Linking small and marginalised producers to external markets: New ideas for demand-side measures using value chain analysis

Sandy Lowitt

September 2008
ABOUT THIS RESEARCH

The 2007 Annual Report of the Accelerated Shared Growth Initiative of South Africa (AsgiSA) identified a need to focus on what was then called ‘the second economy’, and on mechanisms to ensure shared growth reaches the margins of the economy. The Second Economy Strategy Project was initiated in this context. It reported to the AsgiSA High Level Task Team in the Presidency, but was located outside government in TIPS.

A review of the performance of government programmes targeting the second economy was completed in early 2008. The project then commissioned research and engaged with practitioners and policymakers inside and outside government. A strategic framework and headline strategies arising from this process were approved by Cabinet in January 2009, and form part of the AsgiSA Annual Report tabled on 16 April 2009.

In South Africa, people with access to wealth experience the country as a developed modern economy, while the poorest still struggle to access even the most basic services. In this context of high inequality, the idea that South Africa has ‘two economies’ can seem intuitively correct, and has informed approaches that assume there is a structural disconnection between the two economies. The research and analysis conducted as part of the Second Economy Strategy Project highlighted instead the extent to which this high inequality is an outcome of common processes, with wealth and poverty in South Africa connected and interdependent in a range of complex ways. The different emphasis in this analysis leads to different strategic outcomes.

Instead of using the analytical prism of ‘two economies’, the strategy process placed the emphasis on the role of structural inequality in the South African economy, focused on three crucial legacies of history:

- The structure of the economy: its impacts on unemployment and local economic development, including competition issues, small enterprise, the informal sector, value chains and labour markets.
- Spatial inequality: the legacy of the 1913 Land Act, bantustans and apartheid cities, and the impacts of recent policies, looking at rural development, skewed agriculture patterns, and the scope for payment for environmental services to create rural employment.
- Inequality in the development of human capital: including education and health.

TIPS’s work around inequality and economic marginalisation is built on the outcomes of this strategy process.

The research undertaken under the auspices of the Second Economy Strategy Project continues to be relevant today as government explores policy options to reduce inequality and bring people out of the margins of the economy. This report forms part of that research.

A list of the research completed is available at the end of this report. Copies are available on the TIPS website: www.tips.org.za.

May 2012
## CONTENTS

- **EXECUTIVE SUMMARY** ................................................................. 4
- **INTRODUCTION AND CONTEXT** .................................................. 9
- **AN INTRODUCTION TO VALUE CHAIN ANALYSIS** .................... 19
- **VALUE CHAIN ANALYSIS** ........................................................... 30
- **THE NATURE OF VALUE CHAIN INTERVENTION3** ..................... 6
- **LINKAGES** .................................................................................. 37
- **A VALUE CHAIN FRAMEWORK FOR LINKING SMALL, MARGINALISED PRODUCERS TO EXTERNAL MARKETS** .......... 76
- **STRATEGIC THINKING** ............................................................... 105
- **CONCLUSIONS** ........................................................................... 144
- **BIBLIOGRAPHY** ........................................................................... 145
- **ANNEXURES: EU LEADER EXAMPLES** ..................................... 150
EXECUTIVE SUMMARY

This executive summary is not presented in the usual manner of summarising the findings of each chapter of the report. The complexity and detail covered in the report, and the nuances in the debates, makes such an option impossible. Rather, a brief overview of the key issues and approaches is presented as a separate think piece.

This study was commissioned by the Presidency as a follow up to the Review of Second Economy Programmes conducted by the Second Economy Strategy Project. In the Review, it was noted that while social delivery programmes targeting poor people had largely been successful and implemented at scale over the past 15 years, the same could not be said for economic programmes aimed at creating market based employment opportunities. Generally, these latter programmes were found by the Review to be highly project focused, not scalable and, as a result, only reached a small number of direct beneficiaries. The Review cited six contributing factors to the modest success of these economic programmes. One of the cited problems was market access for small and marginal enterprises. It was that broad issue which framed this study.

More specifically, the terms of reference required that the study contemplate mechanisms to support a change in the trajectory of small marginalised producers which will lift them out of poverty. This trajectory change is based upon exploring what it would take to shift these producers away from selling to local, thin markets in favour of selling their outputs to external, developed markets – on fair terms. The terms of reference proposed the use of value chain analysis as the theoretical construct upon which the study is based, and very importantly, that it focus on what kinds of systemic-level changes would facilitate such linkages or allow them to take place at scale.

The study is designed to deliver two outputs. The first output is a linkage framework which will guide policymakers, researchers and practitioners in identifying the systemic issues which consistently, across sectors and nations, constrain marginalised producers from entering deeper and more established formal value chains. The identification of these issues, using value chain analysis, provides a list of issues which any policy intervention will need to address. The second output of the study is to stimulate policy debate in this area by suggesting new and novel approaches to possible linkage strategies. Two strategies are presented, although, an infinite number of strategies could emerge from the framework. The terms of reference are clear that the strategies presented in the second output do not need to be developed to the point where they are ready for programmatic roll out, but should rather catalyse debate. In addition, the terms of reference remove the need for the strategies and framework to deal with all areas of second economy production and poverty, because this study sits alongside other work streams all dealing with different aspects of the challenge.

Value chain analysis has been the cornerstone of the study. The appeal of value chain theory to our linkage study is fourfold.

Firstly, value chain analysis emphasises the issues of governance and power in markets which provides us with important information on the advantages and disadvantages of entering a specific value chain and different realities which will be experienced at different links within a given chain. Importantly, governance and power also direct our attention towards understanding how and why barriers to entry are created by value chain controllers and how these inhibit, but also potentially create, opportunities for small and marginalised
producers. Understanding how and why barriers are created and who ‘controls’ these barriers is crucial if one wishes to breach or harness such barriers.

The second appealing feature of value chain analysis is that it directly addressed how and why economic and other rents are distributed across a chain. By understanding which activities are ‘well’ rewarded along a chain, and which activities attract poor returns, we are able to develop a feel for which types of activities in the value chain that are likely to attract a return sufficient to positively impact on incomes and returns and which activities are like to result in immiserising growth. This is a crucial point because linking marginalised and small producers to developed value chains is not a guarantee that the livelihoods of such participants will improve. It is possible to increase such linkages without improving income generation or returns to small producers. As such, chain activity and product selection within a given power and governance environment must be carefully considered to ensure that the created linkages do in fact result in improved circumstances for small producers.

The third appealing feature of value chain analysis is that product and/or process upgrading is an intrinsic part of the theory. Firms go to the trouble and expense of implementing governance structures in order to assure themselves of access to the right goods, of the right quality, at the right time. As such, lead firms often see investing in their suppliers as a sound business decision and may either offer embedded services or facilitate the access of suppliers to appropriate upgrading services. The fact that upgrading to meet standards and critical success factors is intimately tied to governance and the exercise of chain power means that at least some of the supply side issues which will need to be dealt with in relation to small, marginalised producers can be dealt with endogenously i.e.: a successful linkage programme will by its nature incorporate some upgrading within the linkage itself, thereby decreasing the need to provide extensive, external supply side support over and above that provided by the core economy linkage partner.

The final appeal of value chain analysis is the fact that it is a demand side approach. For too long, policies, programmes and strategies in South Africa (and the rest of the world) have been supply driven, often resulting in production and productivity improvements in small and marginalised economic activities which do not translate into improved livelihoods; either due to a lack of final demand or low prices/returns earned. By adopting a demand side approach, we improve fundamentally the probability that if a linkage is successfully created, the activities or products of such producers will have an effective market in which to sell their outputs and services at a price that will improve their income and return earning potential.

These four appealing features of value chain analysis have motivated us to use value chain analysis as an appropriate construct on which to base our framework and strategic thinking. Essentially, these features offer us a consistent and rigorous methodology with which to isolate and express the crucial questions that will need to be answered in any attempt to link, at a systemic level, mainstream and marginalised economy players in South Africa.

Using value chain analysis for this study has not, however, been a simple task. Value chain theory is based on investigations of a specific product or sector, in a specific location, with specific actors, at a specific time. It is an empirically driven analysis. In our study, where we are searching for systemic obstacle identification and systemic solutions to obstacles, this sector specific approach creates difficulties in terms of the level of analysis.
To counter this, a framework has been developed, and strategic options compiled, based on cross-cutting issues. The study looked at hundreds of case studies and specific sector value chain analyses undertaken in scores of countries. Surprisingly, the same issues arose time and again. This lent credence to the study’s assertion that, irrespective of sector, some characteristics of lead firms in the mainstream economy, and some characteristics of small producers in the second economy, lead consistently to the same obstacles to successful linkages. As such, we identify these cross-cutting issues as systemic in nature and believe that they reveal the key constraints which must be addressed in order to implement a successful linkage strategy.

The framework identifies 15 key systemic constraints. These are shown in Table 1:

<table>
<thead>
<tr>
<th>No.</th>
<th>Systemic issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>The rise of large lead firms as a dominant characteristic of demand in the 21st century.</td>
</tr>
<tr>
<td>1.1</td>
<td>Large lead firms demand increasingly large volumes from suppliers</td>
</tr>
<tr>
<td>1.2</td>
<td>Large lead firms tend to shift away from being resellers of other enterprises products and produce their own brands. Brands are used as market differentiators using: innovation, quality and standards</td>
</tr>
<tr>
<td>2</td>
<td>Concentration at lead firm level has cascaded down value chains to increasing concentration at all points along a value chain</td>
</tr>
<tr>
<td>2.1</td>
<td>Input suppliers are more concentrated and usually now offer one-stop shops</td>
</tr>
<tr>
<td>2.2</td>
<td>Processors, packers, manufacturers, etc. are becoming increasingly more concentrated and are shifting towards contractual relations, rather than sourcing inputs on the open market</td>
</tr>
<tr>
<td>3</td>
<td>Standards have become increasingly important and apply not only to actual product standards, but also to social and environmental standards</td>
</tr>
<tr>
<td>4</td>
<td>Profits and returns are gravitating towards points of concentration along a value chain</td>
</tr>
<tr>
<td>5</td>
<td>Profits and returns are gravitating towards logistics, branding, marketing and design activities and away from production inputs</td>
</tr>
<tr>
<td>6</td>
<td>Lead firms increasingly only want to deal with large competent suppliers</td>
</tr>
<tr>
<td>6.1</td>
<td>Lead firms are increasingly relying on codification and certification to decrease governance costs</td>
</tr>
<tr>
<td>6.2</td>
<td>Lead firms are continuously seeking to decrease the number of hand over points in a chain</td>
</tr>
<tr>
<td>6.3</td>
<td>Lead firms are increasingly delegating additional activities to lead suppliers</td>
</tr>
<tr>
<td>7</td>
<td>Contract based linkages (captive network) provide better returns and greater opportunities for upgrading for small producers than spot market linkages (arms length network)</td>
</tr>
<tr>
<td>8</td>
<td>Contractual linkages are dependant upon trust, relationship building and an understanding of rights and obligations of both lead firms</td>
</tr>
</tbody>
</table>
Continuous supply is often incompatible with the rural and cultural life of small producers.

Small producers and their contractual relations often cannot survive worst case scenarios.

Small producers are predisposed to indulge in extra contractual marketing.

Linkage programmes must address financing. Internal financing is preferable to external financing. Financing individuals is preferable to financing group formations.

Horizontal aggregation (grouping) of small producer activities is necessary to overcome high transaction costs, but group formations fail more often than they succeed.

Group formation fails if not commercially driven and competently directed in an appropriate legal structure.

Group formation fails if it is inconsistent with rural social systems and hierarchies.

Small producers are unlikely to be able to negotiate contracts on favourable terms by themselves.

Externally catalysed linkage programmes are not scalable.

Traditional commodity products face decreasing terms of trade and lead to immiserising growth.

Most small producers produce traditional commodities.

The lower the level of critical success factors necessary to win a contract the lower the income share distributed to producers.

Product segmentation is crucial.

Small producers are ill equipped to undertake strategic product segmentation.

While each of these is dealt with in detail in the study, some of the more important issues (or groups of issues) are:

Issues one and six are important from the study’s perspective because they show essentially that the environment within which we wish to establish linkages is a systemically hostile, infertile environment for such interventions. This is an international phenomenon and not an issue specific to South Africa;

Issues five and 13 are important because they alert us to the reality that successful linkages will not necessarily provide increased incomes and returns that will lift poor producers out of poverty. The reality that such producers tend to produce primary or intermediate inputs that are traditional and usually commoditised, together with the reality that profits gravitate towards intangible services along chains, suggest that creating linkages is a necessary but not a sufficient step in reducing poverty. Rather, product selection and niche markets, as well as where producers access a chain, becomes important.

Issue 12 is essentially a turning point for the study. The research reveals that almost all linkage programmes designed and implemented worldwide are externally catalysed programmes. This means that the programme was catalysed, not by actors in a value chain, but by an outside third party (usually a government or non-governmental organisation or
NGO). The literature shows that these externally catalysed projects require enormous resources (financial and human), but are not replicable, scalable, nor do they enjoy economies of scale. This issue creates an enormous hurdle for a study which seeks to develop systemic change or, at the very least, change on a large and substantial scale.

The issues identified in the framework create the basis for two strategic options presented in the study. The options are: one, a systemic change option called the preferential procurement strategy; and two, an incremental change option called the LEADER system strategy.

The preferential procurement strategy is based on issues one and six, above, and is driven by a desire to make the environment for linking small and marginalised producers more fertile by changing the purchasing preferences of the lead firms that dominate the economy. The strategy draws from South Africa’s experience with respect to the Broad-based Black Economic Empowerment (or BB-BEE) Scorecard and the effectiveness of government tenders in certain sectors. The essential argument is that in the Information Technology (or IT) sector, for example, lead firms have changed their modus operandi in terms of sourcing inputs and services from BEE partners because they need to achieve high preferential procurement scores in order to win lucrative government contracts. The lead firms who would potentially buy inputs from small producers are mainly retailers (buyers of food stuff, agricultural products, garments and textiles, home wares, wood products, crafts etc). Retailers will never benefit from government tenders, and as their consumers are not BB-BEE sensitive there is little incentive for them to improve their BB-BEE score.

The strategy suggested is, therefore, intended to create a specific financial inducement for a retailer (such as a tax break) that is sufficiently attractive to make it want to increase its procurement from small producers. Lead retailers would earn points or credits from sourcing products from qualifying small producers and these points would attach to an incremental tax benefit. By incentivising lead firms using an adaptation of the BB-BEE scorecard, the strategy would induce similar preferential procurement along the entire lead firm’s value chain. The strategy suggests further that the incentive be sufficiently large so as to cover the enterprise development that lead firms will need to undertake to create the appropriate supply of the right quality and consistency from small, marginalised producers. In this strategy, government plays a supportive and facilitative role, while leaving the private sector to undertake most of the necessary on-the-ground activities of upgrading and aggregation. The crux of the argument is that lead firms and their suppliers, processors and manufacturers have the necessary industry knowledge and expertise to undertake upgrading activities, whereas such capacity is not readily available in government. Government’s role is to incentivise and facilitate such behaviour; more direct roles in upgrading in the strategy are limited to those areas where lead firms have no core competency; but even then, government’s role is described as supporting the efforts of lead firms in these areas, rather than delivering the services directly.

Companion strategies which offer additional government-led services that support lead firm second economy procurement are also presented. These companion strategies, which include ideas such as lead farmer programmes, the development of market intermediaries and coordination mechanisms in marginalised areas, stand on their own merit, but if undertaken in conjunction with the preferred procurement strategy, they would provide useful channels for lead retail firms to link into.
While the first strategic option is ambitious and generates systemic change based on changing lead firm purchasing behaviour and preferences, the incremental change option is far more modest in its aspirations. In the second strategy, the study takes lead firm purchasing behaviour as a given and submits to the idea that systemic change is not going to occur. Rather, in this approach, the study accepts that linkages will occur on an initiative basis, but establishes a mechanism for the generation, design and implementation of initiatives which is scalable and which enjoys economies of scale. By putting such a mechanism or system in place, numerous large initiatives can be supported which will collectively result in incremental change in the prospects of second economy participants.

The LEADER system strategy is premised on participants in an area getting together and proposing linkage initiatives that improve the livelihoods of participants. Qualifying initiatives are supported financially by the government. The value of this bottom-up approach is that it ‘internalises the catalysation process’ of initiative design and implementation, thus, removing governmental capacity constraints from the equation. In addition, the fact that areas must compete for a fixed amount of funding creates an in-built quality assurance system, while qualifying area criteria assist in ensuring that large scale initiatives are undertaken in preference to small local economic development (LED) type initiatives.

The study stresses that the two strategies put forward are merely two ideas on how to solve the issues identified in the framework. Numerous other options exist, as do options based on multiple strategies implemented either simultaneously or in sequence. This is an important point. The value of the study lies in the fact that it is looking at an existing problem from a new perspective. This new demand driven perspective raises issues which have often not been considered in policy circles to date. We believe that putting these issues on the table, and raising awareness of the nature and consequences of these systemic obstacles in linking small and marginalised producers into deeper, mainstream value chains, can only support the development of more effective poverty-reducing interventions by the state. Whether the two options covered in detail in the study are taken forward or not is less important than is the act of stimulating debate in a new and positive direction.

INTRODUCTION AND CONTEXT

This study looks at an existing problem from a new angle. It aims to catalyse debate and discussion. As such, it was expected that the final document should attract vociferous discussion, debate and criticism. What was not expected was that the terms of reference would attract an equivalent response. This sets the scene for what has been a difficult birth and uphill battle in the production of this study. At every turn, the authors and commissioning parties ran into a hurdle of effectively communicating to audiences the context and purpose of the study and why such a study should be framed in these terms.

The communication gap arises because of three factors. First, the study aims to use a traditional conceptual framework (value chain analysis) in an untraditional manner. Second the study seeks systemic solutions to a problem that is traditionally solved using a project based approach (creation of linkages). Finally, the study aims to develop strategies driven by the private sector, in an area in which such strategies are traditionally provided by the public or donor sector. Critics interpret the study as trying to fit a square peg in a round hole. Supporters suggest the study is a first, tentative step towards a new mindset and approach.
In an attempt to communicate how and why this study was designed in its current form; this chapter deals with its origins, the qualifications of the terms of reference and, finally, offers a guide to the complete study. It is more detailed than most introductory sections in similar studies but care has been taken to ensure that readers understand the purpose of the study and its ultimate goals so as to correctly contextualise and assess the remainder of the study.

