BRIEFING PAPER

TRANSFORMING INTER-FIRM RELATIONSHIPS TO INCREASE COMPETITIVENESS

INTRODUCTION

Emphasis on the role of inter-firm relationships in achieving and sustaining competitivness is a defining characteristic of the value chain approach. Most enterprise development work in the past has focused on tangible solutions to overcome production and marketing constraints, such as technological innovations, the provision of financial services and reform of the policy environment. The value chain approach emphasizes a dynamic that has long been recognized: effective inter-firm relationships are critical to industry competitiveness. The value chain approach provides a framework and tools for analyzing these relationships, as well as best practices for intervening in relationships to improve competitiveness and the benefits that micro- and small enterprises (MSEs) are able to capture.

TYPES OF RELATIONSHIPS

Since the value chain approach focuses on the role of inter-firm relationships in facilitating or hampering inclusive industry competitiveness (competitiveness that enhances MSE benefits), it is logical to categorize relationships in terms of their relation to two extremes: *supportive* of inclusive industry competitiveness or *adversarial* to it.

Figure 1: Categorizing Inter-firm Relationships

Supportive Relationships

Relationships that support industry competitiveness occur horizontally (between similar kinds of firms), vertically (between buyers and sellers in a value chain), and between value chain actors and other stakeholders (such as service providers or relevant government bodies). Supportive relationships typically have the following characteristics:

- *mutually beneficial*—all firms in a relationship recognize that they reap benefits as a result that more than compensate for the costs involved in establishing and maintaining the relationship
- *recurrent and substantial*—firms relate repeatedly over time, exchanging information, skills and services in addition to product and money; in contrast to brief, isolated interactions that facilitate only simple commercial transactions
- *voluntary*—supportive relationships are entered into freely from a motive of self-interest, without social or government pressure; and social, political or economic power is not used to establish relationship terms that are detrimental to the other party

SOCIAL RELATIONSHIPS

Social relationships are based on ties to family and friends that are not easily broken even if they result in financial losses. In contrast, strictly commercial relationships are formed for a specific economic purpose and can be severed if they fail to serve that purpose. Socially based relationships apply social pressure to force behavioral conformity. While this can be a positive factor—prohibiting opportunistic behavior, for example—social relationships can be detrimental to value chain development since there is no inherent convergence with economic self-interest. The degree to which industry actors make distinctions between socially and commercially driven relationships is a critical factor in determining if the industry will be able to reach beyond kinship networks to integrate into more distant markets and include large numbers of MSEs.

Adversarial Relationships

While supportive inter-firm relationships are based on a long-term view of the industry, adversarial relationships are structured to maximize short-term profits. Horizontal relationships dominated by self-interest rather than driven by common objectives often exhibit free-rider problems or invite corruption—as many failed cooperative development programs can attest.

Vertical relationships are generally inequitable: In most industries, buyers are more powerful than suppliers and are therefore able to reap greater benefits from an adversarial relationship. Various factors may facilitate such relationships. For example, where switching costs are low, buyers can exploit producers with impunity, knowing that there are other suppliers from whom they can purchase. Similarly, when there are only a few buyers (monopsony) the potential exists for collusion to maintain inequitable transaction terms and conditions.

BENEFITS OF SUPPORTIVE RELATIONSHIPS

Supportive relationships contribute to industry competitiveness in a number of ways. In particular, they facilitate collaboration; enable the transmission of information, skills and services; and provide incentives for upgrading.

The Ability to Respond to Market Demand

The ability of a value chain to respond to market demand is facilitated or hampered by the nature of relationships between actors in the chain. Firms must cooperate to aggregate product, achieve economies of scale, address shared constraints and market or lobby effectively. Further, sustaining competitiveness requires the capacity to respond to changes in the market. This response, in turn, is dependent upon sharing information, cooperation and trust between parties.

A Vehicle for Learning

AMAP research[1] has shown that most learning that helps MSEs increase production efficiency or product quality occurs through:

- *buyers*—buyers need to satisfy the demands of their clients and so may have an incentive to help MSEs reduce costs and increase product quality by providing embedded services; MSEs are often more responsive to upgrading initiated by buyers because it may translate into increased sales
- *suppliers*—if input suppliers see MSEs as a potential client base they have an incentive to invest in their relationships with them
- *peers*—family members, neighbors, association members and competing MSEs are common sources of learning through deliberate information sharing or as a result of observation and imitation

Research suggests that relatively little learning comes through stand-alone, fee-based service providers.

