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BRIEFING PAPER

THE VALUE CHAIN FRAMEWORK

INTRODUCTION

Globalization is a process by which people, companies, goods and services, capital, information and ideas are exchanged across international boundaries. Although cross-border trade has existed for centuries, modern day trading—fueled by multi- and bilateral trade agreements, global investments and innovations in information and communications technology—has expanded in volume and geographic reach.[i] Today, almost all countries are integrated to some extent into the global economy and are experiencing varying degrees of economic growth. While economic growth generally reduces poverty, it does so at different rates in different contexts, with the greatest impact on poverty reduction occurring in those countries with the most equitable income distribution.[ii]

Globalization of markets ties the sustainability of firms to the competitiveness of the industries in which they participate. Firms within an industry in a country or region must increasingly compete—even in local markets—with firms and industries from across the globe. To succeed in global markets, entire industries (or value chains) must be able to deliver a product to the consumer more efficiently, with a higher quality and/or in a more unique form than the value chains in competing countries. In this way, competitiveness at the firm and industry levels are interdependent. Increasing the competitiveness of the firm is only effective at sustainably creating wealth and alleviating poverty when the competitiveness of the industry is similarly raised by interventions at all levels of the value chain.

COMPETITIVENESS

Competitiveness is the ability of a firm or industry to develop and maintain an edge over market rivals. This can be achieved through a combination of three strategies: producing and delivering goods and services more efficiently, differentiating products or services through quality standards and branding, and/or exploiting new market demand.

Most emerging economies have a comparative advantage in the provision of labor and land and the exploitation of certain natural resource and climatic advantages over more developed countries. Conversely, with the possible exception of China and some South and Southeast Asian economies, investment capital is scarce, and instability in the business enabling environment has not favored the emergence of capital-intensive industries. Exploiting these comparative advantages, the dominant industries in emerging economies tend to be characterized by high levels of micro- and small enterprise (MSE) participation. Any strategy in these countries that seeks to achieve broad-based economic growth and poverty reduction will need to focus on MSE-dominated industries with the capacity to be globally competitive.

Economic growth with poverty reduction can be achieved by targeting industries where the poor are concentrated—such as agriculture and informal sectors—promoting strategies that make the target industries more competitive, and ensuring broad distribution of benefits at all levels of these industries.

VALUE CHAINS

Value chains encompass the full range of activities and services required to bring a product or service from its conception to sale in its final markets—whether local, national, regional or global. Value chains include input suppliers, producers, processors and buyers. They are supported by a range of technical, business and financial service providers.

Value chains have both structural and dynamic components. The structure of the value chain influences the dynamics of firm behavior and these dynamics influence how well the value chain performs. Figure 1 below pre-

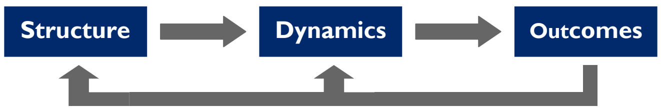
This Briefing Paper is based on:

Kula, Olaf, Jeanne Downing, and Michael Field. 2006. *Globalization and the Small Firm: A Value Chain Approach to Economic Growth and Poverty Reduction.* AMAP BDS Knowledge and Practice microREPORT #42, USAID/G/EGAT/MD. Washington, D.C.: ACDI/VOCA.

Lessons Learned on MSE Upgrading in Value Chains: A Synthesis Paper (2006) by Elizabeth Dunn, Jennefer Sebstad, Lisa Batzdorff and Holly Parsons. AMAP BDS Knowledge and Practice microREPORT #71, USAID/G/EGAT/MD. Washington, DC: ACDI/VOCA.

sents a causal model linking value chain structure, dynamics and outcomes.

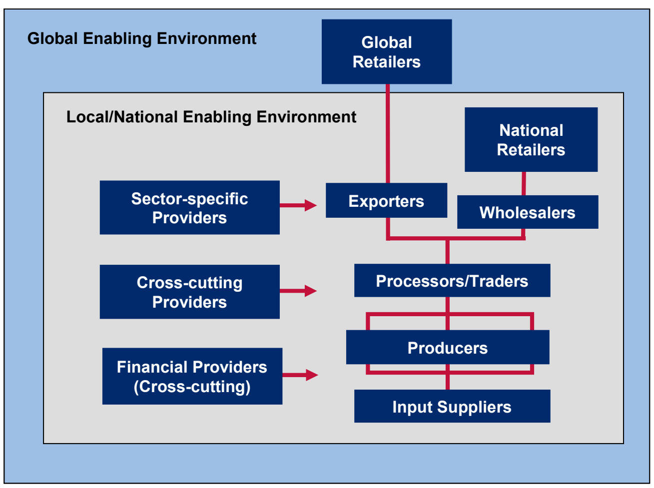
Figure 1: Value Chain Causal Model



VALUE CHAIN STRUCTURE

The structure of a value chain includes all the firms in the chain and can be characterized in terms of five elements described below. Figure 2 presents a graphical representation of the structural elements of a generic value chain.