Before beginning this chapter in earnest, it is crucially important to deal with some terminology issues which are used in this study. As this study emerges from the findings of the 15 Year Second Economy Programme Review, it made sense to adopt the same terminology, namely, to use the concepts of first and second economy to describe different ends of the spectrum in our highly unequal economy, with wealth and resources concentrated at one end, and poverty and economic marginalisation at the other, but with these effects arising as consequences of the structure of the economy as a whole, rather than being disconnected outcomes in two distinct ‘economies’ that operate in parallel. This is an important clarification because the use of this terminology has been contentious for many years. Some policymakers, academics and researchers interpret the delineation of economic activity into the first and second economy as a basis for viewing the economy as a dual economy. Supporters of the dual economy hypothesis see a fundamental disconnect between the two economies. This dualism results in policy approaches based on a premise of parallel economies in action and the need to build bridges and links between these two different entities. In other words, to create links between the two in order to reverse the assumed disconnect.

The Review of Second Economy Programmes and this study disagree fundamentally with the identification of a dual economy. The Review of Second Economy Programmes is explicit and adamant that the domestic South African economy is a single economy, is one that is highly heterogeneous and is best viewed as a single continuum with two extremes and a range of middle ground. On the one extreme sits the so-called mainstream economy which is characterised by a concentration of wealth, power, skills and access to information, opportunities, infrastructure, finance and markets. On the other extreme, the so-called second economy is characterised by highly constrained access to information, opportunities, infrastructure and finance. Most importantly for our purposes, the second economy has limited access to markets and limited power.

The idea of viewing the economy as a single continuum, as opposed to two parallel and separate realms of economic activity, is crucial in understanding the nature of the interventions that this study is seeking. In the dual economy hypothesis, it is assumed that the two economies operate in isolation from each other and that this disconnect should be ameliorated by creating bridges and links between the two discrete realms of economic activity. In the single, but unequal, hypothesis, it is understood that the two ends of the spectrum are already connected and linked: there is no fundamental disconnect to be reversed. Rather, the single economy hypothesis believes that the connectivity and linkages that do exist between the two economies are highly asymmetrical and lead to systemic constraints for small producers in marginalised areas. As such, the nature of policy intervention in this approach is to understand the drivers and consequences of this asymmetry and to seek ways to change the power dynamics that exist.
In terms of what this means for our use of terms such as ‘first economy’, ‘second economy’ and ‘linkages’, strictly speaking, we should not use this terminology. As argued above, we do not believe that the first and second economies are different economies but are merely extremes of a single continuum. Similarly, we do not believe that these two extremes need to be ‘linked’ because this assumes that they are at present unlinked or unconnected, which we have argued is not the case. Having said this, however, we have decided to continue to use the term ‘linkage’ because it is a concept that is well understood in academic and policy circles, and it appears as a staple in the majority of literature we refer to. In place of the first economy, we have used the terms ‘mainstream economy’ as an alternative, and refer to the ‘marginalised economy’ as an alternative to the second economy. Where first and second economy terminology is used, as in the Review prepared for the Presidency, we continue to use this terminology so as to assure consistency with the original text and argument.

**Point of departure: findings of the Review of Second Economy Programmes**

This study has been designed to take forward a key issue raised in the Review of Second Economy Programmes that was produced as part of the Presidency’s 15 Year Review Process. The study argues that the structure of the economy imposes limits on opportunities in local markets in marginal areas, and that economic development strategies need to focus on local markets and how to facilitate access to wider, external markets.

Given that the Review of Second Economy Programmes is the point of departure for this study, it is necessary to begin with a brief summary and analysis of the findings of the Review. This summary will not only contextualise the study and establish a common understanding of the current environment and its challenges, but it will help to clarify the purpose of the current work agenda and how its findings contribute to strategy development to tackle sustainable poverty reduction.
The government’s draft anti-poverty strategy states that 22 million people are poor in South Africa. Of these 22m, the Review of Second Economy Programmes reveals that approximately 10.4m are not able to be economically active and, hence, anti-poverty strategies to reduce poverty for this group remain focused on social grants and free basic services. The remaining 11.6m people defined as poor are either unemployed or involved in economic activity but do so for returns that are too low to lift them out of poverty. The latter group includes: subsistence farmers, very small-scale enterprises, both formal and informal, as well as the working poor (or those in formal employment but who earn insufficient wages to lift themselves out of poverty). The first, best prize for this group of the poor is the creation of market-based employment opportunities which offer an income sufficient to lift them out of poverty.

The Review notes that government’s performance in relation to the delivery of social services, such as grants and basic services, has been “significant and at a scale that has had a measurable impact on poverty” (Philip and Hassen, 2008: 13). Its economic programmes aimed at creating market based employment opportunities have, however, been modest, at best. The Review looks at a host of market based employment programmes such as sector strategies, Small, Medium and Micro-enterprise (SMME) and cooperative development, smallholder development, land reform, BB-BEE, Integrated Development Plans (IDP’s), among others, and finds that while many of the programmes are good, they struggle to scale up and increase their reach. So, for example, whereas a social grant programme can reach millions of individuals, market based employment programmes tend to reach only between 50,000 and 100,000 beneficiaries. From these findings, the Review places, as front and centre, the issue of how to scale up economic programmes which aim to create market based employment as a crucial element of any future second economy or poverty reduction strategy.

The Review’s identification of scaling up market based employment creation economic programmes as the crucial issue to address is supported by Asgi-SA’s (or the Accelerated and Shared Growth Initiative for South Africa) call for the “massification” of such programmes. The solution lies in two areas: firstly, the need to leave behind a project based paradigm and shift towards a wider process paradigm which deals with structural blockages and market failures and results in societal level changes rather than changes for direct initiative participants alone. The second solution lies in developing new ways to think about delivery and implementation.

In making a contribution towards developing these solutions, the Review of Second Economy Programmes spends considerable time on understanding the reasons behind the limited scale of market-based employment economic programmes targeting the poor. They identify six key contributing factors: under funding and a low appetite for risk; coordination and implementation problems; a lack of voice and advocacy; problems with interfaces with markets; low targets; and a project level focus and downward raiding within asset transfer programmes. Of these six issues, we have been asked to focus our study on the interfaces with markets.

The Review of Second Economy Programmes analysis of market structures, distribution and demand is a sophisticated contribution to the poverty debate and, importantly, moves beyond the traditional debate of supply side barriers, such as access to credit and regulatory

---

1. Downward raiding refers to a practice where assets are transferred to the poor in an attempt to relieve poverty, but because support programmes are not available the poor rapidly convert the asset into income usually at below market value.
Barriers to entry. Rather, the Review bases the foundation of its argument on an understanding of demand issues facing the second economy.

The Review argues that many of the key employment creation economic programmes undertaken in South Africa and, indeed, the majority of second economy productive activity is based on local production for local markets. The Review notes that markets in marginal areas are notoriously thin. This is because poor people have limited disposable income and buy a limited basket of consumer goods. Most of these goods are produced in the mainstream economy and distributed to remote areas, where they are the products of preference due to branded goods providing an assurance of quality and meeting aspirations resultant from marketing initiatives. This makes it difficult for local producers to compete in relation to price, quality and brand recognition in any goods other than fresh produce.

The Review notes an important point in relation to how domestic projects in marginalised areas have been developed. Projects which have attempted to meet the thin market challenge have generally done so by attempting to set up production projects in parallel to the mainstream economy’s production systems. In other words, it has involved a domestic interpretation of an import substitution policy with infant industry protection support based on a core periphery model. These projects have generally failed. These projects are criticised by the Review on a strategic level as “implicitly assuming a dualism in the economy that sees first and second economies in parallel, rather than as asymmetrically interdependent.”

This is a crucial point. The first and second economies are two ends of a spectrum within South Africa’s highly unequal economy. Wealth, resources and opportunities are concentrated at the mainstream economy end of the spectrum, while poverty and disadvantage concentrate at the second economy end of the spectrum. This divide is structural in nature and arises from the country’s apartheid legacy.

The debate in South Africa, at present, is focused on the relationship between these two ends of the spectrum and the range of connections, disconnections and dependencies and interdependencies. The overarching aim is to strengthen linkages and access and “to address the terms on which these take place, the spread of benefits and issues of power” (Philip and Hassen, 2008: 2). The debate is not about two dual economies which exist in parallel.

This leads the Review to propose that rather than local production for local markets, or parallel production in the first and second economy, the route to be followed should be to shift local production towards external markets, i.e. to link second economy production into existing mainstream economy production on a systemic basis. In this thinking, an external market is any market outside of the thin local markets of a marginalised area. The external market may be an urban centre retailer, a processor in the same province, or a mainstream economy hotel operating in the same district. The external market, thinking on a grander scale, might even be an international niche export market.

The thinking is simple: if local production targets external markets, then the limitations of the local market are overcome. External markets will provide potentially higher value for producers, demand higher volumes of produce and generate higher returns based on the higher effective spending power and diversification of products demanded in these markets.

---

2 This does not imply that there should be no production for local markets, but merely that local markets are quickly saturated and, hence, hold limited potential for large scale change.

3 It is important to note that these assumptions in the Review are, in principle, correct but, in practice, may be difficult to achieve. For example, a producer in a marginal area selling into a branded retail urban outlet may find that the price the retailer is willing to pay is lower than the price he is currently selling at. The retailer may make up for this by buying additional
The Review makes an initial attempt to demonstrate some key requirements and challenges that need to be met to facilitate this change in target market. They suggest that small, marginalised producers will need to formalise their businesses and business practices, and comply with a variety of regulations before they are able to transact across distance. Secondly, they identify accessing value chains as an important aspect in linking local production to external markets, and see this as a mechanism to reduce transaction costs and risks while simultaneously allowing for specialisation, production and capacity upgrading.

Finally, the Review identifies the role of market intermediaries as crucial in shifting local producers away from local markets towards external markets. They argue that some type of intermediation will be required to help local producers deal with the production of volumes demanded in external markets, and that these intermediaries can help share risk, coordinate production and develop collective market power for local producers. In addition, the Review argues that intermediaries can assist in overcoming information and technical support gaps.

The Review’s analysis of what is required to support the desired shift to external markets is logical, cannot be faulted and its message is correct. However, its suggestions are nascent and require deeper consideration before they are able to inform an implementable future strategy. This is acknowledged by the authors of the Review and formed the motivation behind the commissioning of this study.

The Review programme is exactly that: a review of past programmes, activities and strategies. It was not constructed to cover how new avenues of endeavour should be approached but merely to identify that certain avenues need to be explored further. As such, this study is tasked with unpacking the issues related to how best to support the shift from local production for local markets in marginalised areas to local production for external markets. Figure 2 represents our thinking about the context of the study.

**Figure 2: Broad context of the study**

**CHANGING THE GROWTH TRAJECTORY OF PRODUCERS IN MARGINAL AREAS**

**CURRENT GROWTH PATH OF PRODUCERS IN MARGINAL AREAS FOCUSED ON SELLING TO LOCAL MARKETS**

- Continued thin markets
- Continued low incomes
- Continued low returns
- Limited opportunities for income
- Continued instability of income

**POTENTIAL GROWTH PATH OF PRODUCERS IN MARGINAL AREAS FOCUSED ON SELLING TO EXTERNAL MARKETS**

- Access to dynamic markets
- With high disposable income
- Ability to generate higher incomes
- Ability to generate increased returns
- Improved ability to generate income
- And employment
- Ability to increase security of income

**WHAT NEEDS TO BE DONE TO CHANGE THIS TRAJECTORY**

**Producer base in Marginal areas**

Source: own design
Terms of reference

At one level, the purpose of this study is simple. Those who have commissioned the work believe that linking marginalised small producers to external markets is a robust, dynamic method by which to lift such producers out of poverty in a sustainable manner. As such, the broad terms of reference relate to the red arrow in the diagram that is Figure 2: what needs to be done to change the growth trajectory of small, marginalised producers in marginalised areas? The commissioning parties have asked to study to, firstly, develop a framework or toolkit which will assist in how we think about the complex issues of markets and linkages in the economy. The aim of the framework is to identify issues which constrain the opportunities for mainstream and marginalised actors to transact. On the basis of this deeper understanding, to second requirement of the study is to, secondly, develop novel approaches to inform a strategy discussion on how these resolve issues.

Those who commissioned this study do not require that the proposed strategies be developed to the point where they become implementable programmes. At this time, they are content with the generation of new ideas and approaches. In addition, the study is not burdened with needing to resolve all issues related to second economy poverty reduction as it is part of a broader process which investigates multiple facets and options.

One of the central reasons why this study is only tasked with catalysing strategic debate is that the study and its outcomes are to focus on creating a framework and developing strategy on linkage options at a systemic level, using value chain analysis. It is these two qualifications to the broad terms of reference which have created substantially challenges and attracted much criticism.

Explaining the terms of reference qualification, regarding systemic change solutions as opposed to project based solutions, is self evident given the origins of the study and the 15 Year Review’s findings that scale has been a problem in market-based employment initiatives. The terms of reference for the study clearly specify a desire to move away from project-based approaches where impact is limited to beneficiaries directly involved in the projects. Rather, the terms of reference seek strategic options that talk to the fundamental operation of the systems at play in both the mainstream and marginalised economy, as well as how behaviours can be changed to delivery consistently different outcomes. In the absence of devising systemic level change (which constitutes first best prize), the terms of reference do allow for project-based strategies but require that these initiatives be based on a system whereby benefits are enjoyed by a group larger than just direct initiative beneficiaries and where initiatives can reach scale so that incremental change can occur.

Explaining the terms of reference qualification about the use of value chain analysis is also obvious as soon as one understands the key tenants behind the paradigm. Value chain analysis follows the path of economic activity from the production of inputs all the way along a chain to final consumption. In this respect, it is similar to supply chain management. The fundamental difference is that value chain analysis focuses on the existence of power among actors in the chain and uses this understanding to examine how barriers to entry are created and maintained, how decisions on access are taken and managed, and, importantly, how economic rents created along the chain are distributed. Mainstream and marginalised economic relationships are characterised by numerous asymmetries. Most often, developmental economic strategy seeks to deal with asymmetries related to access to land, finance, infrastructure, skills and training, among others. Seldom do such policies explicitly
take into account asymmetries of power and the consequences of such power imbalances. Value chain theory allows us to deal directly with these issues and, as such, even though the adoption of a value chain paradigm in the context of this study creates academic difficulties, it is still viewed as an optimal approach to adopt.

The search for systemic solutions to these issues, using a value chain approach takes this study into uncharted territory - theoretically, practically, conceptually and in terms of international case studies. It is this movement into uncharted territory that contributes to the difficulty in communicating the thinking and findings emanating from this study.

On the ground, various concerns have been raised in bi-lateral discussions between the authors and various academics, practitioners and policymakers; as well as at two workshops where the interim findings of the study were presented. These concerns relate to issues of methodology, the appropriateness and relevance of the terms of reference, as well as the pragmatism of various strategic proposals. While these issues are dealt with in detail in the document, it is relevant to consider some of these concerns prior to stating the outputs and anticipated outcomes of this study.

Crudely, we can categorise the criticisms of the study into three broad categories, although many of the criticisms cover all three areas, and which include: academic criticisms, policy goal criticisms and practical criticisms.

The academic criticisms of the study relate to the use of value chain analysis for a purpose it was never intended. Using value chain analysis as a foundation for developing a framework and strategy to link the first and second economy in a scalable fashion is indeed problematic. The problem arises from the fact that value chain analysis is an empirically driven methodology used to understand power and governance issues among a given set of economic actors within a specific sector, in a specific location, and at a given point in time. As such, talking about value chains and systemic change without reference to specific sectors, products or locations removes the underlying logic and basis of value chain analysis itself. (Some have suggested that such an exercise is equivalent to neutering value chain analysis). The issue is, essentially, one of a level of analysis. This study aims to provide macro-solutions in terms of its strategy, while using a framework firmly rooted at the meso-level (or a level of economic activity characterised by intra-firm relations).

Having noted the cautions of using value chain analysis for a purpose other than what it was intended, the core concepts which emerge from value chain analysis are profoundly useful in delineating the issues to be resolved when considering linkages and are maintained as a foundation for this study. The four cornerstones of value chain analysis are: emphasis on governance and power and how the exercise of these impacts market access; emphasis on how and why governance and power influence the distribution of economic rents across a value chain; the fact that value chain analysis accounts for upgrading as a core element of the nature of linkages; and, the fact that value chain analysis is a demand driven paradigm.

To deal with the disjuncture of using a meso-level concept to inform a macro-level strategy, we have limited our takeout from our value chain framework into our strategy work to simply an identification of structural and systemic issues which characterise all attempts to link small, marginalised producers to mainstream economy value chains. By studying hundreds of specific value chains analyses across different sectors and countries, we found issues which arise repeatedly, suggesting that there are systemic obstacles which can be identified using value chain analysis.
The second set of criticisms relate to the study’s focus on providing systemic solutions driven at a national government level. These criticisms are based on a belief that national policy is the incorrect lever of power when dealing with what is ultimately a highly intimate relationship: the relationship between a seller and a buyer. These critics suggest that sub-national spheres of government (such as provincial or municipal levels) are more appropriately positioned to deliver linkage type programmes. This criticism reveals how strongly we are vested in a project-based approach to issues of this nature. While we concede that linkages are ultimately about strong and intimate personal relationships, we argue, nevertheless, that national government can provide an environment which is more conducive to developing such relationships and, as such, national government policy is an appropriate lever of policy intervention to consider. Having said this, however, the study has been constructed in such a way that the framework deliverable stands alone. This means that in the event that a national policy response is discounted, the framework can be used at sub-national levels to inform linkage programmes.

The final criticism of the study is that its strategic recommendations will never be implemented because they are counter to current government approaches and government’s modus operandi. We accept this criticism but maintain that the purpose of the study is to come up with new and challenging ways to think about intractable problems. In order for out-of-the-box or blue sky thinking to be successful, it must, by definition, challenge convention. The fact that the study’s strategic suggestions were criticised purely on the basis that they run counter to current policy views, and not due to any flaws in their logic, construction or rigour, suggests that the study may have achieved one of its aims.

In summary, the purpose of this study is to catalyse new and novel thinking about how the nature of economic linkages at the firm level and in value chains can be changed in ways that deliver different outcomes: a fairer spread of benefits, less asymmetry in power relation and increased impacts on local economic development and poverty. The study creates a framework for identifying systemic obstacles that hinder such linkages and suggests options available to overcome these obstacles. The study is based on value chain analysis concepts and ideas and all strategic options are framed in terms of achieving systemic or, at least, highly scalable outcomes.

What constitutes success?

The issue of what constitutes success for a study of this nature must be looked at from two perspectives. Firstly, there is a substantive, quantifiable measure of success in terms of the actual outcomes sought on the ground. Secondly, it is a more subjective outcome in terms of the study’s aim to catalyse new thinking.

