



MSE UPGRADING IN VALUE CHAINS

The success of many of USAID’s private sector development projects depends on business owners’ ability to innovate and adapt to changing market conditions. For example, the success of a trade project might depend on exporters’ ability to meet evolving quality and safety standards in developed country markets. An agribusiness project to promote value-added processing might depend on local farmers’ ability to produce a reliable, year-round supply of quality raw materials. Other projects might require firms to adopt new business practices and make use of new information and communication technologies (ICT). These examples share a common link: project success depends on firm-level upgrading, which is defined here as *innovation to increase value added*.

This briefing paper offers observations and suggestions for promoting firm-level upgrading, with an emphasis on upgrading among micro-and small enterprises (MSEs), including smallholder agriculture. It is not intended as the final word on MSE upgrading, but instead serves as a point of departure for stimulating discussion and shared learning based on project implementation experience. Since so much of private sector development depends on successful upgrading, the purpose of this brief is to open the discussion of emerging best practices.

Information for this brief comes from a review of nine

value chains (see box at left). A comparison of upgrading information across these cases provides information about the primary impetus behind different types of upgrading and highlights the importance of

CASE EXAMPLES

- Guatemala:** woven textile handicrafts and high-value vegetables
- Honduras:** horticultural crops
- India:** handmade leather shoes
- Indonesia:** cocoa
- Kenya:** avocados
- Mexico:** specialty coffee
- Mozambique:** oilseeds
- Pakistan:** embroidered garments

linkages between firms, especially vertical relationships

between MSEs and lead firms, and the positive role played by learning and strong information flows.

TYPES OF UPGRADING

There are several types of upgrading (see box below).

TYPES OF UPGRADING

- Process:** increased production efficiency, reducing unit costs
- Product:** improved product quality, increasing value to consumers
- Functional:** firm entry into a new level of the value chain
- Channel:** firm entry into a pathway leading to a new end market
- Intersectoral (inter-chain):** firm entry into new value chain based on a different product

An example of process upgrading might be an increase in productivity due to mechanization, such as increased agricultural output from irrigation. A well-known example of product upgrading, also from agriculture, is an improve-

ment of the product so that it complies with food safety standards in the importing country. Functional upgrading occurs when a firm takes on new functions, such as when an in-country intermediary decides to become an exporter or when an MSE producer buys a truck and begins brokering on behalf of other producers in a distant wholesale market. Channel upgrading occurs when firms begin to sell in new end markets, while intersectoral (inter-chain) upgrading occurs when firms move to a completely different subsector.

IMPETUS FOR UPGRADING

Process upgrading is driven by the need to cut costs and/or increase output in response to competition within the value chain or between value chains. Competition from low-cost alternatives may put pressure on MSEs to reduce the prices of their products. This competition forces MSEs to respond by upgrading their production processes to increase their production efficiency.

Product upgrading is motivated by changes in end markets, usually stemming from changes in consumer preferences. To remain competitive in changing markets, MSE producers must upgrade their products to meet consumer preferences. The coffee industry provides a clear example of demand-driven upgrading. Consumers have become increasingly aware of the origins of coffee and the social and environmental issues associated with coffee production. There has been a corresponding growth in consumer demand for specialty coffee that meets certain health, safety, environmental and social standards.

Functional upgrading is motivated by the desire to eliminate the market power of intermediaries, the desire to improve the flow of market signals to producers, or both. There are two distinct ways that functional upgrading can occur: 1) an entire level of firms may be eliminated, thus changing the structure of the value chain and often improving the quality of information flowing to MSEs, or 2) a single MSE producer or producer group may move to a higher level in the value chain.

Channel upgrading is motivated by the desire to improve risk-adjusted returns. Higher prices, higher sales volumes and more effective risk management through diversification all provide incentives for MSEs to enter into new market channels. MSEs may also enter into new market channels to seek an outlet for lower quality products that do not meet export or other high-value market standards.

OBSERVATIONS FROM NINE VALUE CHAINS

Vertical linkages are an important source of information and technical assistance for process upgrading. This assistance frequently comes in the form of embedded services, in which technical instruction is provided as part of the product transaction. By providing forward contracts, lead firms can reduce some of the risks that would otherwise discourage MSE producers from process upgrading. Stand-alone services from supporting markets were a much less important source of learning for process upgrading for the value chains reviewed in this study.

