



**AMAP BDS K&P  
COMPONENT A:  
CLIENTS AND MARKETS**

**RESEARCH HYPOTHESES**

**Intervention-Based Approach to Research Hypotheses**

The Component A research hypotheses are designed to improve our understanding of how firm owners in value chains respond to the interaction of governance, expected returns, transaction costs, social capital, and risk. There are two groups of hypotheses, both of which should generate useful information for designing effective program interventions. The first group of hypotheses focuses on interventions that will help to create win-win relationships between firms in value chains. The second group of hypotheses focuses on improving the incentives for MSE owners to upgrade their businesses and enhance their contributions to the productivity of the value chain.

**A. Enhancing Inter-firm Cooperation and Coordination**

*Objective: Understand the constraints and barriers to improved inter-firm cooperation and coordination, including the effects of governance, in order to design interventions that create win-win relationships between firms in value chains.*

**Vertical Relationships**

**A.1. Risk in vertical relationships can be reduced by strengthening governance.**

Hypothesis A.1. The risk to each firm that the counterpart firm in a vertical relationship will fail to meet its agreements (i.e., the risk of commitment failure) can be reduced by strengthening governance through alternative means, including

- a. the development of linking social capital,
- b. the development of stronger network types of (firm-on-firm) governance,
- c. increasing the formality of contracts, and
- d. strengthening the legal enforcement of contracts.

**A.2. Trust in vertical relationships can be increased by improving information.**

Hypothesis A.2. Trust between firms in vertical relationships can be increased by improving the information that firms have about each other in several ways, including

- a. building information over time about the trustworthiness of counterpart firms by taking a series of increasingly larger “riskable steps”,
- b. increasing the amount of face-to-face interaction between counterpart firms,
- c. increasing transparency about the distribution of rents in the value chain, and
- d. increasing transparency about the risks faced by firms in the value chain.

**A.3. Lead firms will be more willing to form vertical relationships with MSEs if the transaction costs can be reduced.**

Hypothesis A.3. Transaction costs are a major constraint to lead firms forming vertical relationships with MSEs, but the transaction costs that lead firms incur in working with large numbers of dispersed MSEs (i.e., the costs of communication, knowledge sharing, contract management, production coordination, etc.) can be reduced through the use of

- a. commercial intermediation (i.e., private intermediaries who efficiently manage transaction costs and are reimbursed by receiving a share of the rents),
- b. alternative institutional and/or organizational arrangements that coordinate activities between MSEs, and
- c. cost-effective information and communication technology (ICT).

**Horizontal Relationships**

**A.4. MSE owners will be more willing to form horizontal relationships if the transaction costs can be reduced.**

Hypothesis A.4. Transaction costs, especially the opportunity cost of time, are a major constraint to MSE owners forming horizontal relationships. There are several ways that these transaction costs can be reduced or justified, including

- a. using alternative organizational structures,
- b. using cost-effective information and communication technology (ICT),
- c. opening new, profitable market opportunities (i.e., the increased revenue from the new market opportunity outweighs the costs of forming new horizontal relationships), and
- d. providing entry to competitive environments that value innovation over price.

**A.5. Trust in horizontal relationships can be increased through organizational innovation and improvements in human capital.**

Hypothesis A.6. Lack of trust is a critical barrier to the formation of horizontal relationships between MSEs, and this lack of trust is based on prior experiences with fraudulent and opportunistic behavior on the part of leaders and other group members (i.e., lack of trust is rational). Trust in horizontal relationships can be improved by reducing the scope for opportunistic and fraudulent behavior in several ways, including

- a. using organizational innovations that limit the power of leaders (e.g., rotating group leadership, sharing decisions, increasing availability of information to group members),
- b. formalizing record keeping,
- c. providing training in leadership and group management skills, and

- d. increasing the human capital of all group members so that leadership does not always fall to a few individuals (i.e., increasing literacy, numeracy, language skills, market knowledge).

**A.6. Social capital plays an important role in the successful formation of horizontal relationships between MSEs.**

Hypothesis A.5. Social capital can have both positive and negative effects on the formation of horizontal relationships between MSEs:

- a. in-born social capital reduces the transaction costs of forming horizontal relationships because firm owners are more likely to trust each other and less likely to behave opportunistically;
- b. high levels of bonding social capital can create barriers to investments in acquired forms of capital, including both bridging social capital and physical capital.

**B. Encouraging Business Upgrading Among MSEs**

*Objective: Understand the constraints and barriers to MSE upgrading, in order to design interventions that encourage higher levels of upgrading among MSEs and make them more effective partners in the value chain.*

**B.1. MSE owners base their upgrading decisions on their assessment of the expected returns and risks to upgrading.**

Hypothesis B.1. MSE owners make their upgrading decisions based on their beliefs about future net returns (profits). Because future net returns are uncertain, MSE owners must consider both the estimated level of expected returns and the range (variability) of possible future net returns:

- a. MSE owners who compete in undifferentiated product markets are less likely to upgrade their businesses than those working in differentiated product markets, because expected returns to upgrading in differentiated product markets are higher. (due to higher increases in revenue)
- b. MSE owners will be less willing to upgrade if it requires them to invest in assets that have a high degree of asset specificity and they lack credible assurances of repeated future transactions, because expected returns are lower. (due to high investment costs combined with the risks of low future revenues)
- c. MSE owners with lower household incomes and assets will be less willing to upgrade than MSE owners from wealthier households if the range of possible future net returns includes negative net returns.
- d. Even when expected returns are high and range of possible net returns are all positive, MSE owners with lower incomes and assets may still decide not to upgrade if they lack investment capital (i.e., they cannot afford to make current investments in upgrading in order to generate higher returns in the future).

**B.2. Upgrading can be encouraged by strengthening the linkages between firms.**

Hypothesis B.2. Vertical and horizontal linkages between firms help to improve the expected returns and lower the risks to upgrading:

- a. MSE owners who are willing and able to invest in acquired social capital (networking) will be more likely to upgrade their businesses than owners who are unwilling and/or unable to invest in acquired social capital.
- b. MSE owners who are linked to lead firms through network types of governance structures are more likely to invest in upgrading than MSE owners linked to lead firms through market governance structure.
- c. MSE owners will be more willing to upgrade if they observe successful examples of upgrading among MSE owners with whom they share bonding social capital.

**B.3. Lack of information is a critical barrier to MSE upgrading.**

Hypothesis B.3. MSE owners in developing countries often lack the information that would allow them to understand the possible advantages to upgrading:

- a. Many MSE owners lack basic awareness about the opportunities that exist for upgrading their businesses.
- b. MSE owners who are aware of upgrading opportunities often underestimate the expected returns to upgrading because they lack the information they need to calculate expected returns accurately.
- c. MSE owners consider transaction costs, especially the costs of the time they would need to spend gathering information about new opportunities, to be a major obstacle to upgrading their businesses.