The issue of what constitutes success on the ground has proved to be a very important issue in the development of the framework and the strategic options put forward in this paper. Indeed, this issue has had more influence on the design of our final recommendations than any other issue in the study. The Review of Second Economy Programmes suggests correctly that shifting second economy production away from thin local markets towards deeper external markets is the key to unlocking value for small, marginalised producers. Intuitively, this is correct. In reality, however, the concentration and exercise of power in external markets in absolute terms, as well as, relative to the power of small producers, makes such an assumption incorrect. In reality, it is possible (and probable) that small, marginalised producers can be linked to mainstream economy value chains and that, through such a
linkage (even though the volume of sales increases), small, marginalised producers do not earn sufficient returns to lift themselves out of poverty. As such, success will not have been achieved if linkages are established and the volumes sold increased but at prices and on terms which keep small, marginalised producers in a state of poverty. Success will only be achieved if such linkages and higher volumes result in higher incomes and higher returns to small producers such that they are lifted out of poverty. Linking small, marginalised producers into external markets via core economy value chains is not a panacea to poverty; rather, it is creating linkages that support poverty reducing returns to small producers which are the goal. A linkage strategy is necessary but it is not sufficient. As such, success for this study will only be achieved if the proposed framework and strategies support linkages which provide returns that do actually reduce poverty.

The second criterion related to success is whether the study is able to catalyse debate in a meaningful way and whether the study’s output is useful. To ensure success at this level, the study has been designed to produce a framework and a set of strategy options as two distinct deliverables. The framework is a tool and lists questions and issues that need to be considered when designing any first and second economy linkage intervention at any scale. By using value chain analysis, this framework raises issues which are often not taken into consideration when designing linkage initiatives or second economy supply side interventions, as such, it does provide new thinking on how to approach policies and programmes in this area. The strategy section is simply two options which arise from the framework. The two options presented are novel with respect to the fact that they approach linkage interventions at a systemic level. It is possible that they may elicit a response that seeking systemic change is a goal too far or that less ambitious goals should be set. If this is the case, then a useful debate has been entered into and a decision to not pursue one path is as valid a strategic decision as is the decision to adopt a given path.

**Reading the document**

The study has been written and presented in an incremental manner to allow the reader to be taken along the journey together with the authors. This is done to ensure that those without an economic background are able to benefit from the document and, more importantly, to ensure transparency and the development and coalescence of the ideas.

Chapters two, three and four are the study’s foundational chapters and introduce the reader to the theoretical terminology and concepts of value chains, linkages and product selection. These chapters review current literature and debate, provide case studies and examples, and include conclusions about the issues that are relevant for South Africa, specifically, and the framework and strategic options that we are seeking to generate.

The issues derived from the foundational chapters create the basis for chapter five, the framework chapter. Chapter five begins with a detailed investigation of the scope and parameters of the framework before moving to the presentation of three framework tables. The tables list, in the left hand column, the issues which need to be addressed in any systemic linkage programme while in the right hand column, the strategic implications of such issues are noted.

Chapter six incorporates two options related to how a strategy could be developed to meet the systemic issues identified in the framework tables. The first strategic option, called the ‘preferential procurement incentive option’, is a truly systemic change option as it seeks to address the underlying behaviour of mainstream economy value chain players. The second
strategic option, called the ‘LEADER system incremental change option’, is less of a systemic solution, but is rather a process to support incremental change on a large scale.

AN INTRODUCTION TO VALUE CHAIN ANALYSIS

Value chain analysis lies at the heart of our study. This foundation chapter explains the key concepts upon which value chain analysis rests and identifies recurring issues in such analyses which will ultimately inform our framework tables. Where possible, many examples have been used to illustrate the theoretical concepts covered. Most of these examples pertain to international case studies and experiences, almost all of which involve producing for the export market. In our research, we found few examples of value chain analysis within domestic markets (although, this area of analysis is beginning to receive greater attention (see Humphrey 2005)). As is shown in the subsequent chapter, this is not an impediment. Whether value chain analysis is being used to link developing countries to global value chains, or to link small, marginalised producers to mainstream economy value chains within a domestic economy, the forces at play and logic of the analysis is the same.

The origins of value chain analysis

It is useful to begin our analysis with a brief overview of the origins of value chain analysis because this shows the progression of thinking amongst development economists and practitioners and helps explain why value chain analysis was chosen as the foundation for our framework. We believe understanding the nature of value chain theory is particularly relevant in South Africa as many researchers and policymakers misuse the concept and call their work value chain analyses when in actual fact they are undertaking market or sectoral analyses. On the other extreme, some researcher believe value chain analysis is an entirely new concept and believe that it contains answers to questions and methods of approach which are totally novel and revolutionary, when, in fact, value chain analysis is merely an additional layer of analysis laid upon a traditional supply chain approach.

We begin our story of the evolution of the concept of value chains back in 1970s when policymakers, development economists and development practitioners sought ways to reduce poverty by means other than direct payments via the social grant system. Various government lead programmes emerged, especially with respect to public works programmes but generally these were unsustainable and made no lasting impact on poor communities on a large scale. In the 1980s, a fundamental shift occurred whereby policymakers and development experts attempted to reduce poverty using an approach termed “private sector development (PSD).” PSD noted a major break in policy thinking and led to a host of initiatives aimed at incorporating the poor into the economic mainstream and thereby lifting them out of poverty by allowing them to participate in private sector economic activity and earn a living income. In the late 1980s and 1990 the key private sector development tool was “business development services (BDS).” BDS were aimed at making markets work better and more efficiently for poor participants. The BDS approach was based on identifying market failures and barriers to entry and attempting to address them. Initiatives included: micro lending initiatives, skills development programmes, appropriate innovation and technology programmes and mentoring and contact services for poor entrepreneurs and communities seeking to enter the economic mainstream.

In the late 1990s, it was generally agreed that the business development services approach to private sector development had not been particularly effective. Two key criticisms emerged. The first was that BDS ignored existing business service markets, and indeed, often
created unfair competition to existing service providers through subsidised governmental business promotion programmes and organisations. The second criticism of BDS was that removing market failures and barriers to entry while an important step in integrating the poor into mainstream economic activity, was unfortunately often insufficient. Issues such as transaction costs, income distribution, network development and governance issues often derailed projects even when BDS interventions had made markets work more efficiently.

“Making market systems work better for the poor” (or M4P) evolved directly from these critiques of BDS and as a contribution to the Millennium Development Goals. M4P is the first private sector development concept which is overtly PRO poor in its approach. The key contribution of M4P is that it widens the focus from markets to ‘market systems.’ The argument here is that markets are based on issues of allocation not issues of distribution. Distribution issues are pivotal in reducing poverty. The M4P literature argues that markets are often rigged in a way that only benefits a small group of already well off participants. To level the playing field and create opportunities for the not so rich requires interventions that look at the interactions of markets and different forms of distribution. The principles of the approach are based on a conceptualisation that the functioning of markets depends on two sets of factors: intangible factors which include formal and informal rules and regulations, and; tangible factors which include infrastructure and other services. The inclusion of intangible factors speaks to the issues of how markets interact with each other and how allocative and distributional issues arise due to hierarchies and power relations.

**Figure 3: The market concept of the M4P literature**

While the M4P conceptualisation is useful in raising issues such as rules, regulations, the governance of relationships and the importance of intangible factors such as quality standards, licensing and certification, it has been criticised for being vague and fuzzy in key areas. Stamer and Waltring (2007) provide a substantial critique of the approach including criticism of the model for failing to clearly define ‘the market’ and ‘the poor’ as well as practical considerations such as a failure of the model to deal with the sustainability of intervention vehicles and structures for improved market alignment, as well as, no tool kit that would permit efficient analysis of market failure. While these critiques may be unduly harsh given that the M4P concept is still nascent and is evolving rapidly, the critique does
provide a departure point for the next generation of thinking concerning reducing poverty using private sector development – namely value chain analysis.

Technically, value chain analysis (VCA) arose from sectoral and cluster analysis but moved beyond a static analysis and a business administration conceptualisation of markets by focusing on a key issue, namely, that value chains exist and companies invest time and resources into developing such chains because **markets rarely work properly in the modern age**. This is due to changes in the nature of markets and consumerism. Thirty years ago, consumers who wished to buy fruit and vegetables went to their local grocer and purchased unbranded products. Today, the majority of consumers purchase their fruit and vegetables from large retailers, such as Woolworths or Pick and Pay. They purchase branded products and have expectations of quality associated with these products. The rise of private labels means that commercial retailers can no longer procure produce in the spot market at venues such as the fresh produce market because they may not be able to meet their quality standards and final consumers’ expectations. Instead, the large, final demand buyers need to develop relationships with specific suppliers who provide quality assurance and reliable delivery. This global trend towards branded goods in all sectors has fundamentally changed how markets work. Simply put, no firm will incur the expense of developing arrangements with specific suppliers in order to purchase products that the market freely provides. An International Labour Office (ILO) study on international value chains argues that firms go to the trouble of developing and supervising value chains instead of relying on the market because (1) often firms require high specification product to meet their brand requirements and hence there is a need to ‘capture’ suppliers who will meet these specifications, and (2) that buyers are vulnerable to the shortcomings in the performance of suppliers – and that in a world where non-price competition is important; quality, response time and reliability are crucial. This leads the ILO to conclude that the density and quality of relationships matter.

So, whereas relationships and value chains were less relevant 20 years ago, in the modern markets, relationships and value chains are crucial.

It is important to note that supply chain and value chain analysis are essentially the same concept approached from different angles. Supply chain analysis is based on business administration and business engineering paradigms which seek to create a competitive advantage through improved planning and logistics efficiencies which decrease costs. Value chain analysis looks at the same set of activities but is rooted in development studies, organisational behaviour and sociology – specifically the interaction and relationships between suppliers and lead firms. Using our fruit and vegetable example, we can see how value chain analysis is a better explanatory tool for our framework than mere supply chain analysis. In the 1960s when fresh produce was predominantly purchased at local grocery stores, 70% of Africa’s fruit and vegetable exports were sold to these stores using wholesale distribution channels. In the 1990s, when purchasing patterns had changed 75% of fruit and vegetable products in Europe were sold by large retailers and supermarkets, only 20% of Africa’s fruit and vegetable exports are sold to these markets. The reason for the change in fortunes of African fresh produce exports is simply that large retailers and supermarkets have become the gatekeepers of the market and they became unwilling to rely on the arms length market relationships of the wholesale distribution system and replaced it with captive preferred suppliers with whom they could develop an intensive relationship. As such, African fresh produce exporters lost market share in Europe for reasons unrelated to price, quality, demand or supply but simply because of organisational behaviour changes in the final demand market.
Value chain analysis allows policymakers and practitioners to:

- Uncover the dynamic flow of economic, organisational and coercive activities between producers within different sectors and between producers and suppliers;
- Understand the inter-relationships between the actors in a sector and where and how power relations are exercised;
- Understand the positioning of new entrants into an existing market system and who the gatekeepers are in a given chain;
- Uncover the flow of distribution of incomes and rents and how such rewards change with time;
- Understand how interaction and upgrading occurs within a market.

We deal with each of these issues in detail in the next section. What is important to take away from this section is that VCA is the most current approach adopted by development analysts and practitioners to attempt to deal systemically with poverty reduction in the broader context of private sector development. VCA has been arrived at over three decades of trial and error and conceptual development which has lead to the broadest view of what steps are necessary to link the poor to mainstream economic activity. VCA's departure point is that most markets in the current era do not function properly in an unsupervised environment. As such understanding why, how and where supervision occurs is a key in any attempt to integrate new entrants into a market. This is true whether one is trying to integrate a developing country's exports into international markets, or equally, if one is trying to integrate small, marginalised producers into domestic external markets.

**Key concepts**

Now that we have a crude understanding of the origins of VCA, we can turn our attention to understanding the theoretical building blocks of the approach and developing a suite of terminology that will be used throughout this study.

The first difficulty is that, as Sturgeon (2000) wrote in a paper entitled ‘Defining value chains’, “there is no right way to talk about value chains.” The UN Handbook on Value Chain Analysis suggests that value chains are often descriptive constructs which map out a series of economic activities along a given chain. These activities need not only relate to physical transformation, but importantly include: the process of supply (inbound/outbound logistics, operations, marketing, sales); the transformation of inputs to outputs (production, logistics, continuous improvement) and support services (strategic planning, procurement, development, management). However, there is general agreement within the literature that to transform VCA from a heuristic device to an analytic tool it should an appreciation that:

- Value chains are repositories for rent and rents are dynamic;
- Efficiently functioning value chains involve some degree of governance;
- There are different types of value chains;
- A chain by its nature cannot be moved by pushing it, but needs to be pulled.

Emphasising these additional points is important for South African policymakers and practitioners. To date, much of the VCA completed in South Africa has stopped at the point of describing activities within a product or market chain. Value chain maps are produced showing activity flows and chain participants but little additional research is completed. This
approach, while valuable in its own right, falls short of providing the information necessary to develop successful programmes which positively influence the outcomes producers enjoy from entering a new external market. Much of the literature warns strongly against focusing on value chain analysis populated by macro-economic data, as it is the invisible, intangible issues that are really important. This is a crucial point, as in the previous chapter we showed how it was possible that linking a small, marginalised producer to a core economy value chain is only a successful endeavour if the small, marginalised producer benefits from this linkage via increased income generation, improved returns and increased employment.

Given that allocative and distributional issues are core to our approach, we suggest the following working definition of a value chain for our purposes: “Value chains denote a particular product based thread of activity that at a given moment in time runs through a constellation of activities and dynamic configurations embodied in a production network. It is the nature of the network linkage itself – its information load, connection mechanism, governance style, power dynamic, geographic reach and distributional implications that should be the centre of our research focus” (Sturgeon 2000: 3)

We now look at: (1) different governance structures; (2) different types of value chains as traditionally described in the literature; (3) distributional issues within value chains; and (4) pull and push interventionist options. This section is theoretically dense as we are attempting to develop the necessary rigour to underpin our eventual model. Many issues are highly nuanced; hence, we have tried to explain them in as much detail as possible.

**Different governance structures and power relationships**

Governance and power are two different but inter-related concepts. Market power relates to the idea that one firm in a market may be able to exert significant influence over the goods or services traded or the price at which they are sold. Governance plays a large part in determining and explaining various firms’ market power, but commercial competence, market development (e.g. branding) and technical capabilities also determine the market power of an individual firm. In South Africa, where the market is very highly concentrated and monopolies, oligopolies and highly vertically integrated enterprises dominate – understanding power and governance are crucial in developing a linkage framework.

A commercial transaction’s price is determined by economics. Bargaining power refers to the ability to set prices or wages usually arising from some sort of monopoly like position or non equilibrium situation in a market. The economic actor with the greater bargaining power has the greater decision making freedom. Typically value chains can be divided into two bargaining power relationships: buyer driven and producer driven relationships.

Producer driven value chains are most often characterised by knowledge intensity, relatively high levels of technology and skills, scarcity, high levels of marketing and capital intensive production practices. These high level factors, scarcities and differentiators produce barriers to entry for competition. Most producer-driven value chains have high research and development (or R&D) expenditures or have been strongly branded producing additional barriers to entry. Producer driven value chains are most often found in the airline, automobile, computer and pharmaceutical industries. Producer driven chains are usually dominated by large, transnational manufacturers who play the central roles in coordinating production networks. As producer driven value chains activities fall outside of the market areas where South Africa’s small, marginalised producers are likely to be involved we will now turn to buyer driven power relationships which are more applicable to our framework.
Buyer driven chains are most often characterised by labour intensive production, low levels of technology and lower levels of capital investment; this results in lower barriers to entry and, hence, a larger number of potential suppliers. In this market, the buyer has the advantage of purchasing from a host of producers and suppliers based on the buyers particular criteria. Buyer driven chains are notably found in agricultural products, garments, footwear, and furniture and houseware. However, private labels and branding have become increasingly important in buyer driven markets and buyer driven chains such as large fashion retailers and large supermarket chains increasingly set up decentralised production networks so as to ensure reliable quality and delivery of goods and services.

Whereas the different power relationships embodied in buyer and producer driven chains used to be clear cut and useful in analysis, the distinction between the two appears to have become increasingly blurred. Kaplinsky raises two concerns with the distinction between these two sets of power relations. Firstly, he shows that some chains embody both producer and buyer power. One example of this is in the production of denim jeans. The Gap Company does not operate its own manufacturing facilities and represents a classic buyer driven value chain whereas Levi Strauss do undertake their own manufacturing and governs a strongly vertically integrated producer driven value chain. Thus, one product can be described as both a buyer driven and a producer driven chain. The second warning against using this binary typology, according to Kaplinsky, is that increasingly value chain rents are rewarding intangible activities more than tangible activities. As such, competency in branding, advertising conceptualisation, logistical management at all points along a chain are attracting increased returns which will lead dominant parties to try to capture these activities irrespective of whether the chain is buyer or producer driven. This is reflected in the Gap and Levi jeans example, where in both chains the majority of rents accrue to Gap and Levi with the manufacturers of the actual articles receiving a smaller percentage of the revenue generated. Research showed that incomes received by manufacturing companies (suppliers) for Levi and manufacturing companies (suppliers) for Gap were roughly equivalent.

While the producer/buyer distinction may not be highly relevant at any but the broadest market level analysis, it does emphasise that demand is crucial. Whether in a buyer or producer driven chain, the reason why firms engage in setting up value chains is to ensure their demands for a good with a particular specification is met, consistently and reliably. All the literature covered emphasises this point, which leads to a strong recommendation that value chain analysis should be driven by a strong focus on demand and not the often adopted approach of government policymakers to approach this from the supply side.

Understanding governance in value chains is complex but absolutely crucial as it embodies the issues of where power resides, how it is used and the consequences of using it. The type and source of governance can (1) shape market access; (2) provide a fast track towards the acquisition of production capabilities; and (3) determine the distribution of gains to various actors within a chain. So, for example, with respect to shaping market access, the EU-Africa horticultural chain analysis showed that small growers in Africa are marginalised as suppliers to large European Union (or EU) based retailers. The marginalisation occurs not because of the efficiency advantage of larger growers but because of the lead firms sourcing strategies. The decisions of the large firms thus create winners and losers based on their decisions which de facto shape market access. On the other hand, producers who do gain access to a chains lead firm often find themselves on a steep learning curve. Lead firms set high standards for suppliers but often transmit best practice, hands on services and pressure
which all assist firms to upgrade their productive capabilities for the better. These two examples show the positive and negative aspects of power within a chain as well as why it is necessary to fully appreciate the types and sources of governance within a given chain.

**Box 1: Governance, power and distribution in South Africa’s milk industry**

The Milk Producers’ Organisation has recently taken the country’s supermarkets to the Competition Commission arguing that they fix the price of milk. The organisation argues that because of the supermarkets market dominance they fix the price they pay milk processing companies which in turn forces milk processors to cut the price they pay to farmers.

Citing one example, the MPO reveals that Elandshoek, a diary farmer in Pretoria, produces 600 litres of milk a day at a cost of R2.60 a litre. He sells this output to Clover at a price of R3.00 a litre. Clover then processes the milk, at a cost of approximately R1.50 a litre, and sells the milk onto Spar or Checkers at an average price of R5.50 a litre. Spar sells milk to consumer at a price of R11.55 a litre and Checkers at R9.49 a litre.

