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# TRADE, MICRO AND SMALL ENTERPRISES, AND GLOBAL VALUE CHAINS

AMAP BUSINESS DEVELOPMENT SERVICES (BDS) KNOWLEDGE AND PRACTICE (K&P)  
RESEARCH TASK ORDER

FEBRUARY 2005

This publication was produced for review by the United States Agency for International Development. It was prepared by Lara Goldmark and Ted Barber for Development Alternatives, Inc.



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The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

The logo for Development Alternatives, Inc. (DAI) features the letters "DAI" in a bold, serif font. Above the "I" is a stylized graphic consisting of a horizontal line that curves upwards and then loops back down, resembling a swirl or a stylized "e".  
Development *Alternatives*, Inc.



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## ACRONYMS AND ABBREVIATIONS

ATC	Agreement on Textile and Clothing
BDS	business development services
CDA	Centro de Desarrollo de Agronegocios (Agribusiness Development Center-Honduras)
DAI	Development Alternatives, Inc.
FTA	free trade agreement
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)
ICT	information and communications technology
IDB	Inter-American Development Bank
ILO	International Labour Organization
ISO	International Organization for Standardization
JOBS	Job Opportunities and Business Support (Bangladesh)
LDC	least-developed country
M&E	monitoring and evaluation
MFI	microfinance institution
MSE	micro and small enterprise
MSME	micro, small, and medium-sized enterprise
NGO	nongovernmental organization
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
SEPA	The Support for Export of Artisan Products (Mali)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
USAID	U.S. Agency for International Development
WTO	World Trade Organization

## FOREWORD

This paper was written as part of the Accelerated Microenterprise Advancement Project (AMAP) Business Development Services Knowledge and Practice (BDS-K&P) research initiative. The AMAP-BDS project's major objective is "integrating micro and small enterprises into productive value chains to create wealth in poor communities."

The research draws on experience and insights from three distinct areas:

- The U.S. Agency for International Development's experiences with development programming in the areas of trade promotion and small enterprise development;
- The writings of a global research community that has studied enterprise development, clusters, and, most recently, value chains; and
- Business practices—some new, others as old as time.

The paper's objective is to provide readers with a compelling rationale for implementing trade-related projects that help integrate micro and small enterprises into global value chains and to highlight some effective strategies to do so. The strategies discussed in this paper are expected to help development projects better contribute to broad-based economic growth associated with deeper linkages and an increased capacity on the part of developing countries to both respond to and benefit from trade opportunities.

Research for this paper was conducted over a period of six months. The authors carried out a broad literature review and consulted with leading researchers and practitioners in the field through a series of expert opinion interviews, as well as drawing from their own experience in business and development. The paper benefited greatly from the intellectual guidance of Jeanne Downing and Michael Field, as well as the work of other research teams under the BDS K&P project. Useful input included the expert opinion interviews conducted for the agribusiness paper (forthcoming), a database of donor programs compiled for the review of programs (Snodgrass, et al., 2004), and preliminary field research carried out in Guatemala by researcher Elizabeth Dunn. Contributors to the paper included Ulrich Ernst, Vicki Tsiliopolous, Linda Nemece, Andrea Chartock, and Matthew Rees. The experts kind enough to share their time with us included Doug Anderson, Cliff Barton, Charlie Bell, Jill Donahue, Jeanne Downing, John Ellis, Michael Field, Bill Grant, Richard Hatch, Olaf Kula, Juan Llisterri, Reid Lohr, Frank Lusby, Lance Marston, Cressida McKean, Maggie Meyer, Edward Millard, Cuan Opperman, Glenn Patterson, Santiago Sedaca, Hubert Schmitz, Don Snodgrass, and Jim Winkler. Olaf Kula, Santiago Sedaca, Rich Magnani, and Steve Parker also contributed valuable comments to an earlier draft.

## EXECUTIVE SUMMARY

Increasing trade volumes in developing countries may result in economic growth, but do not necessarily result in poverty reduction. This paper argues that development programs can promote broad-based growth if trade promotion initiatives are designed to be inclusive of small firms. Micro and small enterprises (MSEs) employ the majority of the low-income population in most developing countries, and in many cases these firms already participate in international supply chains.

Small firms in developing countries are increasingly affected by **global trends** such as the use of private international standards by supermarkets, the elimination of the quotas under the World Trade Organization's Agreement on Textiles and Clothing, and production opportunities that arise as multinational firms outsource the production function to an extended supply chain. While there are risks that in some markets small players may be squeezed out, there are clearly opportunities for small firms to increase their participation in a number of sectors.

Small firms offer a number of potential advantages as partners in value chains, often serving as a flexible and low-cost production resource, offering proximity to markets and access to land and other key resources, providing a storyline for companies and consumers interested in social responsibility, and supplying unique products. There are, however, persistent obstacles to be overcome when doing business with small firms, such as high transactions costs and limited production capacity.

Four **critical success factors** can enable small firms to compete in global markets: a business-friendly enabling environment, strong inter-firm linkages (vertical and horizontal), opportunities and support for upgrading, and dynamic supporting markets for products and services like finance, business services, inputs, and information and communications technologies. Examples from commercial, donor, and academic case studies illustrate how these factors can be leveraged to contribute to MSE growth and competitiveness.

The focus on opportunities and threats to MSE participation in value chains, as well as the identification of four critical success factors, is part of an **analytical lens**—meant to illuminate the rapidly evolving business systems in which small firms operate today. This lens suggests that development programs should support the implementation of competitive strategies not only for geographic clusters and individual firms but for entire industries. In today's markets, globalization calls for systemic competitiveness since industries in one country must compete with industries in other competing countries. Globalization has thus shifted the locus of competitiveness to the entire chain or industry, which must be able to get a product or service to consumers at a price, quality, or uniqueness that out-competes its rivals.

The changing types of programs supported by the U.S. Agency for International Development (USAID) during the 1980s and 1990s and in the new millennium reflect lessons learned as well as the changing global environment for trade. The experience from current development programs that have successfully included MSEs in trade-led growth—distilled into 15 lessons learned about intervening in global markets and six intervention guidelines—may interest USAID program designers and implementers.



# 1. INTERNATIONAL TRADE, ECONOMIC DEVELOPMENT, AND MSEs

Development programs can promote broad-based growth if trade promotion initiatives are designed to be inclusive of small firms. Micro and small enterprises (MSEs)<sup>1</sup> employ the majority of the low-income population in most developing countries, and in many cases these firms already participate in international supply chains. This chapter discusses how the globalization of trade brings new opportunities—as well as potential threats—to firms in the MSE size range.

## 1.1 GLOBALIZATION AND THE DISTRIBUTION OF BENEFITS

The past 15 years have seen dramatic changes in the global production system and market structure. Falling trade barriers, decreasing transportation and communications costs, and the adoption of new technologies have both created opportunities and leveled the playing field so that competition is a worldwide phenomenon. Bilateral and regional initiatives—free trade agreements (FTAs), regional integration agreements, or association agreements—will also continue to open up trade between major markets and partners in the developing world, as well as to integrate regional markets in Asia, Africa, and Latin America.

On the whole, developing countries are involved more than ever in international trade, supplying about one-third of the world's exports. There are, however, some disturbing trends. First, while the overall proportion of trade originating in developing countries has grown enormously, China, the Asian newly industrializing countries, and a few oil-producing states account for the lion's share of this total.<sup>2</sup> The 49 least-developed countries (LDCs) account for just 2 percent of developing-country exports and 0.5 percent of global exports.<sup>3</sup> Evidence suggests that LDCs' disproportionately small share of trade benefits is attributable to a number of factors that include dependence on primary commodities, conflicts, poor governance, domestic trade policies, macroeconomic instability, and obstacles and inequities in the world trading system.<sup>4</sup>

Second, even when trade liberalization results in growth at the national level, benefits may not be distributed equally. While debate continues about the relationship between economic growth, poverty, and inequality, the balance of evidence points toward the conclusion that inequality is harmful to growth.<sup>5</sup> Some recent research has focused on the role that MSEs can play in boosting productivity and more equally distributing the benefits of globalization.

MSEs comprise the majority of businesses throughout the world and are active in nearly every economic sector—including manufacturing and agriculture—that exports into international markets. They are the principal source of income and employment for hundreds of millions of people in developing countries. In a recent issue of its *Economic Perspectives* journal, the U.S. Department of State notes that firms of five or fewer employees account for half of the nonfarm workforce in Latin America and more than 65 percent of the nonfarm workforce in Africa. In Asia as a whole, micro, small, and medium-sized enterprises (MSMEs) account for more than 90 percent of all firms outside of the agricultural sector (and typically more within) and generate a significant proportion of export earnings.

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<sup>1</sup> For clarity, this paper follows USAID's guidelines that define microenterprises as having 10 or fewer employees and small enterprises as having up to 20 employees. The authors are concerned with growth-oriented businesses rather than economic activities operating on a subsistence level.

<sup>2</sup> USAID, 2003: 5.

<sup>3</sup> *Ibid.*: 6.

<sup>4</sup> Newfarmer, 2004.

<sup>5</sup> BIDE/DAI, 2002: 5.

A recent study (Ernst, 2003b) examined the case for looking at micro and small enterprises as a source of growth. Ernst based his conclusions on the well-accepted premise that innovation leads to increases in productivity and forms the core of competitiveness. He observed that in today's business systems, innovation is increasingly a product of network or relational learning through vertical linkages in the value chain—with suppliers and customers—as well as lateral linkages with competitors. Intense participation in value chains and collaboration among small competitors can open up new technology and management options, and may offset the advantages that larger firms derive from economies of scale.

## 1.2 GLOBAL SOURCING, STANDARDS, AND COMPETITION

The supermarket phenomenon in developing countries and the evolution of the textile industry are two examples that demonstrate the global nature of production networks today, and the way that both the larger context (such as trade agreements) and specific value chain dynamics (such as the implementation of standards by private buyers) are critical to understanding the actual and potential contribution of MSEs in a given sector.

### 1.2.1 SUPERMARKETS

Led by trade liberalization and an increasing demand for processed foods, developing countries in Asia, Latin America, Africa, and Eastern Europe have all witnessed the growth of multinational supermarket and fast-food chains over the past five to 10 years. In many regions, these retailers have penetrated well beyond the urban, middle-class markets to serve lower-income markets as well.<sup>6</sup> Typically as much as 60 percent of a developing country's food retailing is likely to be controlled by supermarkets,<sup>7</sup> which in fruits and vegetables may represent more than two or three times the volume of national exports.<sup>8</sup>

#### Box 1

"Even if they don't get sued locally, if a child dies from DDT on a tomato in Guadalajara, Mexico, the supermarket that sold it to him will take a billion dollar hit worldwide through immediate communication of the problem."

Source: Reardon, 2004.

As global food retailers try to develop efficient and standardized procurement systems and become increasingly concerned with their worldwide reputations, there has been a rising convergence of food grades and standards around the world (see Box 1). Although food retailers are legally obligated to respect local public standards, in many developing countries these standards may be considered insufficient. Therefore, supermarkets gradually work to impose international standards on their local suppliers.

In all sectors, there are winners and losers from the process of imposing international standards in developing country value chains. A lucky few meet the standards, acquire formal certifications, and realize increases in revenue and opportunities. The majority find themselves relegated to waning and unprofitable markets.<sup>9</sup> In the 1990s, trade liberalization in Brazil led to an influx of global dairy products firms such as Parmalat, Royal Numico, and Nestlé. Lead processors imposed new private standards in quality and safety for local milk producers, including refrigeration at the farm and during transport as well as monitoring of microbiological content. This required investments by farmers, truckers, and receiving plants that often exceeded their technical training and financial resources. The result has been the exclusion of thousands of dairy farms in the past decade, leading many small farmers to withdraw into informal markets in more isolated regions. As global retailers penetrate more deeply and take the place of

<sup>6</sup> Reardon, 2004.

<sup>7</sup> Ibid. As opposed to about 80 percent in the U.S. market.

<sup>8</sup> Ibid. Statistics cited were for Latin America as whole, China, and Kenya.