Incentives for Upgrading

Various types of benefits—income, secure markets, access to learning and social benefits—create incentives for upgrading. Relationships that promote a performance-based distribution of benefits provide firms with an incentive to invest in upgrading, increasing the competitiveness of the whole chain. Conversely, relationships that concentrate benefits in the hands of a few firms within an industry or that result in unpredictable benefits limit incentives for upgrading and threaten long-term competitiveness.

WHY FIRMS ESTABLISH ADVERSARIAL RELATIONSHIPS

With such clear benefits arising from supportive relationships, why do so many firms continue to establish adversarial relationships? In every business community there are unscrupulous actors who prioritize quick profits over long-term returns. However, a number of factors influence the attractiveness of adversarial relationships, as discussed below.

The Moral Economy

The *moral economy* is defined as the way people conduct themselves in market relationships to benefit the actors involved and the market economy as a whole. The moral economy is comprised of commercial culture and organizational norms and systems, and the way these play out through relationships. Some business cultures are more permissive than others, with adversarial relationships being viewed as an acceptable way of doing business.

Conflict

Conflict exists in any market system—and can produce a competitive force to drive innovation. But conflict along ethnic, religious, class or political lines can cause a proliferation of adversarial relationships, reducing industry competitiveness. Violent conflict can transform industries as infrastructure is destroyed, assets lost, actors displaced or killed, and market linkages severed. Instability and desperation can lead to short-term thinking, and mistrust may be pervasive and/or focused around conflict fault lines. Consequently, conflict-affected environments

[1] See for example Dunn, E., et al. Lessons Learned on MSE Upgrading in Value Chains: A Synthesis Paper. microREPORT 71 USAID 2006

are often characterized by opportunistic behavior and prioritization of immediate benefits over long-term relationships.[2]

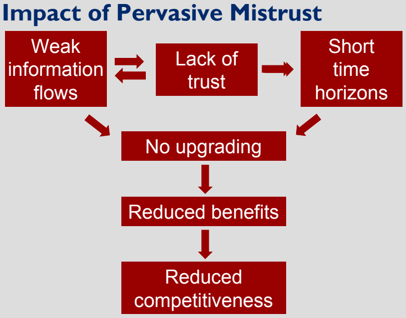
Disenabling or Shifting Business Environment

When the business environment lacks transparency or otherwise fosters corruption, or when systems are not in place to monitor and enforce agreements, firms offer lower returns to suppliers to off-set risk and are less likely to invest in supportive relationships. Similarly, economic, social or political shifts—especially those that undermine traditional structures—can create inequities of knowledge and power, leading to increased mistrust, risk and the incidence of adversarial relationships. These upheavals need not be unhealthy, but can include increased democratization, trade liberalization, economic development programs and the like.

THE EFFECTS OF MISTRUST

Value chains in environments of pervasive mistrust are often characterized by truncated marketing systems, lacking forward linkages to value-adding facilities and backwards linkages to input suppliers. This eliminates opportunities for embedded services and financing, as well as channels for demand-driven market information. In such situations, information is often not shared, restricting learning and reducing transparency—further fuelling mistrust. In the absence of learning about market demand, innovations and technologies there are little or no incentives or opportunities for upgrading. Upgrading is further discounted by the short time horizons for investment returns that often predominate in environments of pervasive mistrust. Without upgrading, there is limited potential for increased benefits and industry competitiveness is compromised (see figure 2).

Figure 2: Impact of Pervasive Mistrust



[2] For more on the impact of conflict, see Saperstein, A. and R. Campbell. Accelerating the Transition from Conflict to Sustainable Growth: Value Chain Development in Conflict-Affected Environments—A Literature Review. microREPORT 111 USAID 2008

The goal of transforming relationships is to break the negative cycle described in the text box above by changing the behavior of value chain actors. Emerging best practices in effecting this change are described below.

EMERGING BEST PRACTICES IN TRANSFORMING RELATIONSHIPS

Strengthen multiple types of inter-firm relationships. Strengthening supportive relationships i) among MSEs and ii) between MSEs and input suppliers or service providers can serve to counter-balance adversarial relationships with buyers. Strengthened horizontal relationships may enable MSEs to bypass intermediaries, create economies of scale and/or increase market power. Supportive relationships between MSEs and input suppliers can incorporate the delivery of embedded services and can provide MSEs with access to other market actors, including new buyers. In addition, relationships between MSEs and multiple buyers can reduce risk.