In this example, the farmer makes a profit margin of 13%, the processor an 18% margin and Spar a 52% profit margin.

Source: Business Times (February 2008)

Kaplinsky’s (2000) and Gereffi’s (1994) contributions towards understanding governance are useful. Governance is not merely coordination. Value chains imply repetitiveness of linkage interactions. Governance ensures that interactions between firms along a value chain exhibit some reflection of organisation rather than being purely random. Value chains are governed when parameters requiring product, process and logistic qualification are set. The enforcement of these parameters has consequences up or down the value chain withj bundles of activities, actors, roles and functions. Governance thus involves (1) coordination, (2) monitoring outcomes, (3) linking discrete activities between different actors, (4) organising logistics to maintain the network, (5) identifying dynamic rent opportunities, (6) apportioning roles to players, and (7) ensuring consequences along the chain.

Kaplinsky suggests using governance in civil society as a basis for understanding governance in a value chain. As we know in government there is a separation of powers – the legislature (which makes the laws), the executive (which implements the laws) and the judiciary (which monitors conformance to laws). Similarly, in value chains, there are three forms of governance. Firstly, we have legislative governance. This establishes the conditions for participation in the chain. Initially these rules were largely concerned with guaranteeing supply and meeting cost targets, but more recently entry requirements have been substantially upgraded. Now, participatory rules may include conformance to: ISO9000 (on quality), ISO14000 (on environment), SA8000 (on labour standards), fair trade standards, as well as, industry specific standards such as hazard analysis and critical control point (or HACCP) standards in the food processing industry. These standards are affected through legislative governance, i.e. the laws, which set the parameters for participating in a given chain. Simply put, legislative governance concerns the “price of entry” into a value chain. Meeting these standards is a necessary but insufficient step in entering a value chain.

The second type of governance relates to judicial governance, i.e. coordinating conformance to the set parameters established by legislative governance. Essentially, this is performance monitoring and to be effective the power to govern requires that the holder of the power, (the governor), be able to sanction behaviour. Sanctions are often negative when suppliers transgress and may include penalties or exclusion from the chain. Equally, there may be
positive benefits where conformance by a supplier is rewarded by the governor. These may include performance bonuses or improved contract terms.

However, Kaplinsky notes that governors of chains are often proactively involved in the businesses of their suppliers so as to avoid the need to implement judicial governance. He terms these proactive activities as executive governance, i.e. where the governor assists suppliers to meet the legislative requirements of the chain. This executive governance may be direct where the governor helps the supplier meet quality standards, known as embedded services, or it may be, indirect where the governor introduces a supplier to a service provider who can assist them in meeting such standards.

What is crucial in understanding these three elements of governance is that all three sets of powers may not be controlled by a single party within a chain, often some of these powers are held by parties external to the chain. As we will show later, the identification of where power resides (inside and outside of a chain) and within a given chain have significant implications for which chains are the best potential partners for small, marginalised producers and how we develop institutional structures to support linkages within given value chains. We will also highlight international and local trends regarding the shifting of governance responsibilities along a chain. The shifting of the exercise of specifically judicial and executive governance down chains from final demand buyers to trusted large suppliers has enormous consequences for where our framework should focus its interventions. Table 2 contains some examples of legislative, judicial and executive value chain governance.

Table 2: Value chain governance

| Legislative governance | Setting standards for suppliers in relation to on time deliveries, frequency of deliveries, quality of product, product specifications, accreditations and certifications | Environmental standards, Equitable employment standards, Health and safety standards, Organic certification standards, Fair trade certification |
| Judicial governance | Monitoring the performance of suppliers in meeting these standards | Monitoring of conformance by specialised firms and certification boards |
| Executive governance | Supply chain management assisting suppliers to meet required standards, Producer associations/bodies assisting members to meet required standards | Specialised service providers, Government industrial support policy, SME support systems, NGO programmes |

Exercised by parties internal to chain | Exercised by parties external to chain
An added point of complexity to these three types of governance is that in most value chains there are multiple points of governance across all three areas. At any point in time, multiple parties may be setting rules, auditing performance and assisting producers to achieve required standards. So, for example, a grocery retailing lead firm may establish legislative governance rules related to required food preparation standards and procedures to be adhered to, while government’s Department of Agriculture and Department of Trade and Industry (DTI) may have additional or different rules related to hygiene requirements in food preparation. These may, in turn, differ from international requirements in food preparation necessary to enter markets such as the European Union (EU) market.

Different types of value chains

Due to the existence of complex governance structures and the likelihood that there will be vertical and horizontal overlaps across different forms of governance, researchers and practitioners have attempted to identify different types of value chains based on generalised expressions of governance power. The four types of governance described below should be seen as a continuum with variations between the four types finding expression in specific examples. Leading work in this field is ascribed to Humphrey and Schmitz (2002, 2005, 2007).

The four types of relations as described by them are:

Arm’s length market relations: In these relationships there are a large number of sellers and a large number of buyers. Buyers and sellers do not need to develop a close relationship because the product is standardised or easily customised. A range of firms can meet the buyers’ requirements and the switching costs are low. As such little information is shared between buyers and sellers, interactions are limited and no technical assistance is provided. An example of market relations is a small vegetable grower who sells his daily output to the Fresh Produce Market from which local greengrocers come to source stock for their shops. The buyer and seller never meet and never exchange information.

Balanced networks: In these relationships both buyers and suppliers have alternatives in terms of who they buy from and sell to, however they tend to develop information intensive relationships, frequently dividing essential competences between them. The interaction is characterised by reciprocal dependence. The buyer may specify certain product performance standards or process standards to be attained, and is confident that the supplier can meet them. An example of a balanced network relationship is a component manufacturer who provides spark plugs to a motor vehicle assembly company.

Captive networks: In these relationships the buyer takes a large percentage of the suppliers output and exercises a high degree of control over firms in the chain. The buyer specifies the characteristics of the product to be made by the suppliers and the processes to be followed and monitors that their instructions have been carried out. This occurs when a buyer has doubts about the competence of firms in the supply chain. In this relationship the suppliers exit options are more restricted than those of the buyer. An example of a captive relationship is an Ayreshire milk producer who sells his output to Woolworths.

Hierarchy: In these relationships, vertical integration of value adding functions occurs within a single firm. The supplier is owned by the buyer and vice versa with the junior firm having limited autonomy. The case of the intra firm trade between a transnational company and its
subsidiary falls into this category. An example of a hierarchy relationship is the De Beer’s mining house and its relationship with its subsidiary mines.

These four types of value chains which are described in terms of governance, trust and power directly influence the actual business relationship between suppliers and buyers. More specifically, in the context of this study, which looks at small, marginalised producers and mainstream economy external market players, the density and character of the relationship will impact on:

- The degree of dependence (vulnerability and opportunity) between the marginalised participant and the mainstream economy player;
- The type and length of the contract between the players;
- The type of technical assistance and product and process upgrading provided by the mainstream economy player to the marginalised participant;
- The methods of communication between the parties;
- The determination of pricing and the distribution of rents;
- The nature of credit relations; and
- The modalities of payments.

**Distributional issues**

Now that we understand the three types of governance found in value chains and the four types of value chains traditionally used in value chain analysis, it is necessary to discuss the dynamics of value chain rents and how these influence the distribution of income along a given chain. Remember that in our introduction we stated that the strategy programme would not succeed if small, marginalised producers were successfully linked to external markets but still remained in poverty. To succeed small, marginalised producers need to link to mainstream economy external markets on terms which allow them to rise out of poverty. These issues are the basis of this section on rents and allocative distribution and are taken up again in chapter five on product selection.

Rents are the returns received for undertaking a particular activity, such as production, design and marketing. The ability of a party or entity to earn and protect rents is related to differentials in the productivity of factors of production and the ability to create barriers to entry. When the concept of economic rent was first described by Ricardo, he argued that economic rent accrues on the basis of unequal ownership, access or control over existing scarce resources. This notion was developed by Schumpeter who showed that scarcity could in fact be created via innovation and entrepreneurship which created ‘new combinations of factors of production’ – leading to entrepreneurial rents. Any entrepreneurial rent will lead to other entrepreneurs attempting to duplicate or improve on these innovations which will in time erode these rents if not barriers to entry exist. This leads to a continuous search for upgrading, improvement and innovation and the rewards of entrepreneurial rents.

These economic and entrepreneurial rents are not merely about finding innovative way to produce products. A firm can construct rents by having command over scarce technologies (technology rents), having access to better skills than their competitors (human resource rents), they may possess superior forms of internal organisation (organisational rents) or they may possess better marketing capabilities or valuable brand names (marketing rents).
Kaplinsky (2000) adds that other types of rents also exist and that these are important in developing a value chain framework. The additional rents he adds to the list are:

- Relational rents – having superior quality relationships with suppliers and customers;
- Policy rents – operating in an environment of efficient government and constructing barriers to entry of competitors;
- Infrastructural rents – access to high quality infrastructural inputs such as telecommunications;
- Financial rents – access to finance on better terms than one’s competitors.

Our framework will need to consider all of these sources of rents and the ability to secure rents over time in determining where, along a given value chain, a linkage programme should be sited so as to ensure a reasonable return for the participants. Crucial to this is the fact that new rents will be added over time, existing areas of rent will be eroded through competition and the dynamism of the distribution of these rents will continually evolve. It is because these rents are so dynamic and because these rents will determine whether small, marginalised producers are able to escape from being in a situation of poverty that our framework and strategy suggestions will need to be dynamic and flexible.

**Upgrading**

Upgrading is a key concept in value chain theory because it determines the competency of the producer and hence the producer’s opportunities to access a value chain and to partake in the distribution of rents across the chain. Upgrading covers all issues which relate to improving the quality and quantity of output produced or manufactured by the supplier, as well as, issues of value addition, differentiation or other critical success factors in a given chain. As mentioned earlier, non-price competition has become increasingly important in modern markets, hence, the ability to access skills and upgrading to compete on issues other than price is crucially important.

The literature on upgrading is extensive but one point emerges emphatically in all the literature. The key point in the literature is that “buyers are more effective in transmitting the capabilities required to compete in distant markets than publicly or donor funded business development services” (UNDP, 1988: 27). This view has been empirically tested by the UN and ILO and has informed one of the world’s largest new development tools – the UN Global Compact which together with UNIDO runs the Business Partnership Programme which is designed to use multinational enterprise know how and power to upgrade SMMEs across the world.

Because buying firms require competent suppliers and because buying firms acknowledge that they are the best providers of such competency, an increasingly large number of buyers offer upgrading and competency services as part of their commercial transactions with suppliers. This is known as embedded services because the upgrading services are part and parcel of the transaction contract. The degree of upgrading, type of upgrading and value of upgrading services contained in embedded services is obviously chain and product specific. Embedded services and upgrading are undertaken by buyers, not for altruistic reasons but because they fear that not providing these services will result in them being unable to source the required products. Embedded services are expensive and will only generally be undertaken for larger suppliers or groups of suppliers who act as one. Humphrey (2005) notes that embedded services will also be offered based on scarcity and increasingly as part
of corporate responsibility and image programmes. This latter motivation will be an important lever which our framework will need to incorporate, particularly as it relates to mainstream economy players’ BEE scorecards.

Upgrading via embedded services is positive for the receiving firm, however, such contracts may make the receiving firm highly dependant on the firm supplying it these services and may become even more of a captive firm than if upgrading services were sourced outside of the chain. In addition firms who become highly dependant on embedded services run the risk of ruin if the buyer switches suppliers and removes all support. While these risks are real the consensus view is that embedded services are a positive aspect of accessing an external value chain.

An alternative to embedded services is the provision of upgrading via supplier organisations and associations or by third parties such as NGOs or governmental institutions. In Mozambique, the upgrading of cashew nut processing and grading was organised by a group of private sector processors organised by a lead firm who had particularly strong processes, systems and knowledge. This lead firm invited 22 other firms to create an association and amongst themselves they upgraded local processing capabilities such that they were able to access international markets. On the other hand, for example, a Rwandan coffee growers’ association was assisted by the World Bank and a US consulting firm, Technoserve, with developing coffee washing and grading services in order to upgrade the local industry. These contributions were then taken over by the Rwandan government, which expanded the programme and provided additional services to coffee growers. The advantages and disadvantages of various systems of upgrading will be covered extensively in the framework as such upgrading will be paramount to the success of linking small, marginalised producers to mainstream economy external markets and will be a lynchpin of any support package aimed at creating these linkages.

VALUE CHAIN ANALYSIS

Now that we have an understanding of the basic concepts of value chain analysis, we can look at a range of actual case studies and distil from them issues which arise on a regular basis. Although value chain analyses are product or market specific, we were amazed by how often the same themes or issues emerged irrespective of sector, product, market or geographic location. In this section we identify these cross-cutting issues which are then used to inform our framework tables and strategy options. The key cross-cutting issues identified have been divided into four categories: issues of demand, distributional issues, supply issues and issues of intervention and intermediation.

Demand issues

The first theme that arises strongly in VCA is that any VCA analysis must begin by focusing on demand and, more specifically, on the nature and character of demand. What will become apparent is that demand in a value chain analysis is not simply a micro-economic graph which plots price against quantity demanded, but is about relationships and linkages and the cascading effects of decisions in one part of the chain on all other actors in the chain.

In South Africa, as in the rest of the world, three new challenges are appearing at a systemic level in terms of how demand exists in various markets. The first is the increased importance of large buyers or lead firms. In virtually every sector and for every product large companies, franchises or chain stores are increasingly dominating market demand. This is true at a global
level with the rise of enormous multi disciplinary multinational and transnational corporations, at a national level where horizontal and vertical integration is occurring as firms strive to increase competitiveness and even at a local level where technology, information systems and sophisticated logistics and distribution systems are allowing branches of large companies to infiltrate markets which used to be serviced by small owner managed stores and producers. So, for example, in small town South Africa, the local town pharmacy is being overtaken by franchised local branches of national pharmacy chains such as Dischem and Pharmarama, local bakeries and greengrocers are shutting down as supermarket chains, such as Spar and Checkers, sell branded bread, produced by Tiger Foods and Premier Milling, and fresh fruit and vegetables under their own private labels; meanwhile, the local hardware store is being marginalised as Mica stores win market share. These larger firms offer competitive prices due to economies of scale, quality assurance and inspirational values to consumers. The rise of large lead firms as a characteristic of demand in the 21st century has three key implications.

The first is that as large buyers; these lead firms in the final demand market have acquired the market power to increase their buying requirements in terms of quality, reliability of delivery and adherence to standards. This translates into raising the level of competence required by producers who wish to sell to these lead firms. The second implication is that these lead firms demand increasingly large volumes from suppliers. Because of their requirements for particular standards, quality and reliability they are unwilling to source inputs from wholesale distributors and hence seek captive relationships with key suppliers. As coordinating suppliers is a costly exercise, this shift towards high volumes results in a tendency for lead firms to favour larger suppliers or relations with groups of suppliers. The third implication is that these lead firms, with their massive purchasing power, have tended to shift away from being resellers of products made by others into firms that go out to find suppliers for products they believe their clients want. They develop in-house brands and shift their attention to product development, branding and supplier selection and distribution. This shift results in product differentiation becoming more important and leads to the nurturing of innovative products, niche markets and high quality standards as key elements of competitiveness.

From the perspective of our framework, the general shift away from large numbers of small buyers towards a smaller number of large sellers in most sectors raises substantial challenges for linking small, marginalised producers into these mainstream economy final demand external markets. The first challenge is that our small, marginalised producers will not be able to be linked to external final markets on a one to one basis. Rather, a high degree of horizontal integration will need to occur so that a group of suppliers can be linked to a lead firm thus meeting the volume requirements. The second implication is that the competence of the small, marginalised producers will need to be substantially upgraded. Given that existing competency levels are most likely generally low, many potential market opportunities may not be realistic opportunities given the cost of increasing these competencies. The third implication is that we will need to carefully consider niche products rather than commoditised or general products. The key point is that meeting the standards and requirements of external final demand markets in South Africa or abroad have become increasingly onerous for small producers. In the 1960s, developing a linkage programme would have been a relatively simple affair of increasing quality and quantity and placing such output with wholesale distributors. In the 21st century, the changes in how markets operate makes developing a linkage programme considerably more challenging.
The second demand challenge which is emerging in South Africa and internationally is increased concentration at various points along any given value chain, i.e. not only are we seeing final market demand becoming more concentrated in the hands of fewer buyers, but there is increased concentration within input suppliers and processors who facilitate the production of goods and services for final demand buyers. The rise of technology and the drive towards offering a one-stop-shop have seen traditional suppliers of inputs such as seed suppliers for farming increasing their product offering to include fertilisers, irrigation systems and technical and technological advice. This shift towards high value-added services has reduced the number of input suppliers. Similarly concentration ratios at the processing and production stage of virtually all goods have similarly increased. There are now fewer processors and fewer production facilities and they are changing the way they operate. Processors and producers are increasingly moving away from sourcing inputs from the open market and moving towards contract purchasing from reputable suppliers in order to ensure reliability and quality. Along with this shift has been an increased role of processors and producers in the production activities of their key suppliers.

From the perspective of our framework, these two tendencies in value chain behaviour are more positive than the first change cited earlier. Input suppliers who offer a fuller range of services and one-shop services will be advantageous in decreasing the number of linkages required to improve small, marginalised producer competency and standards. In addition, processors or producers who more are willing to become involved in contract relationships with embedded services included in the relationship will reduce the amount of external support required to improve productive activity to meet external market standards. Although it is too early to draw conclusions these first two changes in demand already indicate that accessing processor or producer markets rather than final demand markets may be a better option for a linkage programme.

The third change in demand, both locally and internationally, pertains to the importance of public and private standards. Standards are increasingly being used by companies to demonstrate to consumers that their products are superior to those of their competitors. In the past, standards related to the quality of the actual product were paramount, today, consumers have forced lead firms and processors and production facilities to take into account social and environmental standards. This has lead to the rise in the importance of credence goods. A credence good is a good with quality aspects that cannot be known to a consumer through sensory inspection or observation in consumption. Credence attributes include: authenticity, production processes, fair trade attributes, and social responsibility and safety aspects.