<sup>9</sup> Reardon and Farina, 2004.

local food markets, and as the Brazilian government moves to enforce stricter public standards for dairy products,<sup>10</sup> these small dairy producers will soon have to make the choice between upgrading their production or closing down.

On the other hand, where developing country producers demonstrate the ability to upgrade and expand, certification can provide an entry ticket to new markets and result in rapid growth. In 2001, three small melon exporters in Brazil's Northeast region succeeded in joining the preferred provider list for the French supermarket chain Carrefour. Over the next three years, they graduated from providing melons to a few supermarkets in their region to 67 hypermarkets throughout the country, and then to stores in the 21 countries where Carrefour operates.<sup>11</sup>

### 1.2.2 TEXTILES

The textile and apparel sectors provide another example of significant changes in global business. These value chains are dominated by large retailers, brand-name merchandisers, and trading companies based mostly in developed countries and characterized by decentralized production networks. Shielded from competition for more than three decades by quotas, these sectors have provided many developing countries with a point of entry into export-oriented industrialization.

However, the elimination of quotas under the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ATC), coupled with China's accession to the WTO, is expected to produce major shifts in the textile and apparel production systems. Industry analysts expect buyers to source principally from large low-cost countries like India and China, leaving countries like Egypt, Pakistan, and Bangladesh, where textile and apparel revenues have constituted between 25 and 60 percent of overall manufacturing exports and contribute significantly to national income and employment, in a difficult situation. Opportunities for cut, make, and trim operations, the mainstay of MSE participation in the sector, are likely to be reduced.

#### Box 2

"Companies have outsourced more and more of their operations. The things that they used to make—what most people on the street think a company make—well, they don't make it. They may put it together, and they certainly market it, but they don't make it."

Source: As cited in Neef, 2004: 73.

### 1.2.3 HOW BUSINESS IS ORGANIZED TODAY

Led by multinationals, global producers are becoming global buyers and coordinators, concentrating their efforts on branding and marketing rather than production. The effect on global trade is apparent: trade in components is growing more quickly than trade in final products, and now accounts for an estimated 30 percent of world trade in all manufactured goods.<sup>12</sup> In this new order, the production function is outsourced to an extended supply chain—which for large companies includes hundreds of subcontractors in multiple countries.<sup>13</sup> In developing countries, these subcontractors may in turn outsource to small business units operating outside the factory system.<sup>14</sup> (See Box 2.) These trends offer new opportunities for micro and small enterprises that link into global value chains, but also carry new risks as large intermediaries wield market power and enforce quality and efficiency standards.

<sup>10</sup> In Brazil, as in many developing countries, the government regulatory agencies are now engaged in a game of "catch-up"—developing stricter public standards based on what the leading private firms have already implemented in their value chains.

<sup>11</sup> Reardon, 2004.

<sup>12</sup> Yeats, 2001. Cited by Slaughter, 2004: 16.

<sup>13</sup> Neef, 2004: 38.

<sup>14</sup> In some cases the supply chain extends all the way down to home-based workers. Carr and Chen, 2003. As cited in ILO, 2004: 33.

There are some opportunities, however, that tend to favor MSEs; particularly when labor-intensive harvesting or production processes are required, products are made for niche markets or face seasonal or rapidly changing demand, and goods and services are not easily sourced, transported, or sold from central locations. Well-known examples include specialty foods like high-value coffee, organic produce, fresh fruits and vegetables, and nuts as well as home and fashion accessories like handmade paper, clothing and jewelry, leather goods, and furniture. Often in such cases, creative solutions must be found for additional obstacles—such as high transactions costs, commitment failure risk, and regulatory disincentives—before market leaders willingly source from small firms.

### 1.3 OPPORTUNITIES AND THREATS TO MSE PARTICIPATION IN GLOBAL VALUE CHAINS

Integration into the global economy means participation in one or more global value chains by linking local networks to their international counterparts and vice versa. As the supermarket case illustrates, the local segment of the value chain must meet world competitive standards with respect to quality and price. Further, the competitive performance of lead firms, or buyers, in global markets depends ultimately on the performance of the entire value chain, a criterion captured by the concept of value chain productivity, or “systemic efficiency.”

The productivity, or efficiency, of a value chain is primarily a function of how well each of the participants performs, both upstream (providers of inputs such as raw materials, product components, and services) and downstream (distributors, shippers, and retailers). If there are weak links anywhere along the chain—such as a lack of access to inputs, unreliable transport, or a processing glitch—all of the businesses in the chain will be affected. When buyers trace production problems back to the source, they may find that small suppliers are directly responsible, or they may find that the breakdown occurs in some intermediate link that prevents small suppliers from participating effectively. If commercial solutions are found for such key value chain constraints, the benefits can ripple through the entire chain, from the largest participants all the way down to the smallest MSEs.

The most commonly encountered opportunities and threats to MSE participation in global value chains are presented below. It is important to note that threats (constraints) are viewed *from the perspective of the entire value chain* rather than through the eyes of the firm. The opportunities represent the raw elements of MSE competitive advantage, which successful development programs can build on; the threats represent the challenges these interventions must work to mitigate.

#### 1.3.1 OPPORTUNITIES

Small firms offer some potential advantages as partners in value chains, including:

#### Box 3

##### MSE Suppliers in Manufacturing Networks

Gold Star Audio (GSA) is a part of the Lucky Gold Star conglomerate, the third largest in Korea with interests in a number of sectors. As a manufacturer of electronic consumer goods, GSA restructured its production organization with an emphasis on downsizing to enhance efficiency and sustain its competitiveness. Between 1992 and 1994, GSA's production lines were reduced from 37 to 8 and the workforce was halved, while productivity increased by 40 percent and exports rose to 75 percent of output. This was achieved through extensive subcontracting to local firms and subsidiary units in lower-wage economies (Philippines and China). GSA's new production organization, which hinges on inter-firm production networks, includes MSEs and homeworkers as subcontractors. The majority of GSA's own employees are now involved in what they term “indirect production,” which includes supervising contracts, material procurement, and inter-firm cooperation.

Source: Nadvi, 1995: 61.

- **Flexible production resource.** In industries that face seasonal demand such as garments, apparel and footwear, subcontracting with MSEs allows large firms to increase their production capacity without making significant investments in additional plant and equipment. The ease with which MSEs can enter and exit the value chain makes subcontracting a flexible, low-overhead strategy for lead firms. (See Box 3.)
- **Low-cost production.** For agricultural commodities whose production or handling is labor-intensive, or for labor-intensive manufactured consumer goods such as footwear and certain categories of textiles and housewares, MSEs can be a low-cost production alternative (see Box 4).
- **Proximity to markets.** Small firms often possess an advantage if they are physically close to or can easily establish relationships with the end consumers in a given value chain. In such cases, they may be recruited by large multinational firms as distribution partners or retailers (see Box 5).

#### Box 4

##### MSE Advantages in Agriculture

The countries of Sub-Saharan Africa have established a niche in fresh fruits and vegetables, with exports going primarily to the United Kingdom and Europe. Although stringent quality standards and other requirements imposed by buyers have excluded smallholders from some value chains, there are cases where small farmers may have an advantage. For example, green beans, Kenya's largest fresh vegetable export to the United Kingdom, are considered to be less amenable to capital-intensive, mechanized production due to labor-intensive requirements in both production and packing. Large farms require supervision of wage labor, whereas smallholders use family labor, which is both low-cost and self-supervising. For some crops, small plots and intercropping help to reduce problems associated with the spread of disease and wind damage. Smallholder sourcing can also be an effective response to problems of land scarcity, particularly in Zimbabwe where land is a politically sensitive issue.

*Source:* Adapted from Dolan and Humphrey, 2000.

#### Box 5

##### Telecom Distribution in Russia

In the mid-1990s, several U.S. original equipment manufacturers (OEMs) of telecommunications companies outsourced the work of finding, developing, and managing their sales channels in Eastern Europe and Russia to Capital Communications Corporation (CCC), a small company based in Herndon, Virginia.

Leveraging its contacts in Eastern Europe and the former Soviet Union, CCC built a network of MSME resellers and provided them with technical training and support, as well as assistance in managing a business, opening credit lines, and transitioning from gray market dealerships to formally registered businesses. CCC delivered these "embedded services" at no charge to the MSMEs because it was profitable to do so. The more resellers that were successfully distributing the products, the greater the market share CCC owned and the more return it received on its investment. With the same goal, the equipment manufacturers also provided MSMEs with training and technical support.

CCC's channels included systems integrators, value-added resellers, and straight distributors. The size of the channel partner ranged from three to 100 employees. The OEMs did not have the contacts, time, or patience to work with the myriad micro and small businesses, which typically require intensive hand-holding to learn how to prepare marketing materials, manage paperwork, and obtain a line of credit for purchasing inventory and demonstration equipment, but were happy to have CCC resell their channels to in-country MSMEs.

All of the MSMEs benefited from the training and technical assistance provided by the OEMs, and from the sales, administrative, and on-call engineering support provided by CCC. A number of the distributors climbed the value chain by adding services such as installation of equipment and local area networks, while others began producing their own cables and connectors. And several companies climbed to the top of the value chain to become large systems integrators. In turn, they then began to outsource some of the simpler tasks – production of cables and connectors—to smaller companies.

*Source:* Interview with Linda Nemec, DAI, April 28, 2004.

- **Access to land and other key resources.** In some countries, land ownership may be highly politicized and controversial. Small producers may be the de facto occupants of large tracts of land, a reality lead firms must address. Remote areas where rare forest products or tropical fruits can be found may be populated exclusively by small farmers or indigenous tribes.
- **Social responsibility.** Consumers are increasingly aware of and concerned about fair trade, safe working conditions, low environmental impact, and the preservation of small-scale producers and indigenous lifestyles. Products that support small enterprises may have a perceived higher value and carry a premium price. Examples of retailers that have pursued this strategy and developed upstream partnerships with small producers include Starbucks Coffee, Aveda, and The Gap.
- **Unique products.** This advantage is most commonly associated with the handicraft industry, which is dominated by MSEs. For decades, development initiatives have promoted the production of unique items associated with local culture, and an assortment of fair trade organizations and small boutique “art” shops have commercialized these products. Increasingly, as upscale retail markets in developed countries demand unique and “authentic” looking housewares, commercial interests are sourcing handicrafts in larger and larger quantities.

### 1.3.2 THREATS

Some persistent obstacles to involving MSEs in value chains include:

- **Transaction costs.** MSEs will only be desirable partners from the perspective of a large lead firm to the extent that they act in a coordinated fashion. It is simply too costly and time-consuming to work with numerous small suppliers. Importers prefer to communicate with one contact and receive a single set of documents meeting the agreed terms for the products or services ordered. Implied here are the many challenges involved in group formation and cooperation—whether they are formal and legalized, as is the case for many agricultural cooperatives, or informal and based on collaborative arrangements between firms. Another way that transaction costs can be reduced is through the use of an export agent. The Vietnam Competitiveness Initiative, a project implemented by Development Alternatives, Inc. (DAI), is currently working in collaboration with a private in-country agent who coordinates the production, delivery, and invoicing process for several dozen small producers at the village level who have obtained orders for ceramic products from a large California buyer.
- **Standards.** Nations, companies, and consumers are requiring greater compliance with an increasing number of safety, quality, environmental, and social standards. These tougher requirements present significant obstacles for small enterprises. One innovative project in Bangladesh, however, has found a way to transform this obstacle into an opportunity in the shrimp sector.<sup>15</sup> By using standards as the focal point for discussion, the project helped bring about two shifts among key participants in the value chain: buyers recognized that to obtain adequate volumes, they would have to work with small shrimpers—the majority of firms in the sector, and small shrimpers understood they were going to have to comply with certain standards and obtained the information they needed to begin doing so.
- **Capacity.** Even when individual MSEs can meet quality and other standards, they often cannot produce enough volume to be of interest to large buyers, and the scale at which they operate may be insufficient to run processing equipment at full capacity or justify new investments in needed

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<sup>15</sup> The authors gathered information on the Agro-Based Industries & Technology Development Project-II, implemented by Louis Berger International, through a variety of sources: Interview with Charlie Bell, March 30, 2004, and associated project documents; Economic Perspectives: Microenterprise: Laying the Foundation for Economic Development, Vol. 9-1, February 2004; Seal of Quality Program at [http://www.atdpsq.biz/SSOQ\\_Program.pdf](http://www.atdpsq.biz/SSOQ_Program.pdf); Xinhua General News Service, October 26, 2003 and October 30, 2003, and The Bangladesh Observer, March 28, 2004.

technology. In general, small firms need to be able to deliver larger quantities if they want to interest buyers serving external markets and operate on an efficient, production-line basis rather than performing piecework. In some instances, small enterprises are able to survive in the market by serving as a subcontracted resource for flexible production and highly specialized, niche products. In most cases, however, MSEs must be willing to work together to create sufficient aggregate capacity.