A well-functioning value chain transmits information to producers about consumer preferences, along with the price signals associated with those preferences. In order to respond to changing demand, producers must first be aware of consumer preferences. One of the best ways to

entice firm owners to invest in product upgrading is to offer them higher prices for higher-quality products. Because of the importance of vertical information flows, intermediaries often play a central role in promoting (or impeding) product upgrading.

Because firms that buy from MSEs must satisfy their own buyers further up the chain, they have an incentive to provide MSEs with embedded services that encourage product upgrading. When consumers demand new or different products, the pressure to respond is applied to firms all the way down the value chain. In addition to offering price premiums for improved products, buyers also may provide non-price incentives, such as technical and design assistance, training and input advances. These embedded services encourage product upgrading by reducing the costs and risks to MSEs.

There is often a connection between product upgrading and other types of upgrading. There is a link between product and channel upgrading in that product upgrading may be a requirement for entering a new market channel. Similarly, product and functional upgrading are linked in that the creation of direct relationships between producers and exporters facilitates the flow of information about the type and quality of products demanded in end markets.

Physical and social distance can hinder upgrading. Expenses associated with inputs, transport and training may increase with distance from markets, reducing the profits from upgrading. In some cases, the transport of products or cash payments over long distances may expose MSE owners to increased security and market risks. Socio-cultural segmentation based on gender, caste, class or ethnicity also can constrain upgrading. Functional upgrading in domestic market channels may be easier for MSEs because physical and social distances between layers of the value chain are smaller and better information is available.

ICT can facilitate upgrading. Increased access to technologies such as cell phones, fax machines and the internet can help MSEs strengthen horizontal and vertical relationships with other firms in the value chain and, through these relationships, improve their opportunities and incentives for upgrading. In addition, cell phones and the internet provide MSEs with better access to current market information.

GUIDELINES FOR PRACTITIONERS

Several lessons have emerged from the review of nine value chains. These suggest ways to facilitate upgrading and increase the benefits to MSEs by reducing many of the costs, risks and constraints to upgrading.

1. Improve transmission of market information and price signals to MSEs. MSEs will have little incentive to upgrade if there are “weak links” in the flow of market information and price differentials related to quality. To increase benefits to MSEs in value chains, it is important to strengthen vertical information flows and to ensure MSEs receive a price premium for higher quality. In Pakistan, women sales agents have facilitated the flow of information to individual producers about designs and colors demanded by urban buyers. This, along with the payment of higher prices, has helped to elicit a strong product upgrading response. If intermediaries take these price premiums as rents, then MSEs will have little incentive to upgrade. In situations where buyers demand higher quality as a condition of doing business, without offering higher prices, MSEs will be less likely to respond unless there are some compensating reductions in costs or risks. In any case, the minimum requirement for upgrading is that MSEs must receive timely information about consumer preferences in end markets.

2. Increase the bargaining power of MSEs. Increased bargaining power for MSEs provides greater incentives to upgrade by increasing the risk-adjusted returns to upgrading. The bargaining power of MSEs relative to their buyers can be enhanced by improved MSE knowledge of markets, prices and quality. Horizontal collaboration among MSEs for purposes of collective bargaining can play a key role in improving profits in the short run. It can also open the door to future opportunities for MSE owners by bringing about new knowledge, skills and relationships that shift power and information asymmetries in favor of MSEs. Avocado smallholders in Kenya formed groups linked to a lead export firm, through which they negotiated an agreement that guaranteed a market for upgraded fruit at an agreed upon price, and included embedded services to support upgrading.

3. Promote effective collaboration between MSEs. Horizontal collaboration among MSEs can take a number of forms. It can involve a large group of MSEs or just two or three. It can be either formal or informal. Collaboration may occur through groups formed specifi-

cally for business purposes, or groups formed for other purposes. Collaboration can be a one-time activity or take place on an ongoing basis. In any case, horizontal collaboration can facilitate upgrading in several ways. It can increase MSE bargaining power, reduce buyers’ transaction costs of dealing with large numbers of MSEs, and provide a platform for sharing information and demonstrating new products, processes or technologies. Producer groups and other structures that promote horizontal cooperation among MSEs can help to bridge the physical and social distance among individual MSE producers and between groups of MSEs and buyers. This can reduce the isolation of individual producers and build social capital. Horizontal collaboration can facilitate MSE access to support services such as training, extension or finance; it can provide a platform for buyers to provide embedded services to larger numbers of MSEs. The benefits of horizontal collaboration are reflected in the coffee value chain in Mexico and the horticulture value chains in Guatemala and Kenya.

