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BRIEFING PAPER

KEY ELEMENTS OF THE VALUE CHAIN APPROACH

WHY USE THE VALUE CHAIN APPROACH?

Many people talk about the "value chain approach" but interpretations of what this approach entails—the principles upon which it is based and how these principles are applied through analysis, project design and implementation—vary. Moreover, donors and their implementing partners have different motivations for drawing upon the approach.

This paper outlines some of the key features of the value chain approach as articulated and promoted by USAID's Microenterprise Development office (USAID/MD). USAID/MD applies the approach to drive economic growth with poverty reduction through the integration of large numbers of micro- and small enterprises (MSEs) into increasingly competitive value chains.[1] By influencing the structures, systems and relationships that define the value chain, USAID helps MSEs to improve (or *upgrade*) their products and processes,[2] and thereby contribute to and benefit from the chain's competitiveness. Through this approach USAID enables MSEs—including small-scale farmers—to create wealth and escape poverty.

The value chain approach has distinctive features in terms of both i) the scope used in analyzing an industry (addressed in the following section: "What is the Value Chain Approach?"), and ii) the tangible and non-tangible considerations used in designing and implementing interventions ("How is the Value Chain Approach Implemented?"). The features discussed in this paper are not necessarily unique to the value chain approach; but few, if any, other economic development approaches simultaneously emphasize all of these features:

- A market system perspective
- A focus on end markets
- Understanding the role of value chain governance
- Recognition of the importance of relationships
- Facilitating changes in firm behavior
- Transforming relationships
- Targeting leverage points
- Empowering the private sector

WHAT IS THE VALUE CHAIN APPROACH?

A Market System Perspective

Taking a value chain approach necessitates understanding a market system in its totality: the firms that operate within an industry—from input suppliers to end market buyers; the support markets that provide technical, business and financial services to the industry; and the business environment in which the industry operates. Such a broad scope for industry analysis is needed because the principal constraints to competitiveness may lie within any part of this market system or the environment in which it operates. While it may be beyond the capacity or outside the mandate of a donor or implementing agency to address certain constraints, the failure to recognize and incorporate the implications of the full range of constraints will generally lead to limited, short-term impact or even counter-productive results.

The decision of *where* to intervene in a value chain should be primarily driven by the end goal of sustainable economic growth with poverty reduction. Interventions that target a particular part of a value chain (e.g., processing) or group of beneficiaries (e.g., small-scale producers) must therefore be designed and implemented:

i) within the context, and with an understanding, of the value chain as a whole; and

[1] For a description of the framework which underpins this approach, and definitions of basic terms, see "The Value Chain Framework" Briefing Paper www.microlinks.org/ev.php?ID=21629_201&ID2=DO_Topic

[2] For a discussion of upgrading and its relevance to MSEs, see "MSE Upgrading in Value Chains" Briefing Paper www.microlinks.org/ev_en.php?ID=17737_201&ID2=DO_TOPIC

ii) with an explicit focus on benefits to MSEs.[3]

A Focus on End Markets

The end markets into which a product or service is sold—whether local, regional or international—provide the opportunities and set the parameters for economic growth. Generally there are multiple actual and potential end markets, each with different demand characteristics and returns. It is therefore important to *segment* the market: list each of the potential end markets, what is required to compete in them, and what benefits and risks can be expected by selling into them. Since end markets are dynamic, the identification of trends should complement information about the current situation.

By *benchmarking* key attributes (e.g., quality, price, reliability of supply, flexibility, time from order to delivery) against competitors, industry stakeholders can see where they have a competitive advantage and where they need to upgrade in order to compete. The information needed for benchmarking can often be obtained through simple interviews with end-market buyers; secondary information alone is generally insufficient.

Buyers can often also provide information on market trends. Using market-trend information, together with information about the capacity and constraints within the value chain and its environment, industry stakeholders can develop a strategy to *position* themselves in the market: competing through a combination of price, quality and innovation. To sustain end-market competitiveness, this strategy will have to be continually revised in response to changes in the end markets, in the enabling environment or within the chain itself.[4] Additionally, inter-firm relationships need to be such that firms are able and willing to act cooperatively in response to new threats and opportunities in the end market over time.