- **Value chain governance.** Governance is a term used in the value chain literature<sup>16</sup> to describe the various types of hierarchies, or systems of coordination, that exist in today's global production networks. Governance systems vary depending on the nature of firm-to-firm relationships, opportunities for learning, and the distribution of benefits—both economic and social—throughout the value chain. These systems tend to break down at the lower levels of supply chains where MSEs are most prevalent; for example, information on prices or standards may be unavailable. Middlemen may count on producers not knowing the dynamics of the market downstream and may negotiate for the lowest price possible regardless of quality. In such cases, producers have little incentive to improve quality, even if they know what is required.
- **Business environment.** MSE participation in value chains can be affected by a number of external variables related to the business environment. These include factors that impact the whole value chain, such as currency fluctuations, and conditions related to market infrastructure and transport (poor roads, port delays, and customs requirements), as well as specific barriers to market entry for small firms (such as business registration, licenses, and permits). In some cases, systemic flaws can actually create opportunities for MSEs. For example, in countries where there are high payroll taxes and it is difficult to hire and fire employees, large firms may get around inflexible labor laws by outsourcing instead of hiring their own workers.

#### 1.4 SUMMARY OF KEY MESSAGES

Ultimately, the developmental impact of trade will depend on the degree to which a large number of small firms, which employ the majority of the population, can be integrated into global value chains and accrue significant benefits from that participation.<sup>17</sup> Certainly if the smallest and poorest developing countries are to respond effectively to trade opportunities, interventions will need to contemplate the participation of large numbers of MSEs in a variety of sectors. Given the size and importance of the small enterprise sector, MSEs should be an explicit part of trade capacity-building strategies.

The evidence suggests that MSEs are already significant contributors to global value chains—most frequently as suppliers to larger firms participating in an export chain. In the case of foreign direct investment, MSEs may serve as distributors for larger operators looking to penetrate local retail markets.<sup>18</sup> While there are risks that in some markets small players may be squeezed out, there are opportunities for small firms to increase participation in other sectors under certain conditions. To take advantage of these opportunities, MSEs and the industries they participate in will need to upgrade, i.e., improve the quality and/or uniqueness of their products, improve the efficiency of their production techniques, perhaps take on new value-added activities and—where possible—utilize learning in one marketing channel to enter a new and more lucrative one.

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<sup>16</sup> Humphry and Schmitz, 2000; Gereffi, 2003; and Kaplinsky and Morris, 2001.

<sup>17</sup> Newfarmer, 2004.

<sup>18</sup> Estimates by the United Nations and World Resources Institute indicate that by 2015, the 1,300 largest cities in the world will account for some 1.5 billion to 2 billion people, roughly half of whom will be “base of the pyramid” consumers—a group that multinational corporations are increasingly interested in reaching. See Prahalad and Hammond, 2002.

Upgrading strategies—using a value chain lens—are explored in the following chapters. Creative donor interventions are showcased that identify problems or “weak links” as well as commercial solutions that produce benefits that ripple through the entire chain, benefiting lead firm and MSEs alike.

## 2. CRITICAL FACTORS FOR MSE PARTICIPATION IN GLOBAL MARKETS

Although MSEs possess innate advantages in certain sectors, there may be significant obstacles to including them in competitive value chains. The opportunities and threats highlighted in the previous chapter have been magnified by the globalization of trade. While trends like increased outsourcing and innovative use of information and communications technologies (ICTs) can create new opportunities, the growing concentration in ownership of buyer firms and the emergence of private international standards raise barriers to entry for small firms. Global competition is such that to survive, all firms must be part of a constant upgrading process. Only through linkages—with larger firms and with each other—can MSEs access the knowledge and resources necessary to compete. This chapter explores the *critical success factors* that can enable small firms to achieve their productive potential within global value chains.

The key ingredients that facilitate MSE participation in global and regional markets include the following:

- The **business enabling environment** refers to the myriad international, national, public, and private policies, regulations, and standards that—though most are developed for the purposes of transparency or to create a level playing field—frequently provide disincentives to small firms or their partners.
- **Inter-firm linkages** enable MSEs to compete at levels beyond the individual firm’s singular capacity. Linkages provide enterprises with access to the combined economic, political and market advantages of larger businesses. Such relationships provide individual MSEs with the capacity not only to enter new markets, but to compete in the global business system. *Horizontal* linkages develop most frequently between like firms, that is, a group of suppliers working together to deliver products for a large buyer. *Vertical* linkages may develop between large and small firms, for example between a large exporter and several local suppliers. The types of benefits from such relationships differ according to whether the business linkages are horizontal or vertical and according to how market power is exercised by different firms in the value chain. Examples of beneficial linkages show that firm-to-firm relationships can provide MSEs with rapid access to international markets. In some cases linkages can also help firms address constraints related to the policy environment.
- **Upgrading** is critical to firm competitiveness and must be a continuous process. Access to knowledge and resources needed for upgrading often comes initially through vertical or horizontal linkages. As value chains develop, supporting markets will offer a variety of services that firms can purchase or otherwise acquire to help them upgrade.
- **Supporting markets** for products and services like **finance, business services, inputs, and ICTs** can contribute to healthy enterprise growth and increased trade.

Examples drawn from commercial, donor, and academic case studies illustrate how these critical factors can be leveraged to contribute to MSE growth and competitiveness.

### 2.1 POLICY

Policy and regulatory issues are critical to allowing, encouraging, and supporting the participation of MSEs in trade. As McKean and Fox (1994) observed, the potential of proactive trade promotion can be negated by an inhospitable business environment. In addition, a number of studies have shown that micro and small enterprises suffer disproportionately from a flawed policy and regulatory environment.<sup>19</sup> The small enterprise sector tends to be severely impacted by currency volatility, as well as by administrative

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<sup>19</sup> Ernst, 2003b.

provisions such as tax, customs, and registration requirements that discriminate against MSEs.<sup>20</sup> Other key business environment issues that affect MSEs include transport and communications costs and the existence of mechanisms to enforce contracts and resolve disputes.

Donors tend to agree that severe weaknesses and rigidities in the policy and regulatory environment should be identified and addressed before or parallel to any intervention at the individual firm level. Enabling environment conditions relevant to successful trade promotion activities can be grouped into four levels:<sup>21</sup>

1. Macroeconomic policies: monetary and fiscal policies and the exchange rate.
2. Trade policy: import and export taxes, quotas and prohibitions, and compliance with the provisions of trade agreements, including WTO requirements.
3. Business environment: including procedural requirements for investment and export and sectoral policies that pose obstacles to exporting (such as transportation or communication monopolies, government ownership of manufacturing firms). Increasingly, these requirements are linked to international standards, governance structures, and/or rules imposed by multinational buyers on global chains.
4. Other internal barriers such as marketing boards, labor regulations, and underdeveloped service markets.

The first two levels include elements that usually need to be in place before an export and investment promotion effort can be successfully implemented. On the other hand, it is not only possible but may be desirable to work on improving levels three and four in parallel with market and firm-level interventions. Such an approach ensures that proposed reforms are directly relevant to private sector competitiveness in the near term and makes it likely that a vocal group will follow through to make sure the policy changes are effectively implemented.

When policy reform or improvements in market infrastructure are not feasible in the near term, innovative development projects have worked to find creative solutions to overcome obstacles. For example, a U.S. Agency for International Development (USAID)-funded project in Ghana helped found a company to consolidate small shipments of pineapples,<sup>22</sup> allowing Ghanaian producers to take advantage of spare capacity on refrigerated ships. Working together, the exporters were able to fill the minimum volume required per shipment. In Peru and Colombia, the Inter-American Development Bank is working to develop alternative conflict resolution mechanisms that will allow small firms to take greater risks, such as selling on credit to unknown buyers.<sup>23</sup>

Commercial relationships can also contribute to improving the policy environment for small firms. Individual MSEs, MSE associations, and their support agencies often lack the political voice and economic clout necessary to get the attention of policy makers or regulatory agencies. However, a smaller firm can immediately obtain a greater voice and advocate for a more nurturing trade environment by entering into partnerships with larger and more influential lead firms (see Box 6).

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<sup>20</sup> Smith, 2004: Chapter 5.

<sup>21</sup> These four categories are consistent with Fox and McKean, 1994.

<sup>22</sup> Stycker, et al., 2003.

<sup>23</sup> Interview with Juan Lllisteri, Inter-American Development Bank, March 10, 2004.

## Box 6

### Inter-Firm Cooperation Helps Resolve Regulatory Constraints for Smaller Players

A linkage between the Daewoo Corporation of Korea and Desh, a medium-sized Bangladeshi producer of garments, helped Desh address regulatory problems. Prior to 1980, Bangladeshi garment exports were negligible. Firms such as Desh operated under numerous constraints, in particular government restrictions and duties on the import of production materials. Desh was one of many local small and medium-sized enterprises that on its own lacked the ability to initiate dialogue with the government to advocate for a more favorable environment.

Daewoo brought to Bangladesh an intimate knowledge of such restrictions, having overcome nearly identical barriers to competitiveness in Korea. The solution in Korea, as it would be in Bangladesh, was to gain influence with the government and promote a Special Bonded Warehouse System, which provided duty-free and restriction-free imports of production inputs. Daewoo's intimate knowledge of Korea's bonded system, its ability to share that knowledge with Desh staff, and the advice that Desh's management could in turn provide to administration officials were instrumental in initiating the implementation of the warehouse system. With Daewoo's backing the two firms were able to accomplish what Desh alone could not.

Source: Adapted from Rhee and Belot, 1990: 2–14.

## 2.2 INTER-FIRM LINKAGES (HORIZONTAL)

Lead firms selling to export markets may be daunted by the thought of working with hundreds, perhaps thousands, of individual MSEs. In certain sectors, such as agriculture and fishing, such numerous relationships exist and prosper. For many companies, however, the prospect of working with a multitude of small suppliers immediately raises concerns about communication, management, quality, reliability, and transaction costs.

The question becomes how a lead firm can be made to realize that sourcing from MSEs can contribute to the growth and prosperity of its business. For the MSEs, this translates into how they can best present themselves as a valuable resource. One answer is through inter-firm cooperation—in this case, *horizontally* among themselves. If small firms operate individually, they offer few advantages to buyers except lower prices from competition with each other. As an organized group, however, MSEs work together to function more like larger businesses, and thus offer many of the advantages of a larger operation. Whether as cooperatives, associations, consortiums, producer groups, or other collaborative structures, the key is for them to cooperate. The advantages over operating individually are numerous and include:

- Improved market position with an increased production capacity, broader product offering, and more diversified skill set.
- Increased efficiencies through joint production, collaborative marketing, reduced transaction costs, and bulk purchases of raw materials and contracted services.
- Access to more technology and equipment through shared resources.
- Collective knowledge of markets, production standards, and customer requirements.
- Increased access to finance, business services, and transportation.
- Pooled creativity for developing innovative products and services.
- Reduced costs/risks for new product and service development.

- Ability to avoid oversupply and resulting decline in prices.
- Collective efforts to overcome shared obstacles.