Convince stakeholders that "win-lose" strategies will ultimately lead to "lose-lose" outcomes. This involves analyzing incentives, showing actors where they fit into the value chain as a whole and appealing to rational self-interest, recognizing that some actors may be deliberately pursuing win-lose strategies, looking for a quick profit and exit. There are, however, likely to be others with longer-term perspectives, whose rational self-interest can be used as a basis to challenge behavior. For example, in India, vegetable wholesalers are pursuing a price-based strategy, squeezing farmers' margins. Both producers and buyers regularly renege on contracts: Wholesalers buy at the local market when produce is available; farmers sell to the local market when the price there is higher. USAID is helping wholesalers and retailers to see that by differentiating themselves in the market through other means (higher quality, more variety, etc.), they can offer fairer prices to farmers, thereby creating a greater incentive to honor contracts.

Make benefits explicit and transparent. The benefits of entering into relationships must be clear to—and contribute to their business objectives of—the firms involved to ensure their commitment. Transparent pricing and clearly stated fees, explicit contracts and codes of conduct are just some of the ways to foster the transparency of benefit flows. In societies that have a strong tradition of using socially based relationships to conduct business, it may be equally important to ensure that the limits of new commercial relationships are clear. In such relationships, social benefits—such as consumer credit, lobbying of government representatives or assistance with health or education needs—can not be assumed.

Establish common standards. Predetermined quality standards that are measurable help engender trust. This is aided by tools such as weights and measures, reputable testing facilities and third-party certification services. Chili pepper growers in Malawi believed that they were being constantly cheated by traders who discounted previously negotiated prices at the point of sale for reasons of quality. Advice concerning chili grades received by end market buyers, combined with the introduction of moisture meters and the practice of testing product at a local laboratory enabled growers to understand the value of their product and to negotiate with buyers from a position of strength.

Build on existing trust. Trust related to ethnic or kinship grouping may already exist, facilitating sales into regional rather than national markets. For example, Somali migrant and refugee communities, particularly in Nairobi, maintain strong market linkages with Somalia, serving both as a source of goods unavailable in Somalia and as a market for traditional Somali food products, such as camel milk. Trust may also be built around existing market mechanisms. A project in the Philippines working in the sweet palm fruit value chain found that rural semi-processors were unwilling to deal directly with urban-based processors because of cultural differences and a feeling of intimidation. Rather than trying to eliminate the community-based market intermediaries, as had originally been intended, the project instead strengthened their capacity.

Introduce trusted intermediaries into a value chain. Sometimes potential intermediaries are not already active in a value chain but can be brought in to strengthen weak linkages. Women garment embroiderers in rural Pakistan were unable to interact with male input providers or buyers because of cultural rules regarding gender segregation. Building the capacity of female sales agents to better understand market demand (materials and designs) and to manage and train home-bound embroiderers has proved an effective strategy to increasing the competitiveness of this industry.

Introduce guarantees and risk-sharing mechanisms. A project in Zambia has assisted input providers to establish a contingency fund to cover defaults. The fund is financed through an application fee paid when inputs are provided on credit. Similarly, the Development Credit Authority guarantee in Ethiopia has enabled coffee unions to access credit. The unions proved their creditworthiness and the bank increased its lending to the unions even without increases in the guarantee. Donor-funded interventions can also provide a "safe" neutral space for actors to meet to resolve issues and exchange information—which can be an effective means of building trust.

SUSTAINABILITY

All interventions to foster supportive relationships must be designed and implemented with sustainability in mind. Generally this means facilitating the establishment or strengthening of relationships rather than becoming an intermediary or guarantor.

Look for small, "riskable" steps with clear benefits. Quick, easily-implemented activities that demonstrate value can provide a platform on which to further build relationships. For example, a lead firm may provide a half-day training to supplier communities to address quality concerns, leading to less rejected produce and therefore reduced costs and increased income. Such activities can help to build trust and a common sense of purpose, and can contribute to the shift from adversarial to more supportive relationships.

Facilitate changes that make MSEs more attractive to buyers, input suppliers and service providers. By lowering transaction costs or increasing the quality and consistent delivery of products, MSEs can make themselves more attractive to buyers and suppliers and encourage investment in longer-term relationships. This in turn can increase MSEs' confidence and help them to move beyond thinking in adversarial terms. Initiatives that increase MSEs' value to buyers and suppliers include the development of associations, product improvement or branding, and facilitating alternative financing.

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