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BRIEFING PAPER

STRENGTHENING VERTICAL LINKAGES

INTRODUCTION

Value chains are made up of vertically and horizontally linked firms that must cooperate to get a product from inception to the final consumer. Through buying and selling relationships, vertically linked firms engage in "market and non-market interactions while performing different functions (i.e., operating at different levels) in the value chain."[1] In addition to buying and selling, vertical linkages represent conduits for the transfer of learning, information and technical, financial and business services from one firm to another along the chain. These non-financial transactions are important elements of buyer-seller relationships and are central to sustained value chain competitiveness.

Micro and small enterprises (MSEs) are vertically linked to a varied range of market actors including wholesalers, retailers, exporters, traders, middlemen, input dealers, suppliers, service providers, and others. The nature of vertical linkages—including the volume and quality of information and services disseminated—often defines and determines the benefit distribution along the chain and creates incentives for, or constrains, firm-level upgrading, defined as "innovation to increase value added."[2] Moreover, the efficiency of the transactions between vertically linked firms in a value chain affects the competitiveness of the entire industry.

In many value chains, more powerful actors have the resources and influence to define and impose the parameters of commercial transactions in their supply chain.[3] These actors are known as 'lead' firms. They set product and process standards across the value chain and act as coordinators and/or integrators of the value chain. The control that lead firms wield may be based on ownership of well-established brand names, proprietary technology, monopolistic or oligopolistic power, or exclusive information about different product markets. Lead firms can exert substantial influence and, more often than not, drive the upgrading decisions and create incentives and punitive systems for firms lower in the value chain. Lead firms can catalyze changes in a value chain by ensuring that knowledge and information move down the chain. In some instances, however, a clear lead firm is missing and other vertically or horizontally linked actors become the sources for the flow of goods, information and services through the chain.

CHARACTERISTICS OF EFFECTIVE VERTICAL LINKAGES

In many value chains, there is a gap between what end markets want and what MSEs produce due to a "win-lose" mentality or lack of trust between vertically linked firms. As a result, the flow of information between consumers and producers is blocked. Such inefficient vertical relationships negatively affect the competitiveness of the value chain and can prevent MSEs from effectively meeting market demand. Mutually beneficial vertical linkages, on the other hand, facilitate a smooth transmission of information from end markets to small producers.

> The ability of a firm within an industry to supply its buyers with a product or service that meets all the buyer's requirements depends on the ability of the value chain to deliver information, skills, resources and benefits to all participants in the chain.

Effective vertical linkages are generally characterized by:

- **Mutually beneficial relationships.** Symbiotic relationships that benefit all of the actors in a value chain are a major trait of effective vertical linkages. In such a scenario, various market actors focus on their own core competencies and through collaborative action realize synergies that improve the competitiveness of the entire chain. Trust, long-

[1] Dunn, E. (2005) "AMAP Knowledge and Practice Task Order Lexicon." MicroNote #6. USAID
[2] Dunn, E. (2007) "MSE Upgrading in Value Chains" Briefing Paper. USAID
[3] Altenburg, T. (2007) "Donor Approaches to Supporting Pro-Poor Value Chains." Donor Committee on Small Enterprise Development

term joint vision, and mutual respect usually form the foundations for developing such relationships.

- **Knowledge transfer.** Upgrading of production processes, technology, equipment, management systems, etc. is critical for the survival and growth of firms in a competitive marketplace. It is often difficult for small firms to access information about global best practices. Effective vertical linkages facilitate the transfer of knowledge between firms and create the incentives and knowledge platforms required for effective upgrading of MSEs. Prompt information transfers and transparency between vertically linked firms help a value chain respond effectively to changes in market demand.

- **Quality standards.** Well-defined, widely understood, and constantly upgraded quality standards are another defining element of effective vertical linkages. Vertically linked firms are proactive, not reactive: Large firms empower and help small firms to understand and adopt the quality standards to meet market demand.

- **Embedded services.** The frequent provision of high-quality embedded services typifies effective vertical linkages. Lead firms can provide a wide range of embedded services to affiliated suppliers and buyers to ensure consistent quality of end products and services. These embedded services are often seen as an integral part of business transactions and considered a necessary cost of doing business.