Through inter-firm cooperation, capacity rises and transaction costs fall. MSEs become a more substantial and reliable resource that is more easily managed and, from a lead firm's perspective, a solid prospect for win-win subcontracting. As the reader will surely note, the practice of forming producer groups is widespread—although it can be very challenging to form sustainable and effective producer groups. Countless projects over the years have organized MSEs to upgrade their product/service offerings, improve their bargaining positions, and help them appear in markets as entities with which larger firms can transact. These efforts can take place at all levels of the chain. Horizontal linkages may emerge as a result of MSE collaboration, or they may be fostered by an outside party, as in the case of the Job Opportunities and Business Support (JOBS) project or as often occurs when lead firms organize suppliers into groups.<sup>24</sup>

The JOBS project in Bangladesh is one example of an intervention that has stimulated the development of sustainable producer groups. When the country's largest shoe exporter (APEX) needed to upgrade the technical capacity of its workforce, JOBS offered support. In addition to helping the firm hire and train new factory workers, program staff used the opportunity to recruit and train several flexible producer groups. When the first producer groups' trial shipments were accepted, JOBS staff recruited more. APEX has continued to source from these groups and now offers embedded services in exchange for the product, including raw materials, machinery, skills training, quality control, and technology services. JOBS moved on to link additional small producers to other shoe exporters, and has since taken this methodology and applied it successfully in several other sectors.<sup>25</sup>

Another interesting example of the effectiveness of horizontal linkages comes from an entrepreneur's association in Delhi, India:

The Okhla Flatted Factory Entrepreneur's Association consists of 200 small enterprises (5–8 persons) in a variety of manufacturing businesses such as electronics, metalworking, and plastics molding—a few in every conceivable field, all housed in a two-story building, none experiencing much commercial success. After months of internal discussions, these individual MSEs realized they needed to market the entire building as a one-stop manufacturing center. They produced a catalogue that, instead of listing each firm and its products, promoted only their capabilities. It presents the firms as a single factory capable of producing any product with all the required equipment, capacity, and expertise under one roof. For the first time, they were perceived as a supplier of interest and were able to talk to larger customers.<sup>26</sup>

There are many legal and organizational options available to institutionalize inter-firm cooperation, and an even greater variety of informal mechanisms that have been used. Perhaps more important than the mechanism per se is the principle that collaboration must be commercially grounded. Grouping arrangements will hold together only as long as there are clear incentives that reinforce mutually beneficial behavior.

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<sup>24</sup> Experience has shown that groups organized by an outside actor may find it more difficult to collaborate on new product development. Interview with Michael Field, March 9, 2004.

<sup>25</sup> Knopp, 2002; and JOBS, 2003a.

<sup>26</sup> Interview with Richard Hatch, March 16, 2004.

## 2.3 INTER-FIRM LINKAGES (VERTICAL)

Vertical linkages (the relationships between buyers and their suppliers) are critical to the long-term competitiveness of value chains, as well as to the inclusion of MSEs in those networks. These linkages are often the primary mechanism through which MSEs learn about changing market requirements. And it is through vertical linkages, in the form of subcontracting and other agreements, that value chain coordination or governance is established.

The practice of backward linkages (from buyer to seller) has existed for decades within the realms of business and economics. It encompasses a host of outsourcing, subcontracting, and joint production arrangements between larger and smaller firms. MSEs typically do not have the capability or resources to capitalize directly on global market opportunities. Nor can most development programs intervene on a consistent or broad enough basis to have a measurable impact. Instead, an effective way to integrate small firms into trade networks is to link them to larger firms as subcontractors. They can then supply a product, component, or service as one transaction in a series that leads to exports into regional and global markets. In other words, backward linkages plug a small firm into a global value chain while letting the larger firm tackle the challenges of responding to foreign markets and managing international trade.

This task of integrating MSEs into value chains encompasses a number of activities but largely translates into promoting them as valuable suppliers to larger firms. To survive, businesses must constantly adapt to customer demands and regularly grapple with a variety of production issues such as sufficient capacity, flexible and timely delivery, and high labor costs. Often a company cannot meet such demands and successfully compete for orders without significant investment in its own operation. But perceived risks or a lack of capital may prevent it from making that investment. With a substantially smaller investment, these firms can tap into the vast potential of MSE production.

The term backward linkages emphasizes that this process of integration should be approached from the demand side, starting with lead firms and linking back to the MSEs. A market study and value chain analysis help pinpoint opportunities for MSE products and services by first identifying lead firm opportunities and operational constraints as well as market gaps where potential lies for new production. This information then informs how and where MSEs can contribute to value chains as subcontractors. The idea is to expand the capacity, broaden the capability, increase the flexibility, and lower the costs of lead firms to enhance their competitiveness in international markets. Success is based on win-win commercial relationships, as in the following examples:

- A Korean electronics manufacturer increases exports and productivity by subcontracting production to small firms, including MSEs and homeworkers.<sup>27</sup>
- Brazilian and Bangladeshi shoe manufacturers subcontract tasks to microenterprises to increase capacity and reduce costs.<sup>28</sup>
- Azeri dairy processors raise production by purchasing milk from smallholder farmers.<sup>29</sup>
- Ghanaian exporters meet quality and production requirements through production contracts with MSE handicraft producer groups.<sup>30</sup>
- A Kenyan manufacturer of beekeeping equipment purchases honey from its MSE customers for processing, packaging, and distribution in regional markets.<sup>31</sup>

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<sup>27</sup> Nadvi, 1995: 61, 62.

<sup>28</sup> Ibid: 18.

<sup>29</sup> Barber, 2003: 13, 25.

<sup>30</sup> Lusby and Panlibuton, 2004.

Many development programs have begun to emphasize backward linkages as a way to increase value chain competitiveness by introducing new and flexible sources of MSE supply. In Honduras, the Agribusiness Development Center (Centro de Desarrollo de Agronegocios, CDA) implemented by Fintrac operates within numerous value chains to increase nontraditional agricultural exports through, among other strategies, backward linkages from more than 300 lead firms (exporters, processors, and pack houses) to producer groups.<sup>32</sup> USAID's South African International Business Linkages program seeks to create linkages between historically disadvantaged enterprises and local businesses, U.S.-based companies, and multinational corporations. Chemonics' Poverty Reduction and Alleviation project in Peru, Louis Berger Group's Growth with Equity in Mindanao project in the Philippines, and Chemonics' Investment in Development of Export Agriculture project in Uganda—all work to facilitate linkages among producers, buyers, and exporters.

A number of projects have been particularly successful in working directly with lead firms in developing countries. These lead firms (often exporters) serve as an entry point, or portal, through which donors can address specific problems that inhibit the participation of small suppliers in a value chain. Action for Enterprise's Support for Export of Artisan Products (SEPA) project in Mali focused its efforts on exporters as a strategy to assist MSE producer groups. The key lies in recognizing the importance of developing sustainable bonds between the lead firms and the MSEs so that the linkages are not dependent on further outside assistance. Sustainability is dependent upon the linkages providing ongoing benefits to both parties.

Vertical linkages between local MSEs and established international lead firms can prove invaluable to small businesses wishing to enter global value chains. The relationship acts as a catalyst<sup>33</sup> and can provide the lesser player with a complete package of export market prerequisites (policy, upgrading, financing, and technology)—requirements that MSEs often do not know about or are not equipped to provide themselves. Linkages with export firms not only grant MSEs immediate access to foreign markets, the packaging of services also enables small firms to make a comparatively rapid ascent to a level of competitiveness necessary to succeed.

## 2.4 UPGRADING

In the context of integrating MSEs into global value chains, there are three relevant types of upgrading: (1) product upgrading, especially to meet the quality and safety standards necessary for export; (2) process upgrading, that is, increasing efficiency; and (3) functional upgrading or “moving up the value chain,” for example, performing branding, marketing, and exporting functions directly, as opposed to, or in addition to, doing piecework for lead firms.

Successful upgrading requires both industry-specific knowledge and a sophisticated understanding of evolving demand trends. Often the actor best positioned to acquire and transmit such knowledge is an intermediary with links to both developing-country producers and end-country buyers. For MSEs, these intermediaries serve not only as their immediate customer, but also as a vital source of information about global markets,

### Box 7

Upgrading is the process of innovating to increase value-added. Firms that upgrade may improve their processes, products, or functions, or move to new sectors. Upgrading often involves a change in mindset and improvements in skills.

<sup>31</sup> Jiwa, 2002.

<sup>32</sup> Per expert opinion interview with Andy Medicott, Fintrac/CDA Director; and the Fintrac Field Program Description-Honduras at [http://www.fintrac.com/p\\_honduras.asp](http://www.fintrac.com/p_honduras.asp).

<sup>33</sup> Rhee and Belot (1990) coined the term catalyst, meaning a firm or agency that serves as creator and transmitter of the supply response.

particularly in terms of what type of upgrading is necessary to participate in international trade. Often, buyers are willing to cover the costs of transmitting design information or offering production training because the relationships are profitable and their margins can absorb the added expense. In other words, a larger firm provides business assistance to a smaller firm at no charge in order to complete the deal—because it makes good business sense to do so. In addition to buyers, input suppliers often provide technical know-how to small firms engaged in production or processing; the quality of inputs and their correct use will often determine whether goods are considered suitable for export markets.

In some cases, developing-country firms have found that interaction with global buyers leads to significant upgrading opportunities, including moving to more sophisticated functions in the value chain. For example, East Asian garment producers in the 1990s advanced first from simple assembly of imported materials to increased local sourcing and production, then to the design of products sold under other labels, and finally to the sale of branded merchandise in internal and external markets.<sup>34</sup> However, there are also cases—such as the well-known Sinos Valley shoe cluster in Brazil—where upgrading opportunities are limited to production improvements, because intermediaries have been reluctant to share information about marketing and branding, functions they do not want to relinquish to suppliers.<sup>35</sup>

Projects can provide incentives for lead firms to invest in the provision of services that help their suppliers upgrade, such as training and information. In the past, projects—or government agencies—provided these services themselves. By working through the value chain, projects can ensure the commercial viability, and thus the sustainability, of the upgrading process. Ideally, an upgrading process that is beneficial to MSEs will: (1) provide knowledge and skills that are transferable to other areas; (2) be

#### Box 8

##### **Project SUSTAIN (Sharing U.S. Technology for Aid and Nutrition)**

The owner of Fabrica Industrial de Alimentos de Honduras (FIAH), a small local producer of condiments, received technical training in the production and packaging of pickled foods for U.S. markets from a SUSTAIN Volunteer who had worked with Vlasic Foods. After the training proved successful, FIAH secured a contract to supply Vlasic with four million pounds of dills a year. Additionally, technical knowledge acquired in other licensing agreements with R.J. Reynolds (U.S.), Lea & Perrins (U.K.), and W.B. Reiley (U.S.), provided FIAH with a distinct production advantage over local competitors. FIAH used the contacts, skills, and information it obtained through these relationships to develop new product lines.

*Source:* Adapted from Rhee and Belot, 1990: 35.

#### Box 9

##### **Upgrading at the Micro Level**

The importance of linkages in the upgrading process holds true even for the smallest production units. A recent study in Guatemala investigated the role of traditional weaving as one economic activity in a household's economic portfolio. Findings identified "middlemen," in this case artisan-brokers, as the most adept and likely lead firm to initiate upgrading within the value chain. Artisan-brokers are linked on one end to household weavers and on the other to exporters. They have intimate knowledge of the different customs and languages of the culturally diverse producers and their production capabilities, and have greater access to raw materials. The market link between artisan-brokers and exporters also allows for rapid dissemination of design information and other demand preferences, thus allowing producers to focus their efforts to meet market demand. If they know they have a ready market for their products, the Guatemalan weavers have both the capacity and the willingness to increase output. Steady sales at a higher output level can, in time, contribute to the small producers' decision to adopt more sophisticated labor-saving technologies (in this case, the foot loom).

*Source:* Dunn, 2004.

<sup>34</sup> Gereffi, 1999: 37–40.

available through multiple mechanisms; (3) be tailored to MSE owner or worker education levels and other characteristics; and (4) be linked to incentives for MSEs to adopt new practices.