Figure 2: Value Chain Structure



1. End Markets

End markets are people, not a location. They determine the characteristics—including price, quality, quantity and timing—of a successful product or service. End market buyers are a powerful voice and incentive for change. They are important sources of demand information, can transmit learning, and in some cases are willing to invest in firms further down the chain. The value chain approach assesses current and potential opportunities in all possible markets, through interviews with current and potential buyers, and takes into consideration trends, prospective competitors and other dynamic factors.

2. Business and Enabling Environment

The business and enabling environment at the local, national and international levels includes norms and customs, laws, regulations, policies, international trade agreements and public infrastructure (roads, electricity, etc.) that either facilitate or hinder the movement of a product or service along its value chain. Many international trade agreements and quality standards present opportunities for market expansion but can be extremely expensive for firms, especially MSEs, and can easily preclude a developing country from being competitive. The national policy and regulatory environment is critical to the functioning of markets and enterprises. Poor local government operations and weak enforcement of legal and regulatory regimes increase transactions costs and risks, limiting investments in relationships and upgrading. Conversely, local policies can generally be influenced more easily than laws and regulations and can have a significant positive impact on industry competitiveness.

3. Vertical Linkages

Relationships between firms at different levels of the value chain are critical for moving a product or service to the end market. More efficient transactions among firms that are vertically related in a value chain increase the competitiveness of the entire industry. In addition, vertical linkages facilitate the delivery of benefits and embedded services and the transference of skills and information between firms up and down the chain. Research has demonstrated the positive impact on learning and benefits to small-scale producers from entering into contractual relationships with processors, exporters and end market buyers. Mutually beneficial relationships among vertically related firms can improve MSEs' access to markets, new skills and a wide range of services, and can reduce market risk by securing future sales.

4. Horizontal linkages

There is a necessary tension between cooperation and competition among firms performing similar functions in a value chain. Relationships between firms—whether formal or informal—can reduce the transaction costs for buyers of working with many small suppliers. By facilitating bulk purchasing of inputs or enabling large orders to be filled, horizontal linkages can help small firms to generate economies of scale. Industry associations can enable the creation of industry standards and the implementation of marketing strategies. Key to gaining value from horizontal cooperation is recognizing joint constraints that require collective action. Simultaneously, competition between firms is necessary to stimulate and reward innovation and make an industry better able to respond to market changes.

5. Supporting Markets

Support services are key to firm-level upgrading. They include financial services; cross-cutting services such as business consulting, legal advice and telecommunications; and sector-specific services, for example, irrigation equipment or handicraft design services. Where these services are needed over the long term, they must be provided commercially or by markets. These markets can include services provided by actors in the chain, or by stand-alone service providers. Services provided by actors in the chain tend to be embedded, such that the cost of the service is built into an existing commercial transaction. New technologies or technical services can have a substantial effect on the performance of an industry and can even change the competitive dynamic in certain markets.

VALUE CHAIN DYNAMICS

The firms in an industry create the dynamic elements described below through the choices they make in response to the value chain structure.

Upgrading—the investments made by firms to achieve higher levels of efficiency, increase product differentiation or reach new markets, resulting in greater benefits. Factors which facilitate this process include a clear market opportunity, a supportive enabling environment and the availability of critical services including finance, technology and information. Product development and improvements in production processes are integral to sustained competitiveness through enabling firms to meet the market's constant demand for innovation.

Value chain governance—describes who in a value chain has the ability to define the terms and conditions of transactions. There are four types of governance relationships in value chains:

- *Market-based:* enterprises deal with each other in arms-length, price-based transactions
- *Balanced:* enterprises cooperate and have complementary competences
- *Directed:* the lead firm sets the parameters under which others in the chain operate
- *Hierarchy:* enterprises are vertically integrated; the parent company controls its subsidiaries

The various types of governance may be appropriate for a chain at different times. Each type has benefits and limitations. Understanding governance is important for identifying where in a chain to intervene.

Power exercised by firms in their relationships with each other—this shapes the incentives that drive behavior and determines which firms benefit from participation in an industry and by how much. While governance describes *who* has power, it does not describe *how* that power is wielded. Relationships can range from benevolent or mutually beneficial to predatory. In any given industry, relationships can cover the full range, and these relationships can alter depending on shifting market demands or changes in the business enabling environment. Power in value chains typically translates into benefits. The firms able to wield power through branding or access to worldwide suppliers and those traders in a chain able to control information can often exact a larger share of benefits from producers and suppliers.