- **Financial flows.** Effective vertical linkages are often accompanied by a high volume and variety of financial flows. Larger firms may employ a variety of financial instruments (supplier credit, working capital loan, leasing services, etc.) to support the operations of their linked suppliers.

The nature of the vertical relationship between buyers and sellers is typically varied and dynamic and affected by end market requirements, the business enabling environment, product attributes, technology, socio-economic conditions and competitive pressures.

RECOMMENDED GOOD PRACTICES

Market and social forces on their own may lead to the emergence of effective vertical linkages over time. However, development projects often play the role of facilitator and catalyst to transform or strengthen vertical linkages in order to increase value chain competitiveness and ensure a greater distribution of benefits to smaller firms. Some recommended good practices to enable the development of win-win relationships are given below.

1. Understand the imperative for behavior change. The underlying rationale for inducing change should be clearly understood by project proponents before designing any intervention. In some cases, vertical linkages are already established and functioning well; interventions in such cases might risk damaging the existing relationships rather than strengthening them. A detailed objective analysis of existing vertical linkages and commercial and social relationships between firms should be conducted and the imperatives for change, if any, should be clearly understood. Once the nature of incentive and punitive systems is clear, strategies for MSEs upgrading and mechanisms for increasing the flow of benefits to MSEs can be developed.

2. Identify leverage points in vertical chains. Development interventions are often targeted directly at the MSE level to ensure benefits to this segment of the value chain. Some of the most effective interventions, however, are those that focus on a broader range of actors in the chain. Appropriate leverage points and players that can facilitate a greater flow of benefits to the MSEs should be identified during the design phase. Targeting interventions at these leverage points will often yield much more favorable and sustainable outcomes than focusing solely on the MSEs level.

3. Identify catalytic firms. In any given value chain, a large range of actors—input suppliers, traders, middlemen, retailers, etc.—are typically engaged in commercial transactions with MSEs. Some of those actors have a supportive attitude towards MSEs and recognize incentives to expand the breadth and depth of embedded services. These actors can act as catalysts to enable MSEs to upgrade and become more competitive.

4. Understand relationships. Commercial as well as social relationships constitute the foundation of vertical linkages. The implications of these relationships on program interventions should be clearly understood before intervening and continuously analyzed during the course of an intervention. New relationships are not easy to form and sustain. At the same time, old relationships are intertwined with the economic and social fabric of an industry and may take a long time to alter. All relationships are essentially dynamic and in a process of perpetual change. Donor projects should understand the dynamics of these relationships, and the potential trade-offs and conflicts between social and commercial incentives, in order to facilitate changes that lead to increased benefits for MSEs.

5. Foster trust. Trust is an integral element of vertical linkages. It may take years to build trust, and a single mistaken transaction may be enough to break it. Donor projects should be patient when they try to foster new vertical linkages since it will take time to build confidence and mutual trust between MSEs and catalytic or lead firms. Clear lines of communication, understanding of the roles and responsibilities of different parties, and a commitment to fulfilling the terms of agreements are vital for building trust. Donor projects should invest in trust-building activities that lead to increased confidence and openness between market actors.

6. Demonstrate that collaboration is preferable to confrontation. Before creating new vertical linkages in the value chain, the possibility of collaborative action through existing vertical links should be explored since bypassing existing vertical linkages can be a risky strategy. Often even a very small collaborative initiative that yields a tangible benefit can create an opportunity to change confrontational or inefficient vertical linkages.

7. Understand the role of traders and middlemen. Traders and middlemen often represent very important market access and information links and conduits for MSEs. Development practitioners and MSEs, however, often have a negative perception of these market intermediaries. Donor projects should try to avoid falling into the trap of stereotyping middlemen and traders as exploiters since their relationship with MSEs may be mutually beneficial. Contextual understanding of the functions that traders or other middlemen perform in a given value chain can be critical to project success.