4. Develop financial markets for MSE investment capital. Process and product upgrading often require long-term investments for which MSEs must seek outside sources of capital. While lead firms may provide working capital to their suppliers, there are few lead firms that can bear the expense and risk of providing long-term financing to hundreds or thousands of MSEs. The credit terms for most of the available sources of formal and informal finance for MSEs are better adapted to short-term working capital loans and do not fit the long-term investment needs associated with upgrading. Development of financial markets for MSE investment capital would enhance their capacity to respond to and benefit from upgrading opportunities. Lack of capital to upgrade was an unaddressed constraint for MSEs in many of the nine value chains. This suggests scope for donors to facilitate innovations in the development of financial products and services to support MSE upgrading in promising sectors.

5. Identify socio-cultural limitations to upgrading. Upgrading opportunities are often limited by socio-cultural norms related to gender, caste, class or ethnicity. These norms affect information flows, market signals, participation in business networks and inter-firm relationships. Special facilitation may be needed to reach socially isolated groups, such as training targeted explic-

itly to these groups; initiatives to promote horizontal and vertical cooperation involving these groups through networks, producers groups and linkages between MSEs and lead firms; or other support services targeted to traditionally excluded groups. It is important to acknowledge social segmentation among MSEs, and between MSEs and other firms in the value chain. For upgrading information and assistance to be effective, it must reach the right groups. For excluded groups to take advantage of upgrading opportunities, it is important to design facilitation activities that help producers overcome social barriers. In India, where working with leather is associated with lower castes, the movement of producers into higher value-added activities within the leather value chain through product and functional upgrading may provide a stepping stone for lateral movement through intersectoral upgrading.

6. Reduce MSE owners' isolation. Physical and social isolation of MSEs can limit their capacity to respond to and benefit from upgrading opportunities. Both forms of isolation limit market information flows and increase transaction costs. They also limit human and social capital accumulation among MSE owners, which has a negative effect on business relationships and the capacity to respond to upgrading opportunities. Isolation can be reduced by improving physical infrastructure (roads, bridges, transport, etc.) and by deepening the reach of ICT. Improved literacy and public information campaigns can help to facilitate the flow of information related to upgrading. Producers in isolated areas or producers from excluded social groups may require tailored facilitation activities to improve their upgrading opportunities and benefits. Facilitation activities supporting the entry of women brokers in the embroidered garment value chain in Pakistan have helped reduce the isolation of women producers.

7. Resist the urge to herd all MSEs into one market channel. Channel upgrading is a dynamic response to changing market conditions, with the result that channel upgrading is rarely a complete and one-time-only shift

from one market channel to another. In fact, dependence on a single market channel can narrow the risk management options available to MSE owners. The more a household depends on the MSE as its main source of income, the higher the income risk to the household. Diversification of market channels helps MSEs manage risk and is a rational response to dynamic markets. To reduce risk, MSEs should not be pushed to operate exclusively in the market channel that pays the highest price today but may not pay the highest price tomorrow. Moreover, MSEs should not be pressed to totally abandon the domestic market; most MSEs continue to depend primarily on the domestic market and cutting these ties can increase their vulnerability to shifts in global markets. It is important for donors and facilitators to maintain an awareness of opportunities throughout the value chain and not become overly enthusiastic about a single market channel.

EFFECTS OF VALUE CHAIN STRUCTURE ON UPGRADING

The ideas in this brief can be summarized in terms of the effects of value chain structure and upgrading:

1. End markets are the main drivers of process, product and channel upgrading.
2. Vertical linkages are the primary channel through which information and incentives for upgrading reach MSEs.
3. Horizontal linkages facilitate upgrading by helping MSE owners overcome limitations associated with their small scale of operations.
4. Supporting markets for MSE upgrading are generally weak, with lead firms sometimes stepping into the gap to provide embedded services.
5. Within the business and enabling environment, some of the major impediments to MSE upgrading come from social, educational and geographic boundaries.

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