From the perspective of our framework, the rise of the importance of standards is both an obstacle and an opportunity. Increasing the competence of small, marginalised producers working in marginal areas to meet production standards, health and safety standards and issues of certification and traceability will be enormously difficult and costly. On the other hand, the potential to develop credible products and to use this credence as a unique niche market has enormous potential. An example of this is Thandi Wines in the Western Cape. When Thandi Wines was created, as part of an empowerment deal, a decision was taken to attain a Fair Trade accreditation for the company and to market the wine based on its origin and story related to empowerment. The product is now sold successfully in the United Kingdom (UK) and is South Africa’s only Fair Trade wine label.
What the above three system-wide changes in local and international demand patterns reveal is the interconnectedness of value chains. Changes in lead firms in buyer driven markets have cascaded down to the activities of processors and producers, input suppliers and even the types of products which are being demanded. This changes fundamentally the environment into which we wish to link our small, marginalised producers. The first important change is that price is no longer the key determinant in many markets. Rather, non-price determinants are becoming increasingly important in the external markets we wish to link our small, marginalised producers to. Secondly, the mainstream economy markets we wish to link into are becoming increasingly sophisticated and concentrated. This is likely to make access into these markets harder to attain but the benefits of attaining such a linkage are likely to be higher in terms of sustainability and embedded services than in previous eras. Finally, the changes witnessed in the past four decades suggest strongly that product selection for small, marginalised producers is of utmost importance. These issues all reinforce the points made in the previous chapter: that a value chain approach and a linkage programme must be demand driven and that our understanding of this demand needs to be strategic and detailed.

**Distributional issues**

The second theme running through value chain analysis is that of the distribution of incomes, profits and rents along a given chain. In the concepts section of this chapter, we listed a host of various types of rents. In this section, we see how trends in rent distribution occur. The changes in demand explained above are reflected in changes in the distribution of income along value chains.

There are two major trends which need to be considered in the distribution of rents. The first relates to the unit price of goods and whether goods are high value or low value goods. The second relates to how selling price and margins are distributed across a chain.

In relation to the unit price of goods, the general view is that traditionally small, marginalised producers have tended to produce low unit value products which tend to be standardised goods with little differentiation. The worldwide trend is that products with low levels of differentiation and low value added have faced continual world price declines over the past three decades. This is true for the majority of cash crops in the agricultural sector, basic craft and furniture products and even low value added manufactured goods. The literature appears to suggest that moving away from low value added production and low value products is important if returns to small producers are to be increased. However, improving the unit value of the product produced either via product selection or value addition activities will not guarantee small producers a reasonable return on investment. This is because returns are not distributed equally across the participants in a value chain.

The overall, worldwide trend identified across a host of products is that profits and higher returns are gravitating towards points of concentration on the value chain. From our demand analysis above we know that concentration is occurring at the final demand lead firm point in most value chains, as well as at the processors, value added production facilities and input supplier parts of the chain. This implies that profits are gravitating away from producers. In 1998, Morisset conducted a study of consumer prices, wholesale prices and world export prices in six countries for five basic food commodities. The analysis showed that between 1970 and 1997 the gap between producer prices and consumer prices had continuously increased. A study by Milberg in 2003 showed that larger lead firms were able
to negotiate lower prices from supplier than smaller buyers. As markets are being dominated increasingly by larger buyers this suggests a trend of lower prices being paid to suppliers which in turn results in suppliers paying lower prices for output from producers. Increasingly there is an increasing disparity of margins along the value chain resulting in prices and profit rates for producers being systemically squeezed.

An additional point made by Morisset and Milberg is that the consequences of increased concentration across a value chain are not only leading to divergent returns and profits for producers but are exposed to risk and also fundamentally changed. The two authors note that data analysis shows that when excess supply in a market leads to a decrease in the selling price for a product in the final consumer market, this decrease in sales prices is passed back to suppliers and producers in the form of lower prices paid for their products. However, in the converse situation, where shortages lead to increased final selling prices to consumers, the increased consumer price is not passed on back to the supplier or producer. Generally, the trend is that downside risks of lower prices are transferred to suppliers and producers, but not the upside gains. This shows that risk is not evenly spread across a value chain.

To counter this power, which allows final demand lead firms to enjoy these asymmetrical margins, returns and risk exposure when compared to producers and suppliers in their chain, the actors further down the chain are increasingly considering ways to gain a greater share of returns and margins. Kaplinsky and Morris (2001) suggest that marketing, branding and logistics are attracting the greatest returns in value chains; actors (located further down the chain) who develop these services are more likely to capture additional returns. Webber (2007) suggests that producers and suppliers can look to add additional value to their goods and services by deepening their service offering, either through innovation, technological development or new product development. An alternative suggestion by Webber includes setting up geographic clusters. Duguid (2003) suggests that the best option is to see if a product can be branded further down the chain. He use the example of alcoholic drinks where a drink can be branded by the producer (Chateaux Margeaux), a geographic area (Champagne), a manufacturer / wholesaler / distributor (Taylor’s port, Gilbey’s gin) or by a retailer (Sainsbury’s shiraz). Each alternative option results in different allocations of rents along a chain.

The implications of these distributional issues are substantial. Firstly, this section reinforces how important it is to select the correct products for small, marginalised producers to focus on. This product selection needs to be informed not only by the unit value of the product and the price trends related to the sale of the product, but even more importantly through which chain the product will reach the consumer and how rents will be distributed along that chain.

This all suggests that the identification of products and chains for our linkage programme is a highly strategic activity and not merely an activity based on market supply and demand analyses. The second point from this section is that in designing the linkage framework we should not be shy in extending ourselves to think outside of the box. Whereas it may appear simpler to slot small, marginalised producers into existing chains and maintaining the status quo of the chain, it is equally possible for us to consider the possibilities of branding and marketing as a market differentiator and to think how this could result in a less asymmetrical inclusion of small, marginalised producers into mainstream economy external markets; the Thandi Wine example being a case in point.
Supply issues

At the heart of supply issues in value chain analysis is the desire of final market demand large firms to enjoy the benefits of their market and governance power while simultaneously decreasing the costs of governance. We see three international trends in this regard across all types of value chains.

The first trend is that lead firms increasingly only want to deal with competent suppliers and that lead firms are willing to invest in this competency. Both of these strategies lead to increased concentration along the value chain. The general view appears to be that the governance costs associated with dealing with large numbers of small producers is higher than those costs associated with dealing with a small number of large suppliers. For this reason, the last two decades have seen an overall shift towards large producers and away from small producers whether they are competent or not. Related to this is a view of large lead firms that the greater the competency of their large suppliers the lower the lead firms costs in monitoring and evaluation. In order to gain this reduced cost, lead firms are often willing to invest in large suppliers to increase their competency so that over time the lead firms cost of governance is reduced.

A second trend related to supply involves the codification of knowledge flows along the chain. Codification refers to turning tacit hard to communicate knowledge into codified information that can be easily pressed from one agent in the chain to another agent in the chain. Codification is most reliably achieved via certification schemes which set out clear and well known procedures and requirements with clear mechanisms for certifying compliance. Essentially, certification allows lead firms to receive products which meet their standards and procedures in a manner where on-going monitoring and evaluation is outsourced to the certifying agency. The cost of certification is borne by either the original producer or the large supplier, but not by the final market demand buyer. Certification is a second tool in the arsenal of lead firms to reduce governance costs.

The third supply trend, which is observable globally, relates to an on-going reconfiguration of value chains which seeks to reduce the number of hand over points in a chain or the shifting of exchange points at which the complexity and extent of information transfer is reduced. Simply stated, coordination is expensive. Lead final demand firms seek to reduce these costs while still accruing the benefits of their power by delegating functions and activities down the chain. So, for example, many lead supermarket chains delegate supply chain management and logistics to their lead suppliers. In some extreme examples some supermarkets even delegate product development to suppliers. Highly competent suppliers can increase their range of goods and services sold to the final demand market but this from a systemic perspective once again increases concentration within a chain.

These supply issues talk to two factors related to our linkage framework. The first is that it helps us understand where access to a chain should be sought. For example, if the chain we wish to link into is a large supermarket chain, but the retailer has delegated procurement and logistics to a large supplier, then to access this chain negotiations need to occur with the lead supplier and not the supermarket itself. Understanding how governance, supply and certification are applied in a given chain will inform who the relevant gatekeepers of the chain are for our small, marginalised producers. This is strategically a crucial point as international literature suggests that suppliers to lead firms are often more willing to provide embedded services to producers than final demand market lead firms.
The second important implication of these supply issues relates to the fact that even if procurement is delegated down a chain, governance costs will always be higher when a large number of small producers are present than when a smaller number of producers need to be coordinated. As small, marginalised producers will always have an asymmetry of power in an external market value chain, based on their high transaction costs and diseconomies of scale. Small, marginalised producers who wish to service these markets will have to create collective efficiencies to decrease governance costs. Collective efficiencies will be created when groups are formed amongst producers – hence, horizontal integration at the level of small, marginalised producers will be crucial in our linkage framework. Although horizontal integration is important, the next chapter will show that such integration need not be led by small, marginalised producers themselves and that options exist for mainstream economy actors to provide such services.

THE NATURE OF VALUE CHAIN INTERVENTIONS

From all of the above, we now need to make sense of this analysis in terms of how it guides our overall approach to developing a linkage strategy and our mindset regarding the nature of value chain intervention.

The first lesson to be learned is that value chains cannot be pushed; they must be pulled. Imagine a chain necklace lying on a table. If you wish to move the necklace from one side of the table to the other, the only way to do it is to pull it along. If you attempt to push it from the back or from the middle, the chain will bunch up and will not move. The idea that to move a value chain one must pull it (or a participant in the chain) along, rather than push it, has deep implications for the design of any value chain interventions, as well as the role of the state in such interventions.

If the kinetic action required is a pulling action, then the starting point of any intervention needs to be a demand driven analysis and, more specifically, an analysis of the final demand of the ultimate buyer/buyers of a chain’s product. The ILO, UNIDO, UN, GTZ, USAID and a host of value chain academics, such as Stamer, Schmitz and Sturgeon, all argue that the optimal starting point in developing models to link small players to mainstream economy value chains is an analysis of final demand by a key buyer (or buyers) and then to work backwards from this final demand. The United Nation’s handbook finessees this point slightly by suggesting that any point of entry into a value chain analysis can be justified depending on the focus of the research. They suggest that a policy maker or researcher could choose small farmers, independent buyers, informal traders, marginalised communities, sub suppliers, retailers or key producers as an entry point into value chain analysis. However, as soon as this point of entry is defined the starting point is to identify who will demand product from this grouping and hence in reality the starting point is final demand but at the appropriate part of the chain. This is an important point to note in the South African context where value chain projects in the past have tended to focus on issues of supply, starting from the back of a value chain and hoping to push outputs along the chain. As mentioned in our approach in the previous chapter, our study will begin with a demand side approach, which is why we consider different value chains and different products first and only then add producer and intermediary options which relate to supply.

The second implication of a pull-orientated interventionist strategy is that relationships, connections and market intelligence are crucial. Interventionist support to assist marginalised players to do what they are doing better and more efficiently and effectively
will be of limited use if the small, marginalised producers enjoying this support cannot access the market for these goods and if there is no demand for their goods, or if the distributional rents in the value chains they link into are such that their activities do not reward them with a level of return consistent with lifting them out of poverty. This is not to say that technical assistance is not required, rather, technical assistance which deals with the supply side is not enough. Instead, interventionist support must provide: (1) strategic market intelligence assistance in product and buyer identification and (2) connectivity support between small, marginalised producers and relevant value chain gatekeepers (buyers).

The third implication is that any intervention seeking to link small, marginalised producers to external final demand markets will fail if such linkage programme is undertaken at the level of individual producers. Our analysis shows clearly that scale is important as it relates to decreasing governance costs (not to mention transaction costs). Any meaningful intervention implicitly will need to take into account issues of grouping small, marginalised producers and establishing horizontal integration at this level, and also whether such groupings can negotiate directly with value chain actors or if an additional layer of intermediation is required to further reduce governance costs.

The final implication of this pull interventionist strategy is that interventions will need to be of a substantial duration. One of the allures of supply side interventions is that once production has reached a certain quality and standard, the intervention can be considered successful and support removed. In a demand side intervention the development of a long term stable relationship between supplier and buyer, and groups of producers can take years to develop, mature and stabilise. A model based on these types of interventions is a medium to long term commitment on the part of the intervening party.

These four implications of a pull strategy are important for South Africa where traditionally our SMME policy, local economic development and extension services policies in rural areas have been characterised by a push or supply side approach. Shifting our paradigm to a demand driven approach forces us to deal with demand and supply, where and how exchange occurs and on what terms such exchange is completed. By its nature, this is difficult, more complex, and longer road to travel than previous supply side approaches. Because of the scale and complexity of a demand side pull strategy, one often sees such interventions undertaken in developing countries limited to a single product, such as the Kenyan cut flower value chain or the Mozambican cashew nut chain. To achieve systemic change or scalable change in South Africa, undertaking product specific value chain studies and intervention strategies is not an option. High level value chain analysis, such as that covered in this chapter, is also not helpful for achieving results on the ground. It is for this reason that our study has focused on cross-cutting issues that appear consistently in all value chains in all countries; this places our analysis in a new ‘middle ground’ that is developed further in chapter five.

**LINKAGES**

This chapter is the second foundational chapter which informs the development of our linkage framework. The purpose of the chapter is twofold. The first aim is to acquaint the reader with the (1) types of linkages which can occur, and (2) factors which will influence the success of linkages and the rules of thumb for successful linkage programme development and implementation. The second purpose of the chapter is to highlight a host of issues which exist regarding the scalability and sustainability of linkage programmes. As will be shown,
international experiences of linkage programmes all operate at a project level even though some projects are large in scope. Ways of replicating successful project level formulae to benefit a greater number of beneficiaries at an economy wide level has not yet been developed. Indeed, scalability may even prove to be the undoing of successful linkage initiatives. Further, the ideas of systemic change versus change delivered via wide spread programme roll outs raises issues regarding the nature of intervention required and who should catalyse and implement such interventions.

While the first portion of the chapter aims to be informative, and includes important lessons to be learnt for the development of our framework, it is the second part which is crucial to our framework and strategy, highlighting the enormity of the task we are contemplating, the quantum and depth of challenges we face, as well as the fact that we are attempting to achieve is something which has not been successfully undertaken anywhere in the world on the scale that we are envisaging. As we will show, the theory and international literature can take us far in terms of linkage programmes in value chains at a project level. It is when we escalate our intentions to systemic and scalable change that we enter uncharted territory.

The content of the chapter draws heavily on the agricultural sector where the majority of linkage programmes and research have been conducted. In most cases we have found that what applies in the agricultural sector will apply to other producers of non-agricultural products in other sectors and even sellers of services. This is because linkages and value chain theory and practice are driven by commercial realities and involve the same variables of costs, input prices, sales prices, margins and issues of governance, power and structure irrespective of sector.

Types of linkages

The international literature isolates eight key different types of linkages. The proliferation of types of linkages mirrors the changes in demand and supply explained in chapter two and represents a fundamental shift away from sales through open markets towards direct sales to different actors in the value chain.

While some of these types of linkages may appear very similar, many of the nuanced differences are in fact crucial. Subtle differences are usually found in relations to: (1) degrees of formality and type of contractual obligations; (2) differences in catalysing or contracting participants; and (3) differences in the structures through which linkages occur.

The reader is urged to consider all these different types of linkages as there exists no linkage formula silver bullet and, whatever the framework and strategy to be developed, it will be a multi-faceted, eclectic mix of various options of different types of linkages.

Farmer/producer to local trader

Traditionally, local traders interact with farmers, small producers of manufactured goods and crafts, and small service providers on a one-to-one, face-to-face basis. Often, these traders have strong community ties, a shared culture with the sellers and speak the local dialect, all of which assists in the development of a strong relationship. Traders tend to purchase either at the farm gate, the household or at local markets. Purchases from local traders by individuals are very expensive due to transport costs and the opportunity cost involved in time consuming one-to-one negotiations. The efficacy of this linkage is improved if products are aggregated at a single location.
The international literature suggests that aggregation activities do not occur organically and require some type of catalyst external to the group of producers. As these traders usually on-sell their product up the value chain, traders often get involved in quality control and monitoring and offer embedded services. Local traders are a highly heterogeneous group, ranging from small, self-employed, one-man operations with a single vehicle and limited cash flow to larger traders with higher resource levels.

This type of one-to-one linkage is more successful when the local trader is larger and more established because the burden of cash advances for purchases and the opportunity cost of the time to negotiate one-to-one deals is too high for a very small, under-resourced trader to bear.

**Box 2: Embroidery activities in Mennonite Pakistan community**

An example of this type of linkage can be found in a linkage programme developed by USAID and the Mennonite Economic Development Agency in Pakistan. Due to religious strictures, Mennonite rural women in Pakistan are unable to leave their homes. The programme aimed to link these house-bound women, who have exceptional embroidery skills, with external markets. The agency invested in the creation of 185 local traders (sales agents) who worked on a one-to-one basis with individual women. The traders offered embedded services, such as upgrading of designs and aligning designs to market demand, providing quality inputs and assessing product quality. These traders were also trained to develop linkages with external markets in urban areas; thus part of the traders offering to the embroiderer’s was a linkage with external markets. The programme now reaches 7000 women and their average monthly income has increased threefold, from $6 per month to $20 per month. The programme concludes at the end of 2008 and it is too early to determine whether the programme will be sustainable once funding is withdrawn.

Source: USAID (2005: 32)

In terms of our framework, what is interesting to learn from this linkage is that using local traders has advantages for issues of trusts (which we will see is crucial in developing long term sustainable linkages). Secondly, we learn that developing traders not only benefits the traders, themselves, but also the producers. In other words, to assist producers one might not need to work directly with the producer but rather increase the capacity of the intermediary to who they sell their output. This is an important factor when one is considering interventions at scale rather than at the project level.

**Farmer/producer to retailer**

As mentioned in chapter two, the retail sector increasingly has become dominated by large lead firms, with impacts for with whom they will contract in order to secure supplies. Lead firms in the retail sector who operate a centralised procurement system tend not to link directly with small supplier and, if any links occur, they are through wholesalers, lead suppliers or agents. Retailers who operate non-centralised procurement systems are more likely to be open towards direct linkages between themselves and small producers, but such practices are not wide spread and are not a replicable model since they rely on the individual initiative of specific retailers. For example, a supermarket retail chain, such as Woolworths, operates a single procurement system which ensures that every store carries identical merchandise. On this basis, Woolworths would not deal directly with small producers. Spar Supermarkets, however, operate on a franchise system and individual store managers have discretion regarding the sourcing of some goods. Several case studies exist which show Spar owner/managers agreeing to provide shelf space to small local producers and farmers, and most of these linkages have proved to be successful, but were developed by individuals.
Similar dichotomies can be seen in the hospitality, fast food, home wares, and textiles and garment industries: the large branded chains tend to operate centralised procurement systems; while decentralised procurement is undertaken by franchisees or owner manager retailers.

This suggests that decentralised retail procurement may be a more viable linkage option for small, marginalised producers, however, the governance structures and market power of some franchisee and owner manager retailers may still create substantial barriers. This is shown in the example below.