## 2.5 SUPPORTING MARKETS

Supporting markets grow up around dynamic value chains, permitting the exchange of a wide variety of business services. Services may be *subsector-specific*, such as technical assistance in handicraft design, or *sector-generic*, such as the more ubiquitous forms of management consulting, accounting, and legal or tax advice. Services may be *embedded* in commercial relationships, such as production advice offered from a buyer to a group of suppliers, or *stand-alone* and sold on a fee-for-service basis. Considered here as an element of supporting markets, *input supply* is also a critical success factor for MSEs in global value chains.

Well-developed and growing value chains are likely to offer more robust service markets. In the United States, for example, consumer goods derive over a third of their final value from such services.<sup>36</sup> While such an evolution may occur naturally as sectors grow, development projects often aim to accelerate the growth of the business service sector. Business services are critical for firms interested in upgrading. In addition, dynamic service markets can offer small firms greater autonomy and negotiation power.

Supporting markets discussed in detail below include finance, inputs, and information and communications technologies.

### 2.5.1 FINANCE

Financial services are important to firms of all sizes. In addition to needing cash to grow their businesses, entrepreneurs also need access to secure savings for their excess liquidity and the ability to transfer money to suppliers or offer credit to retail buyers. Firms wishing to participate in global or regional value chains very often require outside financing to meet market requirements.

When micro and small entrepreneurs are surveyed, one of the most common constraints they cite in relation to the advancement of their business is lack of access to credit. By far the largest share of donor-financed enterprise development programs tries to increase access to capital.<sup>37</sup> Typical problems for micro and small businesses trying to obtain credit include their lack of collateral and their informal status when legal registration is necessary to obtain a bank loan. Other problems from a traditional banking perspective may include small enterprises' lack of credit history, a perception by the bank that the loan size is too small to be sufficiently profitable or that the business activity is not viable or worthy, or discrimination by the loan officer (client is poorly educated, dressed, illiterate, and so on).

In recent decades, the myth that small and microenterprises are too risky and costly for the banking sector to serve profitably has been shattered by the introduction of a number of innovative techniques such as peer group lending, step loans (gradually increasing in size), and ongoing access to credit for those who repay on time. Other approaches include reducing the cost of lending by decentralizing the loan application, collection, and approval processes. These innovations constitute the core of the "microfinance revolution."

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<sup>35</sup> Schmitz, 1999 and 2003.

<sup>36</sup> Lewis, 2004: xxi and Chapter 4.

<sup>37</sup> Snodgrass and Winkler, 2003: 45.

There are important alternatives available, however, even if microfinance channels are well-established. In most developing countries, the total volume of credit offered to MSEs, whether by specialized microfinance institutions (MFIs) or by commercial banks that have adopted microfinance techniques, is dwarfed by the enormous volume of supplier credit in the market. In some sectors, such as agriculture, the supplier credit portfolio may be as much as 100 times the size of the traditional MFI loan portfolio.<sup>38</sup> In cases where the financial sector and MFIs may not be able to provide access to credit on a profitable commercial basis, such as in the agricultural sector, a common solution is for buyers to provide financing. With minimal investment, donor interventions can help structure and initiate such arrangements in ways that provide a sustainable source of financing beyond the life of the project (see Box 10).

#### **Box 10**

##### **Financing for Fruits and Vegetables**

In conjunction with a USAID-funded project in Zambia, Agriflora, a private exporter of flowers, fruits, and vegetables to European and Australian markets, provides input (seeds, fertilizer) credits to eight cooperatives and irrigation credits in exchange for purchasing contracts. They use a group guarantee and farmers are paid monthly in exchange for produce supplied. Seeds are provided at cost for four months and fertilizers and chemicals are provided at a 10 percent annual interest rate. Collection centers with refrigerated containers and input stores are set up near each cooperative. Annually, 300 smallholders in eight cooperatives have supply contracts with Agriflora. In this project, the Zambia Agribusiness Technical Assistance Centre (ZATAC), run by DAI, has been successful in helping to facilitate smallholder access to credit from a lead firm.

ZATAC has chosen to work through a private firm in the value chain, rather than setting up its own lending operation so that smallholders' access to credit will be sustainable, thus avoiding a common mistake of the past—the provision of overly targeted credit that did not contribute to the development of permanent financial markets.

*Source:* Interview with Bagie Sherchand, DAI, May 11, 2004.

Recently, a number of projects have begun experimenting with new financial mechanisms and products, recognizing that by embedding financial services into value chain transactions many of the traditional obstacles to MSE lending can be overcome. These include supply chain credit through buyers or suppliers, leasing, and inventory financing (warehouse receipts). In practice, when lead firms have adequate access to loans, equity, or trade finance, they in turn offer some form of credit to their MSE suppliers. Ideally, a dynamic business system should make credit available to MSEs from multiple sources, thus providing MSEs with options and reducing financing costs to the overall chain.

#### **2.5.2 INPUTS**

Small firms almost always have more trouble accessing inputs than their larger counterparts. Ideally, MSEs would like to source high-quality inputs in small quantities, at reasonable prices, on a regular basis, with financing options. These conditions are rare in developing-country markets. And in some value chains, such as those for many agricultural products, knowledge about how to use supplies is almost as important as the inputs themselves. Small farmers, for example, may not be familiar with certain varieties of seedlings, pesticides, or drip irrigation systems. In manufacturing, raw materials like wood, leather, or denim may come from illegal sources or be treated improperly—resulting in a lower input acquisition cost that is appealing to small firm owners. The use of these materials, however, makes it impossible for small enterprises to sell their finished products in high-value markets.

<sup>38</sup> Estimate from Zimbabwe: Greenberg, et al., 2004.

Input suppliers can be valuable allies in a development program (see Box 11). By educating them about the payoffs—for them and their customers—of using high-quality supplies properly, program staff can encourage process and product upgrading at the bottom of the value chain.

### 2.5.3 CROSSCUTTING BUSINESS SERVICES

Firms involved in international trade are likely to need legal and accounting services that establish their formality and credibility vis-à-vis international investors, buyers, or regulatory authorities. In addition, general quality certification programs like ISO 9000 offer a set of internationally recognized process standards that apply to a wide range of industries. Although it is often too costly for the smallest firms to meet ISO or other similar requirements, cooperatives or lead firms may be able to obtain certification. Development interventions often work to help MSEs access crosscutting business services or obtain certification. More important than one-time access, however, is the existence of market-level incentives for the continued use and provision of such services.

### 2.5.4 INFORMATION AND COMMUNICATIONS TECHNOLOGIES

An especially fast-growing business service, ICT offers important ways for MSEs to both mitigate threats and exploit opportunities. ICT can help reduce transaction costs, increase access to markets, provide better and more frequent access to critical market and product information, help MSEs work better collectively, minimize and manage inventories, speed the product cycle from design through production, and improve communication throughout the value chain.<sup>39</sup> In fact, complex uses of ICT are fundamental to managing most global value chains. In some sectors, such as tourism and information technology-enabled services, they have transformed the sector itself.

ICT can be used in three general ways: (1) to provide *information* to traders in the value chain; (2) to enable more frequent, regular, and specific *communication* among the players and (3) to support *business applications* for individual firms and across firms. The table at the end of this section provides examples of the many ways ICT can be used for MSEs in developing countries to address threats and opportunities in trading processes.

Accessibility to and costs of ICT dictate what ICT options are practical for MSEs. In developing countries, access to the Internet, phone lines, standalone computers, and even radios may be too costly, especially in rural areas. Fortunately, several factors are helping to

#### Box 11

##### Payoffs from Access to Inputs

Centro de Desarrollo de Agronegocios, a USAID project implemented by Fintrac, helped small vegetable farmers in Honduras get access to credit to invest in drip irrigation systems. Fintrac also targeted input suppliers as a key source of information dissemination. When the owner of a supply store asked CDA staff about proper fumigation techniques, he was invited to participate in a farm visit to inspect tomatoes for pests and disease. After the visit, the storeowner was equipped to offer useful advice to farmers purchasing certain types of pesticides.

#### Box 12

##### ICT Explained

Today, the term ICT is often used synonymously with the Internet, but it encompasses a much broader set of technologies. Certainly use of the Internet is included, as is presence on the Internet via a Web site, but so is the use of radio, cell phones (including text messaging applications), hand-held computers (personal digital assistants or PDAs), standalone computers, print media, RFID (radio frequency identification) tags, digital cameras, and combinations of these technologies.

<sup>39</sup> USAID's EGAT/EIT/IT team can help any USAID agribusiness activity figure out what types of ICT might make sense and what pitfalls to avoid in designing and implementing them. Email [jpayne@usaid.gov](mailto:jpayne@usaid.gov).

lower the costs of ICT: investments in infrastructure are steadily improving, and new technology—such as wireless telecommunications—is dramatically increasing how that infrastructure can be leveraged across users. Technological adaptations can also help lower costs. Examples of low-cost adaptations include shared Internet access points, use of solar power or small satellite dishes for rural Internet access, applications that provide information to MSEs via intermediaries (for example, cooperatives, nongovernmental organizations), and applications that combine cell phones or personal digital assistants with Internet access.

Some programs find it hard to resist “technology push,” focusing more on an appealing technology than on the trade constraints to be overcome. Radios, email, and cell phones will often be sufficient. Internet access alone may solve the problem and Web sites may be unnecessary. Given the growing sophistication of the Web and the importance of search engines, if a Web site seems to be the correct solution to a problem, great care must be taken in its design and focus—figuring out what functionality is really needed, attracting a critical mass of users in a specific subsector, determining how it will be found by the target audience, and establishing a method to keep it up to date.

Sometimes Web portals go beyond information and provide matching services between buyers and sellers. Web-based auction services have been a useful application for businesses in the developed world. Many know of eBay’s success, but fewer are aware that auction applications are used in private e-marketplaces (open only to invited suppliers and buyers) for major global industries such as automotive, utilities, aerospace.<sup>40</sup> eBay-style auction platforms—such as the new site in China, EachNet<sup>41</sup>—could be a powerful tool for MSEs in many countries to conduct market research and find price points in the United States and beyond.

Using ICT in trade processes may change those processes significantly. Sometimes middlemen are eliminated, but that should not be the objective *per se* of any ICT innovation in trade. Middlemen—both local and international—often play useful roles in trade. ICT sometimes can change these roles or help those served by middlemen become better informed and thus better able to negotiate prices. A large firm in India opened Internet kiosks in small villages and fundamentally changed the value chains for several farm products (see Table 1). Among other benefits, farmers were able to know more about prices and decide to whom to sell, no longer dependent on traders as their only customers. Some local traders changed roles, becoming transporters to collection points.

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<sup>40</sup> Examples: automotive industry—[www.covisint.com](http://www.covisint.com); aerospace—[www.exostar.com](http://www.exostar.com); one of a few for utilities—[www.enporion.com](http://www.enporion.com).

<sup>41</sup> [www.eachnet.com](http://www.eachnet.com). EachNet was founded by two Chinese-born Harvard graduates and was adapted well to the Chinese marketplace. After four years, eBay purchased a majority share in it. It began targeting MSEs, not consumers.