Inter-firm cooperation and competition—the extent to which firms work together to achieve increased industry competitiveness and greater benefits while simultaneously competing for supply and market share. Industry competitiveness strategies will vary greatly depending upon the levels of inter-firm cooperation and competition. Where cooperation is limited—such as in emerging industries, transitional economies and those with weak or hostile business enabling environments—strategies will tend to focus on short-term, high-impact activities that create incentives for participants to increase cooperation. Where limited inter-firm competition constrains innovation, strategies are likely to assist individual firms to realize the benefits of upgrading.

Transfer of information and learning between firms—this is key to competitiveness since upgrading is dependent on knowledge of what the market requires and the potential returns on investments in upgrading. Learning and innovation are closely related to the incentives that encourage or discourage the delivery and absorption of new knowledge or skills, and the types of mechanisms that are in place to affect their transfer. The most competitive industries are those that institutionalize learning mechanisms.

These and other dynamic elements—such as the power of end markets and exogenous changes that shape the business and enabling environment—are interrelated and can exert a recursive influence on the structure of the value chain.

VALUE CHAIN OUTCOMES

The dynamic elements of the value chain all play a role in determining value chain performance, which is measured in terms of the two critical outcomes of value chain competitiveness and MSE benefits. These two outcomes are interdependent in MSE-dominated value chains: if the chain is not competitive, MSE benefits will erode over time; and without sufficient benefits, MSEs will lack incentives to change behavior patterns and take on new risks—which are essential to the maintenance of competitiveness.

Value chain benefits are not restricted to higher returns. They include more dependable or timely returns, reduced risk, the increased value of assets and opportunities for learning. Firms in a value chain that have more power typically receive the greatest benefits from business transactions. Understanding the power dynamics in value chains can point to interventions that improve the benefits to MSEs in competitive value chains.

ISSUES AND LESSONS LEARNED

Research and field experience provide many lessons learned in addition to a plethora of issues yet to be resolved. The following is a small sample:

Information from end market buyers has enormous power to drive change. Direct communication from end market buyers to producers—for example, through face-to-face meetings or via recorded interviews—can be a powerful tool in helping producers to understand the implications of competitiveness. >>*Interview end market buyers as part of the value chain analysis and prioritize end market information when designing strategies to increase competitiveness.*

In globalized markets, industry-level competitiveness is as important as firm-level competitiveness. Value chains consist of individual firms that invest in the upgrading that is essential for sustained competitiveness. Nevertheless, a focus on firm-level issues may address the consequences rather than the underlying causes of poor performance, resulting in limited impact on the industry. >>*When interviewing stakeholders seek to understand the reasons behind constraints. Use the value chain framework to organize firm-level issues to prioritize intervention strategies and identify shared constraints that may indicate systemic issues.*

Understanding and fostering incentives is critical to firms investing in upgrading. Firms upgrade in response to incentives, either positive—the expectation of higher risk-adjusted returns, for example; or negative—such as the imminent loss of an end market. >>*Identify incentives for upgrading during the value chain analysis. Ensure that interventions do not diminish firms' incentives to upgrade or to offer services to other firms to enable them to upgrade.*

Learning and innovation are essential for sustaining competitiveness. In the globalized economy, firms need to innovate constantly to meet changes in demand and to respond to the competition. In some chains, MSEs learn primarily from buyers, who transmit information about consumer preference to producers. In other chains, input suppliers are the main sources of innovation. Regardless of how it takes place, learning—which requires access to information—is crucial. >>*Identify sources of learning and ensure that intervention strategies to improve and sustain value chain and MSE competitiveness strengthen learning mechanisms.*

Inter-firm relationships and the ability to capture benefits are linked. The tension between inter-firm cooperation and competition can be influenced by programmatic interventions: by bringing firms together to identify common constraints and opportunities, they can be motivated to collaborate. Similarly, by assisting firms to upgrade, the distribution of market share can be shifted in such a way as to increase competition. >>*Assess the levels of inter-firm cooperation and competition and the resultant impact on value chain competitiveness and incorporate this analysis into the design of intervention strategies.*

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[i] The volume of world trade increased by 20 times from 1997 to 1999.
[ii] Ravaillon, Martin. "Competing Concepts of Inequality in the Globalization Debate." World Bank Policy Research Working Paper 3243. March 2004.

Please send comments and suggestions on this brief to Jeanne Downing (jdowning@usaid.gov) and/or Ruth Campbell (RCampbell@acdivoca.org).

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