**Box 3: McDonald’s fries in Uganda**

Although McDonald’s works on a franchise based system, franchisees are required to meet parent company quality standards and specifications. How a franchisee procures such inputs is left to the discretion of individual franchisees. In Uganda, when McDonald’s began operating, USAID collaborated in a programme to source potatoes for the chain’s franchisees locally. This required a substantial investment in new potato varieties, changes in production practices to ensure increased size and moisture content, and a geographically dispersed implementation programme to ensure year round availability. The link was eventually created but only after five years of substantial, external, catalytic activity, investment and human resources.


The general view is that accessing the retail market directly for a small producer is an enormous task; hence, other linkages may be more appropriate for small scale producers. Having said that, local direct sales opportunities do exist in the franchise and owner manager markets in relation to a broad spectrum of sectors, including house wares, hospitality, fast foods, grocery stores, and butcheries, among others. From the perspective of our linkage framework, however, we need to rate these opportunities with caution because they cannot be developed in a systemic manner due to the pivotal role of the individual within each discrete opportunity.

**Links through leading farmers/producers**

This type of linkage is very similar to contract farming and contract production but tends to be more ad hoc and less formal. In most instances this linkage occurs without a written agreement and services passed from the larger farmer/producer to the smaller producer are often minimal and usually focused on post harvest/post production activities (storage, transport etc) rather than on production activities themselves. Basically, a large farmer or large producer will coordinate supply from other farms or producers in the area to service external markets. Altruism is not the reason; rather increased quantities available for sale may open up market opportunities for the large farmer which would otherwise not be available. In some countries (usually those with a colonial past), where political ill-will dominates relations between small and large farmers, large farmers have linked with their smaller neighbouring farmers for political economy reasons and to ensure safety and security of crops and property.

Sometimes, links through leading farmers/producers which start out in an informal, ad hoc manner, grow into dynamic partnering opportunities which are then formalised. Many of these situations have been identified in Africa and South East Asia.
Box 4: Mozambique’s processed cashew nuts

An example of a lead producer linkage can be seen in the Mozambican cashew nut industry. Mozambique has always had a strong tradition of exporting processed cashew nuts. During the country’s civil war, the industry disappeared and in early 2000, efforts were made to re-establish the industry. An individual processor, Anonio Miranda, was the first to re-establish a processing plant but his output was insufficient to win export contracts. As such, he took it upon himself to increase cashew nut processing in his province of Nampula in order to increase supply to a level where international exports were again viable. As the industry leader, he organised seven other local farmers and provided them with knowledge and skills to increase production. Later, USAID funding was attained and the relationship formalised to create an association of producers and to extend services to them. At present, 32 producers belong to Agro Indistria Associadas and they have gained multiple export contracts.

Source: Webber (2008: 114)

Although this linkage type may not appear to be of great interest, it has one extraordinary advantage, namely, that the active party in the linkage is an expert in the area of activity. As we shall see in the second section of this chapter, ensuring that individuals with the appropriate skills are the ones developing linkages is crucial to the success of a linkage programme.

A large, successful farmer/producer would definitely meet these criteria and negate the need for a linkage programme to source such a resource externally. Given that the South African agricultural sector alone has 50,000 commercial farmers the idea of leveraging this skills base to create linkages becomes enormously appealing when thinking about large scale interventions.

Linkages through cooperatives

The cooperatives being discussed in this section relate to traditional cooperatives where members are provided with inputs and services from the coop (either for free, at a subsidised rate or on a full cost recovery basis) in order to assist them in the production of a good or crop which is then marketed by the coop to an external market. These types of cooperatives are most commonly found in the agricultural and craft sectors, but also in agro-processing, flora culture, aquaculture and some textiles and home ware sectors.

Generally, cooperatives are viewed by politicians and policymakers in developing countries (who are trying to integrate marginalised communities with external markets) as a jewel in the crown and the panacea to a host of intractable, rural poverty issues. As shown in chapter two, creating groupings via horizontal integration to achieve economies of scale and reduce transaction costs is a crucial element in supporting marginal producers’ access to external markets. In addition, supplementing the skills and addressing the asymmetry of power of marginalised producers was also shown to be an important element in any linkage framework. However, “with the honourable exception (of a limited number of successful cooperatives), the track record of cooperative development has often been disappointing” (Shepherd, FAO, 2007: 7). The reasons given for the disappointing performance of cooperatives include: (1) the politicisation of cooperatives which often become quasi-government bodies, top heavy, hierarchical and vehicles for political rather than commercial ends; (2) inadequate management skills of cooperative members and the tendency to expand cooperative activities beyond the scope of management’s capacity; and, finally, (3) an inability of cooperatives to meet the work rates, business acumen and social capital of competing private sector producers.
The list of examples of failed cooperatives is substantial. Virtually all the examples exhibit a similar pattern: cooperatives are successful while governmental or donor support is supplied, but most fail when financial, administrative and marketing support is withdrawn.

**Box 5: Shea butter cooperative**

In Mali, an NGO (SNV) supported women’s groups to improve the processing and marketing of shea butter. Forty community groups were organised, embracing 1,500 women. SNV provided storage facilities and equipment for each group and provided training in production of improved quality butter. Sales were made through a cooperative union developed by the project. Initially the activities were successful and women’s incomes increased but on completion of the project the intervention was unsustainable. This was because of the limited time frame (four years) and the fact that the NGO had been involved directly in running the marketing side of activities without developing a capacity in the cooperative union to take over this activity. Marketing and administrative training were then supplied to the cooperative but over a period of two years it failed due to the limited management and marketing capacity of the members.

Source: Shepherd (2008: 50)

When considering the relevance of this linkage type to our framework, we must not throw the baby out with the bathwater. We know that some form of horizontal integration among small producers is necessary if they are to be linked to external markets. The legal structure of such a grouping, as well as the range of activities to be undertaken by the grouping, must be weighed carefully. However, it is important to take note of international experience which suggests that externally catalysed cooperatives which offer a full range of services are unlikely to be a successful option, and more importantly are a particularly resource-intensive option when considering linkages at scale.

**Farmer/producer link to processor**

Processors, irrespective of whether they be in the agricultural, wood or any industrial sector, share a common commercial characteristic of having invested substantial capital in processing equipment which then needs to be operated continuously at 100% capacity utilisation to provide a sufficient return on investment. Sourcing a continuous and reliable quantity of inputs to be processed is, thus, essential to any processors’ core business.

The largest number of successful linkage programmes worldwide, and also in South Africa, emerges from this type of linkage. Interestingly, these successes are based on existing processors expanding their buyer base to include smaller producers and not situations where a processing facility has been established specifically to source inputs from small producers. In other words where the linkage intervention is based on an existing processor it works, when the linkage intervention is based on a new production facility designed specifically as a source of demand for smaller producer output it tends to fail. International literature suggests that this latter form of intervention which was widespread in the 1980s and 1990s is starting to recede, although, as we will note later, in South Africa, such programmes are still being supported.

Links to processors appear to work for a variety of reasons. Firstly, it is in the best interest of the processor to make sure the linkage does succeed as their need for reliable inputs is pivotal given their high level of asset specificity and the lumpiness of their investments. Secondly, processors understand their markets in terms of the demand for their outputs and the requirements of their inputs. As such, processors possess enormous market intelligence and a considerable understanding of how inputs are produced. As mentioned in chapter two,
it is for this reason that most processors will offer embedded services to input suppliers. Numerous international examples exist, ranging from Nigeria’s ginnery mills and cotton growers to Sri Lanka’s tea processors and tea growers. South Africa has an equivalent range of success stories, ranging from SAPPI’s Grow Programme to the McCains vegetable project. In a way, this linkage type is equivalent to the lead farmer/lead producer linkage covered earlier, the only difference being that this linkage occurs at the secondary processing stage rather than at the primary production stage. This difference is important because of what is known about the distribution of rents along a chain.

**Box 6: Transvaal Sugar Company (success)**

The Transvaal Sugar Company (or TSC) operates a sugar mill which processes raw sugar cane. The large estate sugar growers in KwaZulu-Natal provide about 70% of the input to the company’s two mills, while small growers provide the remaining 30%. A total of 1,000 small farmers are linked to the mills with an average plot size of 6.8 hectares. The company contracts to buy the small producers’ output at a price determined by the South African Sugar Association and technical advice and inputs are available to small farmers directly from the Transvaal Sugar Company. Inputs received by small producers from the processing company are set off against payment for their output. This linkage programme has operated successfully for nine years and small producers are matching or exceeding productivity and operational costs of the large estate growers.

Source: FAO (2004: 70)

**Box 7: Oil seed processing in Tanzania (failure)**

Having identified a lack of reliable oilseed supply as a problem faced by crushers in Tanzania, Faida MaLi, a Tanzanian NGO, ended up linking farmers to a start-up crusher because existing oilseed crushing companies had no capacity to support farmers. One hundred and eighty farmers were organised into three transitional farmer groups. The NGO assisted with contract negotiations and both farmers and the company paid a percentage to the NGO. The company financed production costs, with farmers contributing 40% of those costs to a group savings account. However, problems were encountered with the seed used, the weather and cheaper imports. This led the company to pull out after four years. The company, with other business activities, was not really committed to the oilseeds industry when problems emerged.

Source: Shepherd (2007: 53)

This linkage type holds substantial opportunities for our linkage strategy, especially given the size and scale of the local agro processing industry and processing capacity in other manufacturing sectors. The lesson to be learnt from this linkage type is that it works best when links are forged between an existing processor, who is committed to the industry, and new suppliers. Trying to establish a processor specifically to create demand for small producer output is less likely to succeed.4

**Farmer/producer to exporter linkage**

Much of the value chain literature discussed in chapter two related to using value chain linkages as a method to link developing countries to international export markets. In our analysis, where we were focused on linking rural marginalised producers to external markets

---

4 It will be interesting for the strategy project to keep an eye on the developments of the Department of Science and Technology’s (DST) essential oils project. This project, which is part of DST’s poverty reduction programme, has established an essential oils distillation plant and assisted in the formation of groups and communities to provide inputs to the plant. Experiences across different grower groups vary and the verdict on the success or failure of the project cannot be determined at this early in the project’s life. Break-even commercial viability has not yet been achieved, the plant’s capacity is very under-used and, were it not for the continued support of government, the project would fail.
within South Africa, we applied the same value chain analysis but presented it as trade options within the borders of South Africa.

To be honest, there appears to be no fundamental reason why small producers that sell to domestic traders or wholesalers cannot link to an external market outside of South Africa’s borders. The link remains a producer-trader link, irrespective of whether final demand is local or external.

However, certain international markets present greater barriers than others. Traceability, certification, standards requirements and quality control for western markets, such as the US and Europe, tend to be high, but barriers to entry for less developed export markets, such as Eastern Europe, the Rest of Africa and the Middle East, are considerably lower.

Although, in linkage terms, this export linkage operates exactly the same way as the domestic trader linkage, the reason why it may be of interest relates to a crucial issue raised in the next section: scalability.

One of the inherent problems with scalability is that if a programme in a particular product is highly successful and on that basis replicated widely, the increased supply of that product onto the local market will result in prices falling, thus, undermining the success of the programme. If, however, markets external to South Africa can be developed, this potential problem of excess supply could be ameliorated.

Numerous examples exist of small-scale producers linking to traders who are linked into external markets. Most commonly, these external markets are neighbouring countries and most examples of this linkage occur within border regions.

**Box 8: Jujube exports in Myanmar**

Jujube growers in Myanmar’s Mandalay Division sell their fruit mainly in Muse Town, 300 km away on the Myanmar-China border. The Muse market was first tapped by traders in mango and watermelon. The growers usually ship their fruit to intermediaries in Muse using their own trucks or hired vehicles. The fruit is transported in consignments, ranging up to 500 boxes, across mountain roads and through security and taxation checkpoints. In Muse, the drivers deliver to intermediaries, who contact Chinese buyers and negotiate prices. The drivers usually bring the sales revenue back to the growers, with a voucher signed by intermediaries (if the sales value is high, the intermediaries send money to their suppliers through a private bank, and pay bank charges).

Source: Shepherd (2007: 60)

In the South African context, there appears much scope for this type of linkage, especially as it relates to agricultural output. Two of South Africa’s neighbours (Namibia and Botswana) have substantially different climates and agricultural resources; two of our other neighbours (Lesotho and Swaziland) have limited land resources; and Zimbabwe and Mozambique have, in the short term, major production challenges. As such, it is possible to consider export linkages, not in a grand scheme of accessing foreign high value markets with goods which require the meeting of very high standards; rather, involving a regional export linkage as a possible escape route for excess supply of less standard-bound agricultural production. Having said this, there is no reason why a more distant export arrangement cannot be supported if market conditions support such an option.

**Contract farming/contract production**

Contract farming and contract processing and manufacturing are the most widespread linkage typology worldwide. This linkage is different to trader linkages and processor linkages
as they are usually more specific in terms of deliverables, especially as they relate to volume and date of delivery and quality and standards. Contracting exists at an international level where, for example, Nike outsources on contract the production of certain running shoes to companies in the Philippines. It exists locally where Freshmark contract out to growers to produce horticultural output for Shoprite; and it exists at the one-to-one level where local game farms in Limpopo contract neighbouring farms to provide them salad leaves on a daily basis to their lodges.

There are three main types of contracts which occur: “market specification”, “resource providing” and production management” contracts. These contracts tend to mirror different types and degrees of governance, as was explained in chapter two. In market specification contracts, producers and buyers agree on what will be produced (product and quality attributes) and what commitments for future sale are made (timing, location and price). In resource providing contracts, the same parameters exist as with market specification contracts but, additionally, the contract covers provisions for additional services tied to the marketing specification these may be embedded services, credit extension, input provision or any other assistance provided either on a no cost or cost recovery basis. The third type of contract is the production management contract where suppliers agree not only what to produce but also how to produce it.

Contracting has various benefits to the company issuing the contract. Firstly, by issuing multiple contracts it can reduce its risk if any individual contractor fails to meet their commitments. Secondly, contracting allows the company to overcome its own resource constraints be it land or labour. Thirdly, contracting often allows companies to focus on their core business or on parts of the value chain which are more lucrative such as logistics and marketing. Finally, contracting can often help to reduce costs for the contracting company either by avoiding diseconomies of scale or by the fact that smaller contract producers often produce at lower unit costs than large producers due to lower overheads.

From the small producers’ perspective, contracting is advantageous because it provides a guaranteed buyer for their output and, hence, provides security. In addition to security, producers may also benefit from embedded services. The only disadvantages for small producers are that they may receive a lower price for their output than they would receive on the spot market, and also experience a loss of autonomy.

Most contract linkages do involve substantial embedded services and this is usually reflected in lower proceeds received by original producers. This price differential, as well as the loss of freedom for small producers to sell when they want and to whom they want, often leads to side-selling or extra contractual marketing where producers fail to meet their contractual obligations, seeking short term gratification in a jackpot type of mentality.

Contract production is an attractive linkage option for our South African strategy; however, issues of trust and contractual obligation will be difficult problems to solve. These issues will be discussed at length later in this chapter.
Box 9: SAPPI’s Project Grow

SAPPI produces pulp. It is supplied, in part, by contracted timber growers, including some 7,000 small-scale contract farmers incorporated in a “Project Grow” programme, which aims at converting rural subsistence farmers into emerging commercial operations. Management of Project Grow is contracted to Lima, a rural development NGO. All contracted suppliers are required to enter into a timber purchasing agreement that specifies the commencement and duration of the relationship, the total tonnage to be delivered to the mill during the period of the contract and the annual tonnage. It also specifies the price that the company will pay for the tree species to be delivered or, alternatively, an annual price. The company provides, via the management NGO, an initial interest-free loan for planting, maintaining and weeding the timber, and providing seedlings. Lima's six extension officers and eight field assistants visit the small-scale growers frequently to provide assistance with weed control and the preparation of fire breaks. Contractors assist the growers with the planning and harvesting of their plots. The project generates considerable revenue for local communities, with an estimate of 50% of turnover retained within the community as a result of payments to local contractors, 42% retained by the grower and 8% refunded as loan repayments. However, the high level of company support to the growers has resulted in a high cost to the company. The withdrawal of its support could result in the abandonment of the project, since the smallholders appear unlikely to organise themselves through a farmers' association.

Source: FAO (2004: 75)

Farmer/producer to government linkage

The final type of linkage is one where small farmers and producers are linked directly to government preferential procurement programmes such as the government procuring food and food products for state hospitals, feeding schemes and the army; procuring state office equipment from small manufacturers; or procuring building and construction services from small service providers. This system of preferential procurement has tended not to be highly successful but progress is being made.

In KwaZulu-Natal, in his 2007 budget speech, the MEC announced that several cooperatives set up via the Province’s Ithala fund to produce vegetables and meat and had won several contracts to supply four provincial hospitals. We do not yet fully understand why such success stories are so hard to find given government’s preferred procurement policy, but certainly it appears that such opportunities can be created and taken advantage of, although they usually require considerable external assistance to set up, plus after assistance is withdrawn their sustainability is questionable, as seen in several school feeding scheme programmes. Nevertheless, this may be linkage worth taking note of in terms of our strategy.

Factors affecting the success of linkage programmes/models

This section is based on a host of international experiences collected by NGOs, donor communities, governments, consultants and international developmental organisations such as the World Bank, the Food and Agricultural Organisation (FAO), the United Nations (UN) and its various implementing agencies. By far, the majority of the case studies relate to market linkage programmes championed and driven by non private sector participants, i.e. linkage programmes set up by governmental departments and governmental agencies or donor agencies. We have called these ’external catalyst linkages’ because they arise from an outside party seeking to link two market participants. These are in contrast to ‘internal catalyst linkages’ or ’organic linkages’ which are programmes or projects undertaken by one of the two market participants (either the small producer or producer grouping or a large value chain actor). The fact that almost all the covered case studies and accumulated lessons learned arise from externally catalysed programmes is important for several reasons. Firstly, it highlights the point that most linkage programmes containing marginalised producer and
farmer communities have not developed organically from within these communities; and
have not been initiated by private sector value chain actors who see latent potential in
linking with small producers. Secondly, the profile of working case studies reinforces the
reality that most linkage programmes operate via an external catalyst and at a project level –
even though some projects are very large in scope and may deal with an entire cluster.
Finally, the case studies show clearly the enormous challenge involved in developing a
sustainable linkage programme, even at a discreet project level. By the end of this section, it
is likely that the reader will feel both overwhelmed by the complexity of what is required to
develop a successful linkage programme, even one operating at a project level, and deflated
by the challenges required to make such a programme systemic and scalable. The reason
why we have chosen to emphasise this section is that (1) if, in the final linkage framework,
we include any external catalytic implementation options, it is crucial to understand the
magnitude of the task we are putting before us; (2) the viability of a non-external catalytic
option will be easier to assess against the background of the external catalytic option; and
(3) it will assist us in placing current South African initiatives in context and with
understanding the constraints related to much of the current policy thinking on the issue in
the country. It is important to note that the differentiation between external and internal
catalytic or organic programmes is not as stark as suggested here. Even internally generated
linkage programmes can benefit from external catalytic activities provided to the private
sector or small producer by an outside agent. The purpose of this section is not to discuss
strategic options but to provide information on what has and has not worked internationally
so that we can assemble a list of cross-cutting issues that will need to be dealt with in our
framework and strategy.