**TABLE 1: EXAMPLES OF USES OF ICT TO ENHANCE TRADE**

Problem/Constraint	Examples
<p>Information:</p> <ul style="list-style-type: none"> <li>▪ Domestic and international product prices and availability</li> <li>▪ Market research regarding competitors and key players in the value chain</li> <li>▪ Import and export requirements, standards, tariffs, customs procedures</li> </ul>	<ul style="list-style-type: none"> <li>▪ Web, print: Egyptian Horticulture Export Improvement Association offers EU importer and retail contacts for fresh fruits and vegetables via Web <a href="http://www.heia.org">www.heia.org</a> (USAID APRP)</li> <li>▪ Text via cell phone: Daily prices in domestic regional market(s): Senegalese farmers (Manobi) <a href="http://www.manobi.net">www.manobi.net</a></li> <li>▪ Community Radio: Mali Agriculture Market Watch provides market prices, farm extension information (USAID) <a href="http://www.aec.msu.edu/agecon/fs2/fact/malimarketfact.pdf">http://www.aec.msu.edu/agecon/fs2/fact/malimarketfact.pdf</a></li> <li>▪ Web, radio: daily market prices for crops in 3 Bolivian markets (USAID) <a href="http://www.fdta-valles.org/">http://www.fdta-valles.org/</a></li> <li>▪ Web: <a href="http://www.agribusinessonline.com">http://www.agribusinessonline.com</a> international market prices; information on standards, import requirements, more</li> <li>▪ International Trade Centre's (ITC) Trademap database of import/export data<sup>42</sup> as well as other e-trade-related publications and training materials from ITC.</li> </ul>
<p>Communications and Applications:</p> <ul style="list-style-type: none"> <li>▪ Full range of customer service regarding orders, availability, shipments, and more</li> <li>▪ Ordering (and sometimes consolidating) inputs</li> <li>▪ Communicating with prospective customers</li> <li>▪ Making offers, demands for products, negotiating and closing deals</li> <li>▪ Managing transportation (ordering, monitoring, changing)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Web access and application: Indian e-Choupal, an e-commerce platform reaching over 1 million farmers; allows farmers to opt to sell products at better prices; information on production techniques; aggregates village demand to buy inputs at volume discount prices; see example for coffee: <a href="http://www.planternet.com">www.planternet.com</a></li> <li>▪ Email: simple email—with professional and timely responses—between customers, suppliers</li> <li>▪ Cell phones: Indian women entrepreneurs use cell phones to receive, coordinate orders.</li> <li>▪ Auction services: EachNet in China; eBay in U.S. and many other countries.</li> <li>▪ Tourism sector, hotels: many examples. <a href="http://www.worldhotel-link.com">http://www.worldhotel-link.com</a> offers example of an e-network of hotels in developing countries</li> <li>▪ Artisans, craftsmen: Examples of portals: <a href="http://www.eziba.com">www.eziba.com</a>, <a href="http://www.novica.com">www.novica.com</a>; example of business-to-business site: <a href="http://www.saigonpottery.com">www.saigonpottery.com</a></li> <li>▪ One example of a profitable portal that serves both developing and developed countries is <a href="http://www.globalsources.com">www.globalsources.com</a></li> </ul>

<sup>42</sup> As of September 2005, available to USAID on a subscription basis. See <http://www.trademap-usaid.org/>.

## 2.6 SUMMARY OF KEY MESSAGES

By working to strengthen the critical success factors outlined above, development programs can enhance existing opportunities for MSEs and mitigate threats to MSE participation in global value chains:

- An enabling environment that includes trade, macro, and microeconomic policies and regulations usually sets the parameters for what can be achieved through interventions aimed at improving the ability of industries and participating firms to respond to market opportunities. Addressing constraints in the enabling environment and identifying creative solutions for overcoming obstacles are essential if MSEs and the industries they dominate are to contribute to and benefit from trade. Efforts to reform the enabling environment and strengthen value chain competitiveness can be self-reinforcing and may be best pursued in tandem.
- Inter-firm cooperation is critical if small firms are to be able to participate and contribute to competitive value chains. To reduce the transaction costs, risks, and inefficiencies of working with many small firms, horizontal and vertical linkages that generate external economies, create collective efficiencies, and offer greater and more flexible capacity than unlinked firms are critical to the successful participation of MSEs in competitive industries.
- Where developing-country industries and MSME producers demonstrate the willingness and ability to upgrade, both have the potential for contributing to and benefiting from competitiveness.
- Supporting markets are key to enabling firms to upgrade. All firms in a chain need access to sustainable sources of finance, business services, and inputs if they are to upgrade both in the short and long runs.

Trade programs wishing to stimulate equitable private sector growth will need to analyze the opportunities and threats to MSE participation in their target country/region/sector, identify specific value chain constraints, and design an intervention based on one or several of the critical success factors discussed above. The matrix in Annex 2 provides examples of competitive strategies linked to these critical factors—for example, building on MSE capacities to produce unique products, promoting multiple channels and multiple market outlets (export, regional, national, and/or local), and/or branding MSE products at the national level.

The MSE opportunities, threats, and critical success factors are part of a new analytical lens necessary to understand the dynamic business systems in which small firms operate today. The competitive strategies this paper outlines are essentially business strategies for groups of firms; the analytical lens helps donors and policy makers understand how and where to intervene, while reducing the risk of market distortion. The next chapter reflects on past experience in trade and private sector development programs and offers a set of principles for program design in today's increasingly integrated world.



### 3. EXPERIENCE AND LESSONS LEARNED

#### 3.1 LESSONS LEARNED FROM PAST TRADE AND PRIVATE SECTOR DEVELOPMENT PROGRAMS

USAID's experience in trade capacity building in developing and transition economies spans several decades. The changing types of programs supported by USAID during the 1980s and 1990s reflect lessons learned as well as the changing global environment for trade. Export promotion projects in the mid-1980s typically worked with government institutions to produce promotional materials, organize trade fairs, and deliver business and financial services to firms. These programs adopted what has come to be termed a “*supply-side*” approach to trade promotion—working to help developing-country firms penetrate foreign markets and increase productivity in traditional sectors such as commodities.

Recognizing the critical role of the private sector,<sup>43</sup> USAID programs in the 1990s began to work with private industry associations to support the participation of developing-country firms in privately managed trade fairs and to encourage the development of subsidized institutions or business centers to deliver services to firms. Some of these programs were cross-sectoral; others focused on specific industries, particularly agriculture and agribusiness.

Just as approaches to trade and export promotion were evolving, the broader field of enterprise development was undergoing a paradigm shift. By the late 1990s, lessons from project activities of the International Finance Corporation, the Inter-American Development Bank, the German Technical Assistance Agency (GTZ), and USAID were creating a trend toward a “market development” perspective and away from public-service provision or direct, project-level support to enterprises. In the late 1990s, the Committee for Small Enterprise Development, an interagency group made up of bilateral and multilateral donors, supported a series of conferences and papers to explore the implications of a new approach to providing business services to enterprises. The committee produced some important guidelines and key principles that are relevant to private sector and trade development. They include: (1) the importance of clearly identifying the market failure or failures an intervention is attempting to address; (2) a reduced role for governments, donors, and project implementers, who should act as market “facilitators” rather than players, in combination with an expanded role for private firms; (3) avoidance of highly subsidized or entirely free services; and (4) increased local capacity with a carefully planned exit strategy by donors and implementers, so that impacts are sustainable.

More recently, a new generation of programs has emerged to promote economic growth, competitiveness and trade. These new programs have the implicit if not explicit recognition that by actively seeking to understand the demands of international or national buyers and, in turn, helping local firms to learn how to meet these demands, programs are more likely to induce sustainable change.<sup>44</sup> While past projects

#### Box 13

##### Market Development

The term *market development* has been used extensively since 1999 by a number of donors to refer to the development of markets for business services. More recently, USAID and other donors have broadened the term to refer not only to business service markets, but to product markets in which MSEs are active. Thus where “developing the market” originally might have meant intervening to increase the availability of technical assistance and training services for a given group of MSEs, it might now refer to a range of interventions in a specific sector or market—from policy advocacy to facilitating backward linkages from buyers to the organization of producer groups to the provision of financial services.

<sup>43</sup> This recognition of the importance of the role of the private sector was noted in the McKean studies during the early 1990s.

<sup>44</sup> The sources that discuss this shift are related to a generation of “competitiveness” projects financed by USAID. See, for example Developing Alternatives, 2003; Lewis, 2004; and Fox, 2003a.

focused on the supply-led activity of *export promotion*, newer projects tend toward a demand-led emphasis on *market responsiveness*. What used to be referred to as market *access* in the 1990s—that is, helping firms find a way to penetrate foreign markets—is today considered valuable but only a part of a larger integrated strategy. This broader strategy is increasingly formulated at the value chain or cluster level and encompasses:

- An **enabling environment** that provides incentives for small firm participation in markets;
- **Vertical linkages** among firms at the “top” of the chain—between national exporters and international buyers—as well as the “bottom” of the chain—backward linkages to small producers and/or producer groups;
- **Horizontal linkages and cooperation** among like firms to reduce transaction costs and achieve external economies;
- **Upgrading** of both the chain and firms in the chain by addressing systemic constraints, improving learning and information flows, and promoting product and process innovations; and
- **Supporting markets** to ensure sustainable access to finance, business services, and inputs.

### 3.2 LESSONS LEARNED ABOUT INTERVENING IN GLOBAL MARKETS

If increased trade volumes in developing countries are to result in higher incomes for the poor and broad-based economic growth, then development programs must learn to harness the opportunities for MSE integration into global markets. Rather than focusing on a specific firm size or target group, successful interventions work to increase the overall competitiveness of value chains, and will likely benefit lead firms and MSEs alike. The 15 lessons below and the intervention guidelines that follow are aimed at USAID project designers and implementers interested in including small firms in the growth process, through trade and other private sector development programs.

#### 3.2.1 ENABLING ENVIRONMENT

**Lesson 1: Equitable growth is important.** While poverty reduction cannot happen without economic growth, economic growth can happen without real poverty reduction. In most developing countries the gap between the communities that benefit from economic growth and those that remain in poverty is widening. If trade programs are to translate trade capacity building into broad-based economic growth, they *need to promote backward linkages to large numbers of suppliers*. Exporters with linkages to a large number of firms will be able to respond more quickly to growth opportunities, and benefits are more likely to be widely distributed. An *integrated intervention approach is needed* that addresses systemic constraints to improved trade within a given value chain in order to achieve broader impact.

**Lesson 2: An enabling environment is necessary for equitable growth.** Building a business-friendly enabling environment that offers MSEs a chance to compete is necessary for broad-based growth. An enabling environment encompasses both the kinds of *national-level* indicators included in *Doing Business in 2004/5*<sup>45</sup> as well as the *international* rules and regulations emanating from the WTO, free trade agreements, corporate social responsibility, and public and private standards governing global value and commodity chains. Both have important impacts on the competitiveness of firms, industries, and countries.

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<sup>45</sup> World Bank, 2004.

**Lesson 3: Effective policy reform must be accompanied with effective enforcement.** In many developing and transition countries, there are laws on the books that theoretically protect the rights of small landholders, establish a fair tax code, and govern commercial contracts. However, resource constraints on the part of regulatory agencies and the court system, a lack of awareness by the general public, ingrained cultural tradition, and general inefficiencies may prevent their enforcement. In the case of contracts, this means that MSEs have no recourse if their buyers do not live up to the terms established in their contracts. Often, such a situation leads to reluctance on the part of small firms to do business unless they have close social ties to and/or extensive knowledge of their business partners.

### 3.2.2 VERTICAL LINKAGES

**Lesson 4: Vertical relationships among value chain actors are critical to fostering equity.** Linkages must be designed to produce short-term results while also opening doors to long-term partnerships. The role of trade-related interventions is to help *advance linkage activities beyond the “deal-making” stage and incorporate them into long-term strategies* for networks of firms (as opposed to strategies that benefit only individual firms) in a value chain.

**Lesson 5: Linking MSEs to lead firms as subcontractors has both risks and potential benefits.** Vertical linkages have to be fostered with a full understanding of the risks and opportunities. Whether linking to a lead firm or to key input providers, there are always risks that the larger firms will pressure smaller firms into being price takers, or into behavior that benefits the larger firm in the short term but not the overall chain—such as adopting a specific technology. Although the pressure to conform to market requirements can be important to small firm upgrading, the ways in which lead firms exert pressure down the chain can result either in enhanced business relationships and competitiveness or in more transitory relationships and asymmetrical benefits.

**Lesson 6: Strategies for fostering win-win (vertical) relationships vary depending on the power asymmetries between firms.** The power relationships among firms in a value chain vary depending on the type of governance structure. In buyer-driven or -directed chains, MSEs have relatively less power in the chain that is controlled largely by the buyer. In balanced chains, power is more evenly shared among buyers and suppliers, who typically have something unique to offer buyers. Different power relationships will call for differing strategies for intervening to create incentives for win-win relationships, while creating disincentives for predatory and overly opportunistic behavior that creates win-lose relationships.

