasis on how to use those investments to stimulate economic growth. In a few cases, the line between CSR and public image marketing is unclear. The impact of this type of CSR is generally neutral on MSE participation in value chains. MSEs are generally not participants in the buyer-led chain adhering to some CSR practices, though the gemstone mining industry is an exception (Swift and Zadek, 2002). Value chain leaders are multi-national companies that invest in, or provide grants to, the communities adversely impacted by the extraction process. The economic impact of these grants and investments has been minimal. As a result, some petroleum and mining companies have begun to seek out local and international NGOs to develop criteria for the use of their CSR investments.

Much of the CSR focus has been on supply chain codes of conduct that relate to subcontractors. This has been driven by international consumer group awareness of the conditions under which subcontractors to large buyer driven value chains were forced to work. A growing number of firms—notably garments, textiles, apparel and horticulture—have adopted codes of conduct covering environmental and labor standards for subcontractors. Most of the 2nd Generation level CSR is driven by western (northern) labor practices, including use of child labor, that are based on developed and post industrial society assumptions of labor conditions and land use. This paper is not intended to argue for or against the merits of applying these standards to developing countries.

As a result, many CSR rules create negative externalities by imposing high transaction and compliance costs for MSEs currently operating in value chains. This is a characteristic of 2nd Generation CSR, which frequently has a negative impact on MSE participation in value chains. Adoption of these codes effectively pushes the costs of compliance and monitoring down the supply chain to subcontractors and suppliers who are already operating in a highly competitive market (Raynard and Forstater, 2002). The high cost of ensuring MSE compliance, as with CSR components of EUREP GAP requirements for horticulture and UK supermarket regulations, are forcing many buyers and exporters to reduce or eliminate subcontracting with small scale producers (Dolan and Humphrey, 2000; Bernard, 2003). A number of large buyers and their major suppliers have either ceased or reduced subcontracting with households and very small firms in the horticulture and garment industries as a result (Schullstrom, 2003; Murethi, 2003; Bernard, 2003).

Few firms or industries operate at the 3rd Generation CSR level. While 3rd Generation CSR provides a framework through which broader development impact, equity, and externality

issues can be raised, very few firms adopting some CSR policy currently take these issues into consideration. There are growing exceptions in the Fair Trade community, social marketing firms, and niche firms in the specialty foods market. However, these tend to be small in size and impact. Starbucks and a number of chocolate manufacturers are exceptions.

The number of NGOs benefiting from CSR investments is growing. For example, ACDI/VOCA works with CSR companies in Ethiopia, Angola, Tanzania, Indonesia, and Vietnam in the areas of coffee, cocoa, seaweed, and community development. The NGO community has not yet developed standards of accountability for their performance in the sharing of CSR investments. While we can provide considerable anecdotal evidence, there has been very little empirical evidence that CSR investments benefit small firms at the bottom of global value chains (Michael, 2003).

4.1 Summary

Overall, the evidence to date shows that CSR practices force large numbers of MSEs out of productive value chains. From an economic efficiency perspective, this is not entirely negative. Suppliers who have stopped subcontracting with MSEs are forced to increase their own investment in plant, labor and equipment. This has generally led to an increase in employment, often under better working conditions than those in which the household enterprise operates. There is insufficient empirical evidence of the net impact of value chains shedding MSE subcontractors. Because MSEs are less capital-intensive than larger firms, it is fair to assume that CSR has resulted in employment loss in critical sectors.

However, shedding subcontractors to offset the high costs of CSR compliance may not always lead to increased efficiency. If this “trade-off” proves not to be worthwhile, and the supplier is not realizing enough of the rents to make this option profitable, he or she may try to renegotiate subcontracts with innovative and more efficient compliance arrangements.

One possible role for strong MSE organizations and networks is to assume the social auditing functions of CSR regulations. In most countries, these organizations are weak for reasons discussed in the value chain and cluster sections of this paper. In some countries, weak enabling environments are an added constraint to building MSE organizations and networks.

There is room for—and emerging evidence of—evolution in the CSR field towards 3rd Generation CSR practices. Many of the current CSR regulations were adopted in response to consumer advocacy groups concerned about the labor practices of buyer-driven value chains. These same groups, once aware of the adverse impact of CSR codes of practice on household enterprises, might call for practices that generate fewer negative externalities. NGOs have a critical role to play here.

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