Much of the literature and lessons about linking small, marginalised producers to external
markets relates to correct product and market identification, in other words, that demand
analysis is crucial to any linkage programme given that value chains must be pulled, not
pushed, as was emphasised in chapter two. We will not be dealing with these issues in this
chapter, but will look at the issues in detail in the next chapter. We will also not emphasise
supply issues, such as land tenure and access to credit, as these are dealt with in other
sections of the strategy project. Rather, in this section, we will focus on lessons learnt
relating to issues of relationship building and trust, group formation, contracting and
financing of linkage programmes - the cornerstones of any linkage programme in any sector.
The issues identified in this section occur again and again in virtually all studies we have
looked at and, thus, are viewed as systemic issues.

**Issues of trust and relationship building**

In chapter two, we emphasised the importance of trust and the development of
relationships as key characteristics in value chain operations. The literature which covers
successful linkage characteristics emphasises trust as the crucial element to getting right a
linkage programme. The literature makes three key points in this regard. The first point is
that a successful linkage programme must deal explicitly with small producers’ problems in
shifting from ad hoc to direct sales. Secondly, the literature emphasises the need to
overcome suspicion of the private sector by small producers and farmers; and thirdly, it
stresses the need to deal with small producer and farmer social capital and cultural issues as
they pertain to contracting.

Although we will deal with the characteristics of small producers in detail in future chapters,
it is necessary to develop a general picture of the shared characteristics of most small
producers. We are aware of the generalisations being asserted and these will be refined in the chapter on potential beneficiaries. As a general group, worldwide, small producers, small farmers and other individuals operating in impoverished, marginalised communities, most often in rural areas, are not well educated and may not even be literate, tend to partake in unsophisticated, survivalist economic transactions which include either direct exchange (barter) or face-to-face cash sales and purchases, while their experiences with more complicated commercial transactions are often non-existent. Furthermore, their perception of cash flow and delayed payment is limited; their experience with contracts and contractual obligations tends to be low and, in South Africa, their perception of external markets and, particularly, white-owned businesses is tainted with years of mistrust created under apartheid. None of these factors provide a fertile starting point for developing relationships of trust based on commercial realities. This less than ideal starting point is challenged further if the linkage under consideration is one which is disembodied and will occur over distance and not on a face-to-face basis.

The first finding in the literature relates to issues of small producers providing continuous supply. The literature suggests that continuous supply is hampered by two systemic issues. Firstly, small producers find it difficult to understand that a linkage contract requires them to supply the agreed input to a value chain no matter what – the idea of a 365 days a year commitment is often incompatible with rural and domestic life, as well as religious and social traditions where, for example, production ceases during certain religious events or rituals, tribal gatherings and meetings or family crises. Secondly, many less sophisticated small producers have a tendency to stop meeting their linkage obligations once they have earned sufficient income in a month for covering their immediate needs. Both of these issues relate to the immediacy of the productive paradigm in which most impoverished producers find themselves. Switching from this paradigm to the paradigm of long term commitments and consistency is not easy. The literature suggests that education is crucial to addressing this issue as is getting the support of local leadership, be it tribal or religious leaders and key individuals in the community. The literature emphasises that shifting this mindset must be an explicit undertaking of a linkage programme and cannot just be assumed away.

A second issue related to trust pertains to small producers and farmers understanding upfront the worst case scenarios in their linkage relationship. The literature shows numerous examples where a trust relationship was working well between small producers and larger value chain actors until such time as a consignment from these small producers was rejected due to poor quality or late delivery. The small producers tend to interpret a larger value chain actor’s decision not to accept a consignment as a breach of trust, whereas the large buyer may be well within their rights in terms of the contract. Additional examples of breakdowns in trust relate to worst case scenarios, when small producers sell on contract to larger buyers based on going market prices, but market prices fall such that small producers do not cover their costs when they sell their output. In this scenario, small producers perceive the actions of the large buyer as a breach of trust and not as the commercial reality that it is.

A third recurrent issue in the literature covers the problems of side-selling or pole vaulting or extra contractual marketing. In this scenario, a producer or farmer may be in a linkage or contractual agreement but may seek to sell output outside of that agreement if he can receive a higher price (even if only as a once-off sale). This problem tends to arise most often in distant relationships where there is no social capital involved and, hence, no strong social
incentive to honour an agreement. Enforcing such commercial commitments on the part of an external value chain mainstream economy player is expensive, time consuming and unlikely to yield positive results; hence, the literature shows that, in most cases where small producers fail to meet their commitments because of side selling, mainstream economy buyers usually walk away from the contract.

These issues are difficult to deal with and highly sensitive. Essentially, one is dealing with cultural, educational and experiential, historical and political divides and different production paradigms. In the face of this, the suggestions found in the literature to build trust seem insignificant; however, the lessons learnt will inform the basis for what we will need to develop if we are to undertake a linkage programme in South Africa. The key suggestions in the literature include:

- Getting a trusted member of the small producer community involved in the linkage programme right from the start;
- Educating small producers on the terms of the contract/linkage, worst case scenarios, obligations and responsibilities, and payment terms;
- Allowing for independent arbitration in the case of a conflict;
- Delegating monitoring of contract adherence to someone involved in the project within the small producer/farmer community;
- Having regular communication between the buyer and the small producers;
- Prompt cash payment to support the development of trust, deferred payments make developing a trust relationship difficult;
- Investment by the buyer in tangible assets in the vicinity of small producers helps develop trust (e.g. building a warehouse);
- Corporate Social Investment by the buyer in the broader small producer community helps signal trustworthiness and commitment, although some case studies suggest this leads to entitlement issues and a mentality of non-commercial relationship perceptions. The point appears moot; and
- Finally, the literature suggests that to the extent that flexibility can be built into the linkage, the greater the chance that the linkage will be sustained.

This brief literature review holds good and some bad news for the development of a South African linkage programme. On the positive side, it provides a host of informative suggestions and rules of thumb regarding decisions which will optimise the probability of developing trust between external markets and small producers. The literature review and case studies also aid in focusing on priority issues related to trust and increases our awareness of explicitly dealing with such issues rather than hoping they will be resolved overtime by themselves. The challenge which the case studies provide is that they highlight how difficult it is to create trust when the parties in a relationship are coming from such different experiences, backgrounds, circumstances and perceptions of commercial activity. Changing human behaviour and individuals perceptions is, possibly, the most difficult task, and yet changing this behaviour of small producers and mainstream economy value chain actors is a necessary condition for any successful linkage programme in South Africa.
Group formation and structures

As mentioned in chapter two, market orientated collective action has the potential to overcome high transaction costs faced by individual small producers and to resolve issues of volume when trying to access external markets. For this reason, creating some degree of horizontal integration between small producers is a necessary step in accessing external markets. However, awareness of the advantages of group formation among small producers is often insufficient to overcome the suspicion small producers have of cooperating. The literature stresses the importance of not viewing group formations, such as cooperatives or farmer associations, as convenient vehicles through which to channel resources or implement policy. Rather, the literature stresses that such groups will fail unless they have a strong internal cohesion, and that their members willingly accept and understand the role of the group and their role as individuals within the group, accept the leadership of the grouping, and that the leadership is competent. Weak, externally-initiated groupings with poor management invariably fail. The literature documents that the number of grouping failures far outweighs the number of grouping successes across all sectors and countries. The literature reveals that case studies of grouping among the poorest of the poor and among the least sophisticated producers in a rural marginalised community almost always fail; hence, group formation is only a viable option for more sophisticated small producers and farmers. The literature also shows that groupings of people who have worked together previously are most likely to succeed; consequently, seeking to develop a producer grouping based on an existing stokvel, church group or burial society is more likely to succeed than starting a new grouping from scratch. Similarly, the literature finds that homogenous groups are more likely to succeed than heterogeneous groups.

Having said this, however, the literature is adamant that the most important factor in the successful creation of a group formation is leadership. Even if individuals in a grouping have not worked together, or are not particularly trustful of each other, these challenges can be overcome by strong leadership. Several case studies look into this assertion in detail and find that the most important leadership skills are conflict resolution and inter-personal management skills. This is in contrast to the type of skills training which is most often provided to group structures by governmental and donor agencies which often focus on providing marketing and administrative skills.

Continued support and membership to a group is also an important issue, with many cooperatives and other types of group formations decreasing to about 50% of their original size within the first year as disillusioned members drop out. The literature finds that commitment to a grouping tends to be positively related to initial start up fees and capital, i.e. if a member of a group is required to make an investment into the group they are more likely to stay with the group than if membership or admittance to the group is free. It also shows that groups with larger assets are more successful than groups with no or limited assets. The literature goes on to reveal that cooperative structures tend to be more stable if all members share equally in the proceeds of the venture; with smaller groups tending to be more successful than larger groups. Twenty to 30 members in a group is seen as the optimal size.

Turning to structural options for groupings, the literature suggests that a successful grouping must be: (1) developed from the bottom up; (2) owned by the members; (3) democratically operated; (4) commercially orientated from the start; and (5) set up with a given set of rules and regulations which govern its activities. Various case studies support the idea that small
producer groupings tend not to favour cooperatives as the legal vehicle for their formation. Cooperatives are seen as having high opportunity costs to members, in terms of time spent in meetings and reaching unanimous decisions and as a distraction when the business of being a cooperative becomes more important than the business of undertaking commercial contracts. Contrary to expectation Pty Ltd companies are the most frequent vehicle chosen around which to form a small producer formation.

The final point raised in the literature regarding group formation is a sharp warning to any intervening party that the best laid plans often come to naught if they undermine pre-existing hierarchical structures. In most rural, impoverished, marginalised communities around the world, poor communities are commonly part of deeply entrenched tribal or social systems with strong and well defined hierarchical structures. Any intervention or group formation which runs contrary to these strictures – in the absence of a wider social movement challenging such authority – is at high risk of failure.

The literature on group formation is very interesting, highlighting a host of economic and non-economic issues related to the creation, sustainability and success of group formation. While many researchers and policymakers tend to assume that the key issues are economic and administrative, the literature shows that the most important issues are human behaviour and attitudes. Social forces, learned behaviour and inter-personal relationships are the key to any successful group formation. Most importantly, the literature stresses to policymakers that cooperative structures must not be seen merely as policy and programme delivery vehicles, but must be approached with sensitivity and a depth of understanding as to what will support success and what will lead to a breakdown in small producer groupings. As such, a pure economic approach will not work. Therefore, in this area, any linkage proposals will need to include an equal measure of sociology and anthropology. As will be seen in the framework chapter, these issues have pointed us in directions other than to a focus on group formation at the producer level.

**Contracting**

Virtually all linkages will be based on some sort of contract, be it verbal and sealed with a handshake or written and given weight under contractual law upon signature. The literature suggests three broad areas of focus which must be addressed when developing contracts as part of a linkage programme. These are (1) getting the terms of the contract right; (2) ensuring the parties understand the terms of the contract, have realistic expectations and are able to negotiate a mutually acceptable contract; and, lastly, (3) dealing with who bears the risk under a contract agreement. We will deal with this issue in greater detail in later sections. For now, the key points to emphasise are that in contract negotiations between external markets and small producers, one of the key issues is ensuring that each party understands the circumstances of the other party and hence is able to form realistic expectations. Often this is an enormous challenge. External, sophisticated value chain actors often under estimate the constraints faced by small producers in terms of supply issues, skills and the limitations of small producers’ financial flexibility. With respect to small producers, they often find it difficult to understand how their actions influence the broader activities of an external buyer and the implications for the buyer of any failure by the small producer to meet their obligations. Dialogue and education can alleviate this challenge to some degree.

The second challenge with respect to contracting with small producers relates to the ability of small producers to negotiate effectively. In order to successful negotiate a mutually
acceptable contract small producers need to have an understanding of market prices and price trends for the good they are contracting to supply; secondly they need to have a thorough understanding of their own cost structures, productivity levels and output capabilities, as well as a view on their break even points. Finally, small producers need to understand the market into which they are selling in terms of the type of chain, governance structure, levels of competition and the distribution of rents across the chain. It is unlikely that small producers will have all or any of this information available and hence the literature stresses that external support to small producers in the preparation for negotiations as well as in negotiations themselves is usually required.

The third issue pertains to the distribution of risk. Mitigating risk is one of the most important motivations for contracting, while perception of who bears the risk is an important factor affecting the sustainability of contractual relations. Some risk sources can be known a priori and their sharing among the parties can be negotiated, but many sources of risk cannot be foreseen or fully covered by contracts. Strategies are needed to cope with unexpected events that otherwise could undermine the contractual relationship and jeopardise the livelihoods of the contracting parties. For example, in the case of known risks, or even in the case of so called force majeure events, insurance mechanisms might be developed. For circumstances that cannot be foreseen, flexible contract arrangements with the potential for renegotiation are desirable. The key point to be appreciated in this context is that a linkage programme between mainstream and marginalised actors is a commercial undertaking which, by its nature, encompasses some element of risk for all parties. Although asymmetries of power that lead to unfair or inequitable risk distribution can be factored into linkage contracts to protect weaker contracting parties, the reality is that small producers who enter into linkages with the mainstream economy will face risks and, hence, any framework or strategy developed must take into account the potential downside to small producers of entering such a relationship.

**Financing linkage programmes**

Extensive literature and case studies exist covering lessons learned when financing linkage programmes. Financing arrangements will depend on (1) the type of linkage undertaken, and (2) the role players in the linkage programme.

The first point raised in the literature is that many linkage types are viewed as preferable due to the fact that the linkage explicitly provides for the financing of small producer activity up front. Such linkage types include: links with larger traders who either provide advances to small producers, or who provide credit extension services or embedded services including covering the cost of inputs. Most contracting linkages also include credit extension facilities or direct service options, as do most linkages with agro-processors or non-agricultural processors. Linkages between producers and government institutions, between small producers and retailers, and between small producers and lead producers/farmers, typically have less of an internal financing element as part of the linkage. The literature reveals that the most common practice of financing within a linkage arrangement is a direct system where inputs, technology and services are provided to small producers by an external value chain actor on a cost recovery basis. Small producers draw down inputs and services from the mainstream economy player, and when the small producer delivers their output and is due to receive payment for that, the cost of supplies they have drawn down is off-set against their revenue earned. Although this process creates additional transaction costs for the supplying company which needs to undertake the administration of each draw down, the
system ensures payment for these services and provides the supplier with a measure of certainty regarding repayment. In some cases, the transaction costs are too high for the supply company to bear and in this case an intermediary is often created to reduce these costs, usually funded by government or an NGO. Such a situation arose with the SAPPi Grow Programme. The literature considers a variety of options available to policymakers interested in linkage programmes to support the extension of finance or services within a linkage programme and these will be dealt with in detail in our framework discussion.

The literature is quite explicit and case study data strongly confirm that if financing for a linkage programme is not built into the linkage itself, and if external loans are instead required (to purchase inputs, seeds, raw materials, technology, etc), these loans should not be made directly by the linkage implementing role player but should use existing micro-lending organisations. This is due partly to the cost of providing such services and partly to the poor performance of loan repayments if the loans are extended by a non-professional financing operation. In addition, the literature notes that loans made to individuals are preferable to loans made to small producer groupings because such groupings find it difficult to persuade members to comply with the terms of the loan and scheduled loan repayments. The literature is also adamant that for external catalyst linkage interventions, external role players, such as governments, governmental agencies or donors, should not provide direct services or subsidies to small producers. The literature shows that linkage programmes cannot be a source of handouts and, on this basis, for them to become sustainable. “Subsidies reduce responsibility and reward failure” (Shepherd, 2007: 40) and, by far, the superior option is that commercial activities should be “enabled using commercial principles” (Shepherd, 2007: 40). While short term benefits exist for the provision of direct funding or service provision, there is no case study (other than a Guatamalan horticultural project) where a programme was successful after direct financial support was withdrawn. The Guatemalan case study showed that a group of small agricultural producers, after receiving a direct subsidy from the government to supply a large supermarket chain with vegetables, were able to sustain their business after the subsidy was withdrawn – but this was only after 14 years of subsidisation. By far, the majority of direct subsidisation programmes fail within 12 months of finance being withdrawn.

Having said this, however, the literature suggests that external resources can legitimately be considered for facilitating the process of business development required for small producers to partake in a linkage programme. Grants to enable groups or individuals to carry out local market assessments, prepare business plans, experiment on a particular product, and strengthen skills in areas such as group management or bookkeeping and product handling, are usually effective uses of development funds. So, too, is the use of funds to facilitate private sector activity. This is a large topic which will be dealt with in the next section when we consider who the best drivers of a linkage programme are – external players or internal players.

**Sustainability, scalability and the roles of the private sector, public sector and donor community**

As mentioned in the introduction to this foundation chapter, the purpose of sections one and two above was to provide information on the types of linkages which exist and experiential lessons learned about what works and does not work when developing a linkage programme. As highlighted earlier, the majority of case studies and academic work in this
area relate to externally driven linkage programmes – i.e. where an actor not directly involved in the value chain or in small scale production intervenes to develop and support a linkage between small producers and external value chain participants.

By now, the reader should appreciate the scope and complexity involved in developing even a single linkage project. To reaffirm this, Table 3 has a checklist created by the Food and Agricultural Organisation of what activities need to be undertaken when developing a linkage programme between a small scale agricultural producer and a mainstream economy external market buyer. Not only is the length of the list daunting, but the human and financial resources required, and the complexity of some of the individual items, leaves a policymaker flummoxed when considering rolling out such programmes en mass.