Understanding the Role of Value Chain Governance

Value chain governance is a concept that is fundamental to the value chain approach. Governance describes which firms within a value chain set and enforce the parameters under which others in the chain operate. Embedded in governance are inter-firm relationships, power dynamics—both symmetrical and asymmetrical—and the distribution of benefits. While the form of value chain governance is influenced by the characteristics of the product and the degree of specification in the end market, governance patterns evolve over time with changes in markets, products and inter-firm relationships.

Increasing the competitiveness of a value chain typically requires an emphasis on consistent product quality, traceability and on-time delivery. These changes, in turn, often require a different relationship between buyers and sellers to exert the control needed to meet the demands of higher value markets. Importantly, governance patterns also affect the ability of in-country supply chains to integrate into global markets. Where there are no systems for introducing global standards, national value chains are excluded from global opportunities. Without knowledgeable and resourced lead firms providing information on end market demand and services to facilitate upgrading, in some cases, it is impossible for a value chain to become or remain competitive. Thus, value chain governance is a level of organization that facilitates or hinders upgrading and the ability to respond to market changes, especially in global markets.

Recognition of the Importance of Relationships

The quality of relationships between different stakeholders is a key factor affecting the functioning of a value chain. Strong, mutually beneficial relationships between firms facilitate the transfer of information, skills and services—all of which are essential to upgrading. Value chain opportunities and constraints generally require a coordinated response by multiple firms in the chain—which necessitates trust and a willingness to collaborate. The value chain approach therefore emphasizes a dynamic that has long been

FACTORS INFLUENCING RELATIONSHIPS

The nature of relationships is defined by a number of factors, including:

- supply and demand market dynamics;
- the degree of control needed during production and processing to meet market requirements;
- the capacity of producers
- the need for support services and the capacity of service providers; and
- socio-economic and cultural factors.

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[3] For an explanation of the relevance of MSEs to poverty reduction, see “The Value Chain Framework” Briefing Paper www.microlinks.org/ev.php?ID=21629_201&ID2=DO_Topic

4 For more information on this topic, see “Using the Value Chain Approach to Design a Competitiveness Strategy” Briefing Paper www.microlinks.org/ev_en.php?ID=23640_201&ID2=DO_TOPIC

recognized: Social capital (networks of relationships and social institutions) are critical to business and competitiveness.

In contrast to much enterprise development work in the past, the value chain approach seeks to do more than solve specific identified production and marketing problems. Directly solving problems may create some initial momentum, but building internal capacity to address value chain constraints will empower stakeholders, reduce dependency and ensure sustainability of investment impacts. The focus of the value chain approach is therefore on transforming relationships—particularly between firms linked vertically in the value chain—to:

i) facilitate upgrading to *become* competitive, and
ii) adapt to changes in end markets, in the enabling environment or within the chain to *remain* competitive.

HOW IS THE VALUE CHAIN APPROACH IMPLEMENTED?

Facilitating Changes in Firm Behavior

Implementers of the value chain approach aim to set in motion a process of continual upgrading among the actors in a value chain without themselves becoming a part of the chain. Direct interference in the value chain typically threatens sustainability, drives service providers into the donor market, and isolates MSEs from market-based actors. By contrast, the value chain approach seeks to facilitate changes in firm behavior that increase the competitiveness of the chain and generate wealth for all participating firms, thereby contributing to economic growth with poverty reduction.

Changing firm behavior requires an understanding of the *incentives* of the various stakeholders—why they behave in the way they do, and what is needed to motivate them to change their behavior. Implementers of the value chain approach identify firms within the industry with the incentives, ability and willingness to address constraints and facilitate upgrading throughout the chain. They then work to assist such *catalytic firms* to understand the potential advantages for themselves of intervening to increase the competitiveness of the chain.

To ensure facilitation activities are leading to the intended changes in behavior, value chain development projects need to establish a knowledge-based management system that actively monitors behavioral change and questions the continued appropriateness of project activities. This process of monitoring and redesigning activities will be ongoing since market dynamics and inter-firm relationships are constantly changing.