**Lesson 7: Buying down risk can be an effective strategy for strengthening vertical relationships.** Rather than subsidizing training or credit for MSEs, a good use of subsidies is to reduce risk for a lead firm to do business with MSEs. This intervention strategy is successful when lead firms and MSE suppliers have market incentives to continue doing such business after the intervention has ended.

### 3.2.3 HORIZONTAL LINKAGES

**Lesson 8: Strengthening horizontal cooperation can be an effective strategy for reducing transaction costs and mitigating risks.** Individual MSEs cannot compete on scale with larger firms. However, MSEs that devise strategies that allow them to effectively cooperate to solve joint constraints can and do participate in and benefit from value chains. The form that the cooperation takes does not have to result in formal organizations to be effective, but it does have to address issues that often arise when people cooperate, like the risk of “free riders” or perceptions that ownership rights might be compromised. Cooperative efforts can become distracted by these issues, as well as other organizational challenges that can re-direct the focus of the cooperation away from its original commercial purpose. Maintaining focus on the original commercial objectives is often the key to successful MSE cooperation.

**Lesson 9: A balance between competition and cooperation improves competitiveness.** Promoting a balance between cooperation (for example, horizontal and/or vertical linkages) and competition (at all levels of the value chain and among service providers) enhances the performance, resilience, and competitiveness of the value chain and the firms in the chain. Efforts should be made, however, to limit competition that is based solely on price, while fostering competition based on quality and innovation.

### 3.2.4 UPGRADING

**Lesson 10: Upgrading involves innovation, which in turn requires learning.** Upgrading is the process of innovating to increase value-added. Firms that upgrade may improve their processes, products, or functions, or move to new sectors. Upgrading often involves a change in mindset and improvements in skills. Participation in a value chain can be a powerful means of obtaining information about markets, new production techniques, modern inputs, and product innovations. Both buyers up the chain and input suppliers down the chain are key sources of information, know-how, and learning. Learning can be used to leverage greater bargaining power and therefore benefits. In some cases, MSEs can take this learning from vertical linkages in one chain and apply it to another.

**Lesson 11: Small firms can best upgrade by taking small “riskable” steps.** Approaches to upgrading MSEs—whether via lead firms or through the development of independent supporting markets, or both—will be most successful if small firms are encouraged to take *riskable steps*—first improving the quality of their own production, then adding new products and, in cases where it is feasible, performing additional functions. *Both vertical and horizontal linkages can reduce the risks of upgrading for small firms.*

**Lesson 12: The most successful upgrading for MSEs expands rather than narrows their market opportunities.** An upgrading process that is beneficial to MSEs will: (1) transfer knowledge and skills that can be applied to multiple products; (2) be available through multiple mechanisms; (3) be tailored to MSE owner or worker education levels and other characteristics; and (4) be linked to incentives for MSEs to adopt new practices.

### 3.2.5 SUPPORTING MARKETS

**Lesson 13: Commercially viable solutions to value chain constraints ensure sustainability.** Enterprises face a range of recurrent constraints that will need to be addressed repeatedly. If MSEs are to participate in and benefit from market opportunities on a long-term basis, they will need access to finance, business services, and inputs to overcome the constraints they face. To be sustainable, these services and inputs need to be provided through markets and on a commercial basis. Programs should facilitate the development of these markets and minimize subsidies that unduly distort transactions and limit post-program viability. In developing these markets, an upfront exit strategy is needed, that is, at the start of a project, especially where direct provision of technical assistance to an enterprise or group of enterprises is proposed.

**Lesson 14: Supporting markets strengthen competitiveness.** Vibrant input and service markets are key to the longer-term ability of an industry or value chain to respond effectively to dynamic market challenges. Supporting markets should be stimulated through both supply and demand facilitation interventions and result in commercially viable delivery and payment mechanisms. Access to supporting markets also improves MSEs’ bargaining power up and down the chain, with lead firms and input suppliers.

**Lesson 15: Addressing the needs of firms in value chains requires developing financial markets and enhancing value chain finance.** Although the development field has made great strides in developing

new lending techniques and other financial products offered through MFIs and commercial banks, financial constraints are still significant for large numbers of MSEs. In many developing economies, private-buyer and supplier credit dwarfs microfinance and commercial lending. Recently, program designers have been looking to work with a variety of sources of finance, including financing that flows through the value chain—supply-chain credit, leasing, and inventory financing—in addition to those offered directly by banks or MFIs.

### 3.3 INTERVENTION GUIDELINES

Interventions need to be based on a systemic analysis of constraints and targeted to address market failures. Program design should be based on a vision of what is to be achieved, including expectations about what the market will look like at the end of the intervention. Monitoring and evaluation (M&E) is critical to demonstrate what is working and what is not, and to allow for adjustments to intervention designs. M&E is also fundamental to our learning about effective interventions and their impacts.

Key guidelines for designing interventions include:

- Develop a *vision* of what the market will look like at the end of the project/intervention.
- Analyze the *competitiveness* of the value chain or cluster and the *constraints* faced by firms and the chain as a whole
- *Prioritize* constraints.
- Design/*target interventions* to address priority constraints.
- *Facilitate* market-oriented interventions through private sector actors rather than providing assistance directly.
- Develop a *monitoring and evaluation system* that can identify what works and what does not.

#### 3.3.1 A VISION OF WHAT THE MARKET WILL LOOK LIKE IN THE FUTURE

In developing a vision of the market post-project, designers of USAID trade programs should think about: (1) a longer-term perspective; (2) an explicit, upfront exit strategy; (3) the advantages of multiple markets—regional and national as well as global; (4) branding and niche markets; and (5) integrating local context and priorities into program designs.

Sustainable impacts can be achieved only if local actors—including policy makers, regulators, lead firms, service providers, and MSEs—are prepared to continue identifying and solving problems. Interventions may demonstrate short-term success and serve an important “demonstration” function during a specified period of time, but the market development process needs to continue after an intervention has ended.

To achieve sustainable market development, the level and nature of subsidies needs to be limited. Additionally, a concerted effort needs to be made to build local capacity during the life of the project and to work with private actors who have market incentives to continue doing business with MSEs.

Although most trade-oriented interventions naturally focus on export-related opportunities, it is important not to eliminate regional cross-border trade or promising domestic markets. Global markets can be risky and expensive to enter, while closer regional and/or national markets may allow for more “riskable” steps toward upgrading, as well as attractive margins.

Suppliers, both large and small, are constantly looking for ways to differentiate their product in order to capture market share and increase profits. Specialty products tailored for niche markets can command premium prices and present new opportunities for small firms.

Branding can also help suppliers capture an increased market share and larger profits. Brand recognition is one of the most important factors on which consumers base their purchasing decisions. While branding has traditionally been an option for larger firms with experience and strong organizational skills, it is accomplished with increasing frequency by smaller producers and producer associations to establish market position.

All developing countries are faced with a wide range of development issues that must be considered as part of any private sector project, including population density and movement patterns, environmental degradation, effects of population health, and disadvantaged populations such as women and rural isolated communities. Proper consideration of these issues within the context of a viable private sector development strategy is critical to enhancing the longer-term impacts of any MSE development project.

### **3.3.2 ANALYZING COMPETITIVENESS AND THE IDENTIFICATION OF SYSTEMIC CONSTRAINTS**

International benchmarking and industry analysis can be used to determine the overall competitiveness of a subsector or value chain, including its growth potential and probable future trends. Then, value chain analysis is a useful tool for assessing the competitiveness of industries and subsectors, and identifying key constraints. Typically, constraints are complex and systemic. They can include a poor policy or business environment, weak vertical linkages between firms and markets, or between exporters and suppliers. These suppliers may have insufficient skills and resources to upgrade and produce products that meet buyer standards. Finally, suppliers may not be organized enough to be attractive to buyers. Understanding the full range of these constraints to expanded trade is critical to good program design.

### **3.3.3 PRIORITIZATION OF CONSTRAINTS**

Although value chain analysis can identify critical constraints to trade and to small firm participation in trade, it is more difficult to determine which constraints are feasible to address and which, if addressed, are likely to unlock streams of benefits for lead firms and MSEs and to result in expanded trade.

### **3.3.4 TARGETING OF INTERVENTIONS TO CONSTRAINTS**

Interventions need to be clearly targeted to market failures/constraints. Nodes within chains and/or networks can be cost-effective targets for interventions that leverage large impacts.

### **3.3.5 FACILITATION OF MARKET-ORIENTED INTERVENTIONS**

Facilitation is the appropriate role for program implementers in a commercial or market-oriented trade program. Projects should facilitate the solutions to constraints by linking private sector providers of services or inputs to firms needing finance or business services or improved inputs. Rather than providing technical assistance directly to exporters or suppliers, projects should look for commercial ways of delivering needed assistance if it will be needed over the long run for the growth of the industry. Too often, projects engage directly in solving firm- and industry-level problems. This is clearly not a sustainable solution to a market failure.

### **3.3.6 MONITORING AND EVALUATION SYSTEM**

While USAID needs to report on specific indicators, M&E systems: (1) enable USAID and contractors to discern progress towards given objectives; (2) provide the basis for beneficial midcourse corrections; and (3) measure the impact of program interventions.

It is important to distinguish between monitoring and evaluation. Monitoring is the process of tracking performance to determine progress and to permit adjustments to program intervention tactics. Evaluation is needed to understand causality and attribution, that is, were the observed changes in indicators the result of project interventions or are the results attributable to external factors that had nothing to do with the project?

The lessons and guidelines in this chapter were distilled from a variety of sources, most notably the development programs—used as examples throughout this paper—that have successfully included MSEs in trade-led growth.



## ANNEX 1 EXPERTS INTERVIEWED

1. **Doug Anderson**  
Senior Associate, ABT  
Director of Business Development &  
Market Intelligence Services  
Agriculture-Led Export Businesses  
(ALEB), Egypt  
Interview date: April 25, 2004
2. **Cliff Barton**  
Independent Consultant  
Interview date: April 23, 2004
3. **Charles Bell**  
Senior Vice President  
The Louis Berger Group, Inc.  
Interview date: March 29, 2004
4. **Jill Donahue**  
Independent Consultant  
Interview Date: March 22, 2004
5. **Jeanne Downing**  
USAID  
EGAT/MD  
Interview date: March 9, 2004
6. **John Ellis**  
International Trade Specialist  
USAID  
EGAT/EG/TI  
Interview date: March 9, 2004
7. **Michael Field**  
USAID EGAT/MD  
Interview date: March 9, 2004
8. **William J. Grant**  
Operations Director  
ECIAfrica, South Africa  
March 17, 2004
9. **C. Richard Hatch**  
MSEnterprise Systems  
Interview date: March 16, 2004
10. **Olaf Kula**  
Senior Technical Advisor and Manager  
Financial Services and Enterprise  
Development Unit  
ACDI/VOCA  
Interview date: March 2, 2004
11. **Reid Lohr**  
Independent Consultant  
Former Chief-of-party JOBS project,  
Bangladesh  
Interview date: June 10, 2004
12. **Frank Lusby**  
Executive Director  
Action for Enterprise  
Interview date: March 10, 2004
13. **Lance Marston,**  
Senior Vice President  
Business Development  
Interview date: March 12, 2004
14. **Cressida McKean**  
Independent Consultant  
Interview date: March 3, 2004
15. **Maggie Meyer**  
Associate Director  
Food for Development  
ACDI/VOCA  
March 11, 2004
16. **Edward Millard**  
Senior Advisor, Conservation  
Conservation International  
Interview date: March 10, 2004
17. **Cuan Opperman**  
Independent Consultant  
Interview date: March 22, 2004
18. **Glenn Patterson**  
Independent Consultant  
Interview date: March 22, 2004
19. **Santiago Sedaca**  
Director of Competitiveness Practice  
Carana Corporation  
Interview date: March 10, 2004
20. **Professor Hubert Schmitz**  
Institute of Development Studies  
University of Sussex  
Interview date: April 29, 2004

21. **Don Snodgrass**  
Principal Development Specialist for  
Microenterprise  
Development Alternatives, Inc  
Interview date: March 5, 2004
22. **Jim Winkler**  
Vice President  
Economics, Business and Trade Group  
Development Alternatives, Inc  
Interview date: March 5, 2004

## ANNEX 2

The matrix shows typical constraints along the horizontal axis and common approaches along the vertical axis. The cells that intersect between the constraint and approach provide a simple explanation (often through an example) of the potential effect of the intervention on the constraint. While the matrix is not exhaustive, it does provide a framework for assessing and designing interventions.