8. Clarify the value addition of donor projects. The purpose and value of a donor project and its activities should be clearly understood and communicated to all stakeholders. Donors should avoid intervening in a value chain if there is no clear value to be added by doing so since this is likely to lead to market distortion and a disruption of existing vertical links. Projects should analyze their core competencies and restrict their role to facilitation activities. In particular, projects should resist the common temptation to insert themselves into vertical linkages and assume responsibility for conducting or guaranteeing market functions in order to achieve quick results. Such direct involvement in the value chain is inherently unsustainable and could damage the chain's competitiveness. It also puts the project at risk of being held responsible should there be transaction failures.

LESSONS FROM THE FIELD

Forging and sustaining effective vertical linkages is a challenging endeavor. The presence of vertical links does not automatically lead to increased benefits to MSEs, since such linkages could have both predatory and symbiotic elements. Vertical linkages can, however, be configured to ensure a maximum flow of benefits to MSEs while facilitating improved value chain competitiveness. The following examples from the field contain lessons about developing mutually beneficial vertical linkages and the types of benefits that can result.

- **Lead firms can sometimes drive change in value chains more quickly and effectively than outside catalysts.** Mars Inc., has had a significant impact on cocoa value chain, cocoa sustainability and smallholder cocoa farmers in a number of countries. In Indonesia, Mars has been working through the SUCCESS Alliance and Prima project to improve cocoa farming techniques for thousands of smallholder cocoa farmers.

- **A lead firm may have the incentives to provide embedded services to MSEs to ensure a consistent supply, higher quality and greater control over production.** The USAID-funded GMED project in India worked with the new retail venture of a lead firm (ITC Ltd.) to integrate smallholder vegetable farmers into ITC's fresh produce supply chains. ITC developed an integrated system to deliver a wide range of embedded services to vegetable farmers to ensure a consistent supply of high-quality vegetables. ITC provided agriculture extension services, improved varieties, better seedlings, soil and water testing facilities, access to market information services and access to tools and equipment for improving farmer productivity.

- **Suppliers of goods and services can be an important leverage point for increasing benefits to MSEs and the entire supply chain**. The Strengthening Micro, Small and Medium Enterprises in Cambodia project worked with a large number of feed and medicine suppliers in the swine value chain. The project assisted these suppliers to enhance the depth and breadth of their embedded services to swine producers. Increased embedded technical assistance regarding various aspects of pig breeding, survival and feed boosted the number and marketability of downstream producers' animals, with a consequent increase in demand for the suppliers' products.

- **Local traders or other intermediaries can be used to improve value chain efficiency and transparency.** The Chiapas coffee project in Mexico tried to assist producer cooperatives to export directly to Starbucks. When this proved unsuccessful, it introduced a local trading company, AMSA, into the value chain to provide export services to the cooperatives. Using AMSA for export functions had a positive result for the farmers, leading to increased transactional efficiency, reduced rejection risk, and increased returns. By delegating the trading functions to the trader, the cooperatives were able to focus on fewer core functions.

- **Trust is a major factor in the relationship between different firms, but it takes time to develop**. The Kenya BDS project developed new vertical linkages between avocado producers and five exporters. The new relationships helped increase the supply of export-quality avocados and improve access to markets for smallholder avocado producers. The project also created four new market-linkage firms that linked avocado farmers with exporters and oil processors. An impact assessment of the project revealed that as new entrants in the chain, the market-linkage firms faced challenges in establishing themselves as trustworthy service providers, constraining their future growth.

- **Win-win relationships in which value chain actors engage in behaviors that lead to mutual improvement in productivity and the adoption of innovation are fundamental to long-term competitiveness**. Centro de Desarrollo de Agronegocios (CDA), an agribusiness project in Honduras, convinced firms in a market relationship to behave in ways that served not only their self interest but also that of the firms with which they transacted. The project demonstrated that by improving the flow of goods, services, and information, capacity and quality of growers could be improved which, in turn, led to greater benefits to exporters, processors, and market intermediaries. By demonstrating to firms that long-term win-win relationships would lead to improvements for all, CDA was successful in developing incentives that furthered competitiveness.

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