When incentives or resources do not exist within the industry, or are inadequate to relieve a constraint or drive the upgrading needed for increased competitiveness, an explicit exit strategy should be developed for project interventions. Interventions may be designed to:

i) *demonstrate the potential* of an upgrading initiative;
ii) *reduce the risk* to firms investing in upgrading; or
iii) accelerate the *scaling up* of an upgrading initiative.

Once the purpose of the project intervention has been achieved, the direct involvement of the project in the value chain should cease.

Transforming Relationships

By making the benefits of *win-win* relationships explicit to stakeholders, some firms can be encouraged to change the way they relate to others. However, sometimes conflicting incentives and high levels of mistrust diminish the effectiveness of such simple appeals to self-interest. Other strategies to improving the quality of relationships include:

- using trusted intermediaries;
- establishing standards and increasing transparency;
- shifting the balance of power within the chain (see text box); and
- employing risk-sharing mechanisms.

SHIFTING THE BALANCE OF POWER

Activities that can shift the balance of power include:

- forming associations;
- product branding;
- alternative financing mechanisms;
- strengthening support markets;
- diversifying supply or markets; and
- changing the basis of competition (from price-based to quality, value-added or niche marketing).

Value chain development projects operating in environments characterized by high levels of mistrust may need to start with small initiatives that create quick and visible impact to help actors recognize the benefits of collaboration.

Targeting Leverage Points

Value chain project implementers target *points of leverage* that have a multiplier effect on interventions in order to , maximize impact and outreach. Points of leverage include the following:

- Economic structures—product or service aggregation points and actors with the ability to influence large numbers of stakeholders (e.g., lead firms, traders, input suppliers).
- Social structures—respected community members, chiefs and elders who are able to influence others to collaborate or to adopt new techniques, technologies, services or inputs.
- Commercial incentives—competition and/or firm strategies that can be used to pressure buyers, traders and others to change predatory or abusive behavior.
- Social incentives and norms—social factors that influence decision-making, particularly at the MSE level.

Empowering the Private Sector

The goal of the value chain approach is to enable private-sector stakeholders to act on their own behalf: to upgrade their firms and collectively create a competitive value chain that contributes to economic growth with poverty reduction. If sufficient leadership exists within a value chain, project implementers can provide stakeholders with the information they need to develop and take ownership of a strategy to compete in particular markets. At a minimum, stakeholders need to buy into the competitiveness strategy, taking responsibility for and committing their own resources to completing necessary upgrading activities, and recognizing the need at some level to collaborate—as well as compete—with other firms in the value chain.

The value chain analysis and strategy development process is therefore participatory to the extent possible. Information on the chain is gathered from industry stakeholders and key informants, synthesized, analyzed and presented back to the actors in the chain for ground-truthing. Stakeholders are assisted to understand the information and its implications for the industry.

To encourage stakeholders to invest strategically, implementers of the value chain approach look first at the *opportunities* in the end market, and then consider the *constraints* to exploiting these opportunities. While information about constraints originates primarily with *firms*, the focus of value chain analysis is on the performance of the *chain* as a whole since individual firms can not succeed over the long term if the value chain in which they operate is uncompetitive.

Throughout this process, the role of the donor and implementing partner is to facilitate and support implementation of the competitiveness strategy by the private sector in such a way that ensures that development objectives—economic growth, poverty reduction and other concerns such as sustainable natural resource management—are also met.

HOW APPLICABLE ARE THE PRINCIPLES OF THE VALUE CHAIN APPROACH?

The value chain approach is comprehensive, with an extensive set of tools and best practices. This approach is not appropriate for every development project or in all country contexts. Prerequisites for taking a value chain approach include a minimum level of good governance and stability in the enabling environment, the existence of at least some market activity (even with low-value products or exclusively local markets), and a project goal of economic recovery, growth or poverty reduction.

Nevertheless, there are important aspects of the value chain approach that can be applied to any private sector development project, as well as to other kinds of projects, including those focusing on post-conflict livelihoods and private sector-driven environment or health projects. In particular, these aspects include the need for a thorough understanding of end-market dynamics and consideration of the business enabling environment. Without analysis of these two aspects of the value chain framework, project impact is likely to be limited and unsustainable.

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