Private Sector and Market Environment									
Approaches	Value Chain Constraints								
	1 Lack of MSE Capacity	2 High Transaction Cost	3 Inability to Achieve Scale	4 Lack of Market Orientation and Knowledge	5 Lack of Innovation	6 Commitment Failure Risk	7 Asymmetrical Power Relationships	8 Limited Vertical Relationships	9 Inappropriate Governance Structure
1. Horizontal relationships	MSE capacity to deliver on quality and quantity requirements can be addressed through upgrading mechanisms more efficiently when MSEs cooperate.	MSE cooperation can substantially reduce transaction costs by aggregating logistics requirements and reducing per unit costs of inputs and services by increasing purchase volumes.	By reducing transaction costs and improving the way MSEs organize production, MSE cooperation can achieve some economies of scale.	MSEs that cooperate are more likely to share market information and to establish social capital based around market interests and orientation.		Grouped MSEs are more likely to meet commitments to lead firms, especially if the relationships include a range of embedded services.	MSEs that cooperate have the volume and bargaining power to stand on a more equal basis with lead firms.	MSEs that cooperate are far more attractive to firms on the input and output sides of transactions since volumes will likely increase and transaction costs will likely decrease.	MSEs that cooperate are more likely to enter into directed or relational governance structures that are more likely to include critical embedded services.
2. Input/output support markets	Viable input/output supporting markets that deliver new technology, other quality inputs, and/or important output services (transport, cooling, etc.) directly affect MSEs capacity/performance . Supporting markets are also an important resources for new info, skills, and know-how.	Viable input/output supporting markets will provide incentives for targeting new markets such as MSEs. These incentives often lead to innovations in delivery and pricing mechanisms that can lower transactions costs.		Input/output supporting firms provide a wealth of market information since they are reliant on their customers being successful.	Viable input/output supporting markets can create competitive pressure to innovate since input/output providers must sell new products/services in a competitive market that forces them to differentiate constantly or become uncompetitive.	Input/output service providers linked into value chains will foster greater pressure on MSEs to meet commitments.		Viable input/output supporting markets that focus on MSEs as an important customer base will broaden and deepen the network of firms that have vertical relationships with MSEs.	

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3. Competitive strategies	MSEs that have unique capacities and/or resources such as handcraft skills or access to natural resources can use competitive strategies that build off of these unique characteristics and limit the weaknesses from or a lack of other skills and resources.	Competitive strategies that build off of a product's or service's uniqueness can be effective in limiting the adverse effects of high transaction costs.	Competitive strategies that build off of a product's or service's uniqueness can be effective in limiting the adverse effects of limited ability to achieve economies of scale.	Competitive strategies that focus on building relationships and products or services that meet unique needs of key value chain actors can be effective in limiting the needs for MSE to access and assess market information.	Competitive strategies that focus on building relationships and products or services that meet unique needs of key value chain actors can be effective in creating incentives that push MSEs to innovate to maintain relationships and market position.		Competitive strategies that build off of a product's or service's uniqueness can be effective in establishing greater power in the marketplace.	Competitive strategies that focus on building relationships and products or services that meet unique needs of key value chain actors can be effective in making MSEs more attractive to key input providers and lead firms.	Competitive strategies that focus on building relationships and products or services that meet unique needs of key value chain actors can be effective in making MSEs more attractive to key lead firms, which could lead to a more appropriate governance structure.
4. Backward linkages	MSEs are typically ill-equipped to identify and obtain the skills and knowledge needed to enter into new markets. By linking to lead firms that can transfer the appropriate information, knowledge, and skills, MSEs can better deliver on quality and quantity requirements.	Backward linkages can effectively limit the disadvantage of high transaction costs since the lead firm can distribute these costs over many MSEs and even take on some of these costs itself.	Backward linkages can overcome some limitations related to economies of scale by organizing production inputs and output with many MSEs.	Lead firms often have proper market orientation and knowledge that MSEs can benefit and learn from given a solid win-win relationship		Effective backward linkages programs have to start with risk from both the MSE and the lead firm. By acting as a moral guarantor and ensuring early successes, facilitators can limit commitment failure risk.		Backward linkages programs are defined by approaches that actively link MSEs vertically to lead firms. Backward linkages programs should be balanced with approaches to establish linkages with input providers when appropriate.	Some tactics in establishing backward linkages, such as subcontracting and forward contracts, can be very effective in shifting governance structures, especially from market to directed or relational.

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5. Shifting Governance Closer to MSEs	Directed and relational governance structures are more likely to result in flows of embedded services that allow MSEs to participate in and benefit from market opportunities.	Relational and directed governance structures can be more effective at dealing with transaction costs since the costs can be shared between MSEs and lead firms.	Relational and directed governance structures can be more effective at dealing with economies of scale since the lead firm can assert an effective management process on MSEs or apply an appropriate competitive strategy (e.g., building on a product's uniqueness) for MSE products.	MSEs that are connected through relational or directed governance structures are more likely to receive clear guidance on market requirements related to production. However, lead firms are unlikely to deliver market information-related branding, demand trends, or other information that defines where they add value.	MSEs that are connected through relational or directed governance structures are more likely to receive new management and production skills and know-how that fosters innovation.	Relational and directed structures that are founded on a win-win premise often result in a reduced risk of commitment failure since there are longer-term advantages to fulfilling commitments.	Directed structures may increase the power gap, creating MSE dependency on lead firms. Relational structures are more equitable and continue to provide a rationale for lead firms to deliver information, skills, and know-how. Market structures are by nature based on equitable power bases, but rarely include the delivery of embedded services.	Relational and directed governance structures can result in longer-standing vertical relationships between lead firms and MSEs. However, directed structures can create a dependency where MSEs would be discouraged or even prohibited from establishing linkages with input providers.	Shifting to a new structure may require a range of other approaches identified in this matrix—horizontal cooperation, backward linkages, input/output markets, and competitive strategies.

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6. Local economic development and legal and regulatory enforcement capacity		Improper or poor local enforcement practices and local infrastructure can significantly increase transaction costs. Reforming and/or working on improving transparency and disputes resolution mechanisms can help to counter negative impacts.		Local enforcement can have a substantial impact on establishing incentives that encourage greater (or reduced) market-oriented behavior. For example, corruption can encourage nontransparent business practices, distort investment options, and encourage greater informality.	Greater formality in a local economy can establish consistent incentives for MSEs to make smarter decisions with their limited resources, including investments in new technologies, new knowledge, and new relationships—all of which foster greater innovation.	Local enforcement practices have a substantial impact on the level of informality in a local economy, and the greater the level of informality the greater the risk of commitment failure. Developing effective dispute resolution mechanisms can help to reduce commitment failure risks.		More capable and competent local enforcement of legal and regulatory regimes will encourage investment from outside the community, resulting in more vertical linkages.	
7. National policy assessment, reform, and development, including private sector participation	Poor national policies can exacerbate MSE limitations by distorting markets in favor of larger businesses and encouraging greater informality, which limits MSE investments in capacity building.	Poor national policies can substantially increase transaction costs by limiting new investment in infrastructure, education, and healthcare, as well as weaken key supporting markets like finance and agri-inputs.		Poor national policies can create strong anti-market incentives, encouraging firms to remain informal and noncompetitive beyond local markets.	Poor national policies directly affect the nature of market activities and can limit the value of investments in new technology, knowledge, and relationships. National policy can also affect the connection between industry and academic research that can be a driver of innovation.	Poor national policies directly affect the nature of market commitments and can incentivize short-term business decisions that make commitment failure more likely.	Poor national policies increase transaction costs, limit MSE access to broader markets, and increase the costs of upgrading, resulting in a reduction of MSE power in the marketplace.	Poor national policies adversely affect MSEs, causing lead firms and input providers to disregard MSEs as viable/reliable businesses—resulting in fewer vertical relationships.	

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8. International agreements and market standards	International agreements/market standards can exacerbate MSE limitations by creating market requirements beyond the reach of MSEs. International agreements/standards can also be a driving force for change, including improving the capacity of MSEs.	International agreements/market standards can increase transaction costs by requiring conditions that are hard to achieve in rural poor areas.			International agreements/market standards can be a driving force for change in the nature of markets—requiring improved inputs, management practices, and operational practices—that foster innovation.	International agreements/market standards can increase the commitment failure risk since more rigorous market requirements are harder for MSEs to deliver on, making failure more likely.	International agreements/market standards can further marginalize MSEs by creating market requirements that can only be met with substantial support/information from lead firms, shifting even more power away from MSEs.	International agreements/market standards can make vertical relationships even more unlikely since commitment failure risk increases and the responsibilities for lead firms increase in terms of embedded services and upgrading.	International agreements/market standards can establish requirements that foster directed governance structures since MSEs will require substantial support/information from lead firms.
9. Private sector delivers public services  (education vouchers, registration, disputes, infrastructure)	MSEs often lack basic skills that are more effectively delivered through a public good. However, public resources may not be sufficient to deliver the service directly, which is where tools like vouchers can leverage private sector networks to deliver a public good.	Private sector providers for services and even infrastructure development can be more efficient than the public sector in delivering the public goods that reduce transaction costs.	Infrastructure can have a substantial impact on achieving scale since high costs for communications and transport services are a major factor in achieving scale.	Market information at a generalized level is often a public good and the limitation of public sector capacities may require them to contract out private sector firms to deliver this service.	Generalized research in agriculture and other various technologies is often considered a public good that fosters innovation. Public sector capacity limitations may require them to contract out private sector firms to perform the research.			Private sector delivery of public goods can lower transaction costs and improve the ability of MSEs to achieve some scale, which would make MSEs more attractive to lead firms and input providers.	

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10. Private and public alliances	A shared effort between the public and private sectors to deliver public goods like basic skills development can be more effective and efficient than a purely public sector delivery mechanism, and in some instances may be the only means to deliver the services/goods.	A shared effort between the public and private sectors to deliver public goods that can reduce transaction costs can be more effective and efficient than a purely public sector delivery mechanism, and in some instances may be the only means to deliver the services/goods.	A shared effort between the public and private sectors to deliver public goods that increase the ability of MSEs to achieve scale can be more effective and efficient than a purely public sector delivery mechanism, and in some instances may be the only means to deliver the services/goods.	Market information at a generalized level is often a public good and the limitation of public sector resources may require the private sector to partner with the public sector to deliver this service.	Generalized research in agriculture and other various technologies is often considered a public good that fosters innovation. Public sector resource limitation may require private sector partnerships.			A shared effort between public and private sector that effectively delivers public goods can lower transaction costs and improve the ability of MSEs to achieve some scale, which would make MSEs more attractive to lead firms and input providers.	
11. Social marketing & community development	On some occasions, the private sector needs to pay for and deliver public goods or they will not be delivered. Basic skills building, infrastructure development, health services, protection of resources, etc. are public goods that might require the private sector to pay for and deliver.	Although not the ideal, the private sector may need to pay for and deliver public goods in order to reduce certain transaction costs such as infrastructure and health services to reduce labor shortages in order to remain competitive.	If by the private sector paying for and delivering public goods there is a reduction in transaction costs, the net effect may be an increased ability for MSEs to achieve some scale.	Market information at a generalized level is often a public good, but the limitations of public sector resources may require the private sector to take on this responsibility completely.	Generalized research in agriculture and other various technologies is often considered a public good that fosters innovation. Public sector resource limitation may require the private sector take on this responsibility completely—ownership may be problematic though.		If a lead firm is the one paying for and delivering the public good, the effect can be an increase in the power gap, making MSEs even more dependent.		

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