Table 3: Linkage programme checklist

<table>
<thead>
<tr>
<th>CHECKLIST ITEM</th>
<th>MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>What products are undersupplied on local markets that could perhaps be supplied by farmers in the area?</td>
<td></td>
</tr>
<tr>
<td>Alternatively, what markets exist for products that target farmers do or could produce?</td>
<td></td>
</tr>
<tr>
<td>What are the risks associated with the identified markets?</td>
<td></td>
</tr>
<tr>
<td>Low commodity prices?</td>
<td></td>
</tr>
<tr>
<td>Limited demand?</td>
<td></td>
</tr>
<tr>
<td>Rapid price fluctuations?</td>
<td></td>
</tr>
<tr>
<td>Competition from other existing or potential suppliers?</td>
<td></td>
</tr>
<tr>
<td>High marketing costs that may make supply uncompetitive?</td>
<td></td>
</tr>
<tr>
<td>Quality and certification standards that may be difficult to meet?</td>
<td></td>
</tr>
<tr>
<td>Are the identified markets presently being supplied and, if so, would the proposed linkage affect the livelihoods of other farmers by removing their market opportunities or by leading to oversupply and lower prices?</td>
<td></td>
</tr>
<tr>
<td>For export markets, are farmers able to supply when demanded by the market and in sufficient quantity for exporters to sustain linkage arrangements?</td>
<td></td>
</tr>
</tbody>
</table>

**PRODUCTION**

<table>
<thead>
<tr>
<th>CHECKLIST ITEM</th>
<th>MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do the farmers have the necessary assets to carry out production of the crop/livestock (e.g. irrigation, farm power, tools and equipment)?</td>
<td></td>
</tr>
<tr>
<td>Is the location suitable for the planned production? What production risks are there (drought; disease; etc.) for new products and how do those risks compare with existing risks faced by farmers?</td>
<td></td>
</tr>
<tr>
<td>What existing extension support is available to farmers?</td>
<td></td>
</tr>
<tr>
<td>Are farmers’ education and skill levels suited for the planned production? Have they demonstrated a past capacity to adapt to new activities?</td>
<td></td>
</tr>
<tr>
<td>What farm management skills do farmers have? Do any keep farm records?</td>
<td></td>
</tr>
<tr>
<td>What is the land tenure situation? Is this conducive to the investments required from farmers to produce the planned product? If not, have alternative products been considered?</td>
<td></td>
</tr>
</tbody>
</table>
Have government agricultural research services carried out research on the planned products? If not, could these services be persuaded to assist with such research?

Is existing research based on farm-level research or research farm results? If the latter, what adjustments need to be made to make them realistic for the environment of the target farmers?

Using realistic assumptions, what is the likely cost of production that farmers would face?

What input suppliers and mechanisation services are available locally? Do these carry, or would they agree to carry, the necessary inputs for the products envisaged?

If no suitable suppliers or services are available, what arrangements need to be made to ensure that they become available on a sustainable basis?

Has the individual or company identified as a potential buyer expressed an interest in supplying necessary inputs or extension support to prospective farmers?

If the planned linkage requires following detailed production specifications of the buyer, do the farmers have the capacity and inclination to do this?

If the planned linkage requires capital investment by farmers, do the likely returns justify such investments? Is finance available (see below)?

Are the planned products compatible with the ability of farmers to supply, from a social or religious standpoint? If not, have alternative, less demanding, products been considered?

GROUP FORMATION

Is group formation essential to link with the identified market? If not, what are the advantages of working in groups (e.g. overcoming high individual transaction costs) and are these offset by costs (including time costs) that farmers may incur?

Have alternatives to group formation been considered, such as the “leading farmer” approach?

Does the planned linkage require formal groups with a legal entity or would informal activities, such as bulking up produce for sale to traders, suffice?

What have been the experiences in the country/region/province with collective farmer activities? Which type of farmer organisation appears to work best?

What, if any, collective activities do the target farmers presently carry out? What have been the experiences with this?

Have discussions been held with farmers about forming a group or groups? If so, what has been the initial reaction to the idea?

What is the social structure of the area and does this lend itself to successful collaborative activities? Would there be a possibility of elite capture?

Would different types of groups be necessary to ensure homogeneity, such as male and female groups or groups organised according to roles in the supply chain?

What size should the groups be? What structure should they have (officers, decision-making, etc.)? Is there a possibility of federating with other groups/associations and what would be the advantages of this?

Have bylaws for the group been developed and are they fully understood and accepted by all farmers?

Are there farmers who demonstrate leadership and/or management skills? If not, does the proposed activity justify recruitment by the group of a full-time manager?
What training will farmers require in group dynamics?
What training would group officers require in business management, marketing, accountancy, etc. and how will this be provided?
What existing legislation is there relating to farmer groups and is it appropriate to the type of group envisaged?
Would the group be legally entitled to operate a bank account, if required?

MARKETING, PROCESSING AND CONTRACTS

Has a detailed analysis of the supply chain been carried out and have proposed linkage activities been based on that analysis?
What are the conditions of purchase of the buyers in relation to quality, safety, quantity, packaging, transport and delivery, and pricing and payment?
Do farmers have the capacity to meet these conditions? If yes, what training do they nevertheless require? Are they able to make necessary investments?
Does the location of the farmers present difficulties in supplying the market?
Are farmers likely to fully understand the purchase conditions, particularly in relation to pricing and quality aspects? If not, what steps must be taken to ensure they develop an understanding?
What would be the likelihood of side-selling (extra-contractual marketing) for the envisaged crops? What steps can be taken to minimise the possibility of this?
Is a written contract necessary or will a verbal contract be sufficient? Who will draft the contract and what steps can be taken to maximise the involvement of farmers in this process and to ensure that they fully understand the conditions of the contract?
Does the contract allow for renegotiation in situations of force majeure?
What costs would farmers incur in meeting buyer conditions and would deduction of these costs from the expected price result in returns that would be profitable for them? Would these returns be higher than their existing returns and would they justify any increase in risks faced?
What transport arrangements would be used? Is commercial transport available or, if not, what steps are necessary to ensure that commercial transport will be available? Is the available transport suitable for the planned products?
What arrangements can be made for farmers and buyers to meet, for buyers to visit farms and for farmers to see how their products are marketed and used?
Is any external certification required for the envisaged market? What costs would farmers face in meeting required standards and how would the cost of certification itself be covered?
How long has the potential buyer been in operation and what, if any, risks are associated with the business, such as competition from overseas suppliers?
Does development of the market for farmers require any support to processors?
How can this be done with minimal subsidy to ensure sustainability? Prior to a decision to provide support, has detailed market and business research been carried out to assess the long-term viability of the company?
Do other actors in the supply chain, such as traders, require technical or commercial loan support in order to make planned linkages more efficient?

ENABLING ENVIRONMENT
Is the macro-economic environment suitable for the sustainable operation of exporting and agro-processing operations?

Do the legal and the judicial systems safeguard property rights and is there a workable contract law?

If the answer to the above questions is no, what market linkage activities could be introduced that would not be jeopardised by the absence of a suitable environment?

Is the available infrastructure (roads, electricity, water, communications, stores, port and airport facilities) suitable for planned marketing and/or processing activities?

What sources of market information and other advice on marketing are available?

FINANCING

Is there a bank or other financial institution in the area?

Have any of the financial institutions expressed an interest in working with small farmers, possibly through a tripartite or quadripartite arrangement with the planned buyers and/or input suppliers?

Do those financial institutions have experience in lending to small farmers on a sustainable basis and do they offer loan products compatible with farmers’ cyclical cash flow? If not, would they be prepared to do so? Is any insurance against price or production risks available?

What are the collateral requirements of the financial institutions? Are these acceptable to farmers? If not, can alternatives be explored?

Do any financial institutions in the area offer savings facilities for small-scale depositors? Are money transfer facilities available that could facilitate payment by the buyer?

If buyers have undertaken to supply inputs, would they be prepared to do this on credit, with repayment at the time of product delivery?

SUSTAINABILITY AND REPLICABILITY

What steps have been taken to consult with national, regional and local authorities to ensure that they are fully supportive of the planned linkages?

Have decisions about any subsidies that may be given been taken with full regard for the implication of such subsidies for sustainability?

Have detailed cost analyses been conducted to ensure that proposed linkages will be profitable at forecast prices and production levels and has a sensitivity analysis for different prices and production been conducted?

Has flexibility been built into project implementation?

Is the term of the project fixed by the donor or can this be varied according to progress?

Has it been ensured that where commercial services (transport, banking, etc.) are available they are used and that the project does not attempt to set up parallel services?

Has all necessary training been carried out?

Are the demands that the linkage places on the time of the farmers realistic? Could the linkage create or exacerbate sex or wealth inequalities?

Is the linkage developed specific to the area, or could it offer a model for developments elsewhere? If the latter, what steps can be taken to bring people’s attention to the success?

THE LINKING ORGANISATION
Are employees comfortable working with the private sector? Do they understand the way the private sector functions and the ways in which it can most efficiently link with farmers? What training of staff is required in areas such as business management and market research? What training is necessary so that staff can, in turn, train farmers?

Source: FAO/Shepherd (2008: 46)

Does this mean that it is not viable to consider a linkage programme as an option for systemically providing small producers with access to external markets? The answer to this all important question from our perspective appears to be moot. On the one hand, the literature tends to coalesce around a view that externally catalysed linkage programmes, business and organisational models are too costly in terms of time, human resources and financial resources to be successfully replicated on scale. Ways of replicating and upscaling tried and tested approaches to benefit a greater number of beneficiaries do not yet appear to have been developed.

However, the literature does concede that linking small producers to external markets does appear to offer greater possibilities of success than previous development enthusiasms such as those covered in the origin of value chain thinking in chapter two. Having conceded that linkage programmes do potentially hold promise, the literature is quite emphatic on two qualifications to this potential. The first qualification is that even if market linkages can be successfully formed, they will not guarantee sustained improvements in the position of the small producer in the long run given how markets and market participation changes over time. Secondly, the literature qualifies the potential of the linkage approach to deal with poverty in marginal areas by stressing that successful linkage programmes will by their nature be more likely to succeed when producers are in closer proximity to external markets and producers are more skilled and better endowed. In other words, linkages can potentially assist in poverty reduction – but not for the poorest of the poor. Pro-poor growth orientation can often sit uncomfortably with hard commercial reality. Business development, by way of a linkage programme, cannot be synonymous with social policy and, invariably, commercial requirements will override some equity concerns.

So, where does this lead us? Firstly, we know that a linkage programme has potential to improve the livelihoods of marginalised producers but provides no certainties with respect to long term outcomes and will only be appropriate for beneficiaries who are better endowed with factors of production, higher skills levels and who are closer to major markets. Secondly, we know that scaling up a linkage programme based on an external catalyst model is not an option due to resource costs, time and complexity. Thirdly, no broad based scalable linkage model has yet been developed. The area which we have not investigated and which holds the key to our current task must, therefore, be an examination of the potential of non-externally catalysed linkage programmes, i.e. linkage programmes driven by private sector actors across a variety of value chains. We refer to this option as internal catalysation where a private sector value chain actor, from either the mainstream or marginalised economy, initiates the creation and facilitation of linkages.

Internally catalysed linkage programme theory, literature and case study documentation cannot be found in traditional value chain analysis. Rather, ideas regarding internal catalysation of linkage programmes are found in the broader arena of private sector development practice. To be frank, we found this literature useful in terms of its definition of
the problems and goals but too vague on its implementation suggestions and recommendation to offer any truly useful ways forward.

Essentially, private sector development practices for improving mainstream economy value chain participants’ link with small, marginalised producers is premised on creating a more supportive environment for such activities and by stimulating markets to replicate promising practices on a sustainable basis (ILO, 2006: 1). Several influential papers on this topic concur that this can be achieved by: strengthening learning systems, commercial support markets and by building the capacity of change agents to drive industry competitiveness. These concepts will prove crucial in the development of our framework and strategic options, most importantly, for the notion that desired private sector activity related to linkages will need to be stimulated. These issues are dealt with in detail in chapter five.

PRODUCT SELECTION

In this third and final foundation chapter, we turn our attention to product selection: what products are most appropriate for marginalised, small producers to produce and sell into a designated value chain. As mentioned earlier, product identification is critical because the characteristics of a product and where such production links into a value chain will determine how economic rents are distributed to the small producer. Incorrect product selection or changing market circumstances for a particular product may give rise to a successful linkage programme in terms of sustainable transactions, but may not be sufficient for lifting a small producer out of poverty or providing a decent return on their activity. Despite the paramount importance of correct product selection, value chain and linkage theory provides little guidance on these matters. As we saw in the two previous chapters, value chain theory and the majority of linkage theory and research are demand driven. As such, the theory begins its analysis at the point where a small producer of a given product is seeking to link into an established value chain. The theory is helpful in developing analytical and implementable steps to map given chains, test the market for a given product, analyse the critical success factors required to meet a lead firm’s demand and how best to segment a market for maximum return to the small producer. However, the theory is largely silent on the initial identification and selection of products and chains.

The only substantial body of literature related to initial product or market selection which we have found appears in reports from donor-led projects, many of which begin exogenously catalysed linkage programmes with a product scoping and selection exercise. These exercises lead to initial product lists which are then filtered and refined. These approaches are fraught with potential pitfalls and must be treated with caution, but they are a necessary inclusion in our study as the idea of who should undertake product selection and how such selection occurs is crucial if we are to develop successful linkage strategies which reduce poverty.

This chapter will begin with a very brief analysis of different methods used to select products for linkage programmes. These methodologies are interesting from a philosophical and mindset perspective and will be shown to be important in chapter six of our study. After this, the chapter turns to look at: (1) market trends for various products and the implications of these trends for small producers; and (2) analysing the critical success factors necessary for small, marginalised producers to win contracts from mainstream economy value chains. These two issues raise some serious challenges for our framework and strategy and test
policymakers’ mettle in terms of their commitment to reducing poverty in the marginalised economy using a linkage system.

The overall aim of the chapter is to highlight characteristics and issues which pertain to product selection and which will directly impact on the distribution of economic rent to small producers. The value of the chapter lies in identifying high return product characteristics and differentiating these from low return characteristics. Such differentiation provides invaluable direction and input to our framework and strategy.

Methodologies to select products

The most interesting starting point on the selection of products or value chains for further research is the epistemological concept of whether analysis needs to precede action or whether such a linear, mechanistic approach can be substituted by a less linear, more developmental research approach. While this may appear to be an esoteric and abstract starting point, it is a key issue in how we will structure the framework and strategy in the next two chapters. We consider two broad approaches: an analysis before action approach and an action research approach. Stamer and Waltring (2007: 28) argue that the analysis before action approach is based on the assumption that “most, if not all, of the relevant information for a development activity can be gathered before a strategy is formulated and implemented.” While they concede that this approach appears to be logical, they suggest that it suffers from several theoretical and practical dilemmas. The first documented dilemma is that researchers will run into a catch-22 situation where the information needed to decide whether a value chain is suitable or not for a linkage initiative will only become available through an analysis of that value chain. The second dilemma cited by the authors relates to selecting value chains before understanding them. They argue that in this approach value chains that are to be promoted are selected early and before representative information is available. Because it is impossible for every value chain in a given region or national economy to be considered, the limiting of the value chains to be further investigated results in value chains being investigated not because they have been researched but because they have been chosen. Given that this choice is in all practical likelihoods based on some form of quick, high level scan, Stamer and Waltring believe that the third dilemma facing an analysis before action approach will be using random data for value chain selection which may lead to random decision making.

The analysis before action approach is common in many donor and developmental projects due to its ability to generate a logical, linear, step-by-step framework to a work programme. This has value from an administrative perspective, offering clarity about planning and resource allocation and providing programme managers with milestones and deliverables.

The action research approach, by contrast, is a spiral model of sequencing which provides none of the linear certainty of an analysis before action approach.

The action research approach to product and value chain selection is based on “the insight that ex – ante research will only reveal the information that is relevant to solve a given problem or realise a given opportunity” (Stamer and Waltring 2007: 30). Rather, the action research model suggests that the best way to understand the root cause of a problem is to try to solve it, which naturally leads to a close intertwining of action and research. The approach, which was first adopted by the European Union’s LEADER\(^5\) programme, is shown

---

\(^5\) LEADER is a French acronym and translated into English stands for ‘links between actions for the development of the rural economy’.
below. The bottom-up approach begins with animation activities, where steps are taken to get the ball rolling. These may include getting local communities and potential participants together with value chain players to develop initial ideas of gaps in the market or growth opportunities. This animation is then ‘structured’ in terms of pinning down organisational links that need to be formed or research which needs to be undertaken, until this first round is ‘consolidated’.

Figure 4: Action research development spiral

Source: EU Leader Programme toolkit, chapter 6

Each series of animation, structuring and consolidation leads to another round (spiral) of animation, structuring and consolidation. This ongoing helix gets larger and more complex as additional issues are raised, until a programme of work is finally developed. The benefit of this approach is that it does not separate out pure market analysis from analysis of hierarchies and governance and power issues. This approach sits far better with value chain theory and the demand driven nature of the value chain paradigm, but is administratively difficult because it is highly iterative and exhibits none of the linear, easy to monitor attributes of the former approach.

Turning from epistemological theory to how these approaches actually roll out on the ground, we see that analysis before action is the most prevalent approach adopted internationally. Having said this, however, the type of analysis undertaken before an action programme is determined varies substantially – usually in response to the resources available. In a handbook on agricultural value chains, produced by JE Austin and Associates for the World Bank, the authors suggest that in-depth, qualitative analysis is not always undertaken. They find that in some instances product selection is undertaken initially by consulting with experts, using previous industrial sector analyses, choosing products which the government has already deemed priority sectors or those products which a national government is already supporting through some type of programme. In addition, they note that some product selection processes generate initial product choices simply on the basis of brainstorming or referring to crops already grown in the area or products already being manufactured.

On the other extreme, they note instances where product selection is undertaken as a major multi-million dollar exercise in its own right. In a case study of product identification in Mali’s agricultural sector, a three year, US$4m comprehensive approach was undertaken by a
Canadian based global consulting firm. The firm adopted an 18 step strategy to identify competitive value chains in Mali which would allow them to diversify their agricultural exports. The detailed steps are shown below.

**Box 10: Mali sector selection approach**

**Module 1: Defining Mali’s broad portfolio of agricultural sectors**

Step 1:1 Create a comprehensive list of agricultural sectors in the country, including informal ones.

Step 1:2 Categorise each sector using criteria that defines its particular storage, and/or delivery needs, such as perishable, semi-perishable, durable, transformed, semi-transformed, or processed.

Step 1:3 Classify each sector based on potential end markets, such as export markets for consumption or processing, regional markets for consumption, or local markets for consumption.

Step 1:4 Summarise the structure of the various value chains by organising the categories defined earlier, incorporating upstream-downstream relationships and key factors of value addition.

**Module 2: Analysing market demand and market entry conditions**

Step 2:1 Create a market demand data sheet for every value chain listed in Module One, providing a comprehensive snapshot of that chain’s viability and market opportunities.

Step 2:2 Chart opportunities in each end market for all identified classifications. For example, identify European markets for perishable product-value chains intended for export markets, including value and quantity. Do the same for other end markets and sector classifications.

**Module 3: Analysing the competitiveness of potential Malian offerings**

Step 3:1 Determine the production potential for each sector using information from the first two modules. Add data on number of producers, production, farm yields, unit price, and revenue.

Step 3:2 Analyse regional potential based on comparative advantages. Map the key production regions to determine target areas for select agricultural products, highlighting geographic advantages (e.g. access to water or growing seasons); constraints (e.g. distance from main markets, distance from Bamako for transport, pollution, or poor climate); and producible crop sectors.

Step 3:3 Create sub-regional identification sheets that present annual rainfall, temperature, sun exposure, and humidity for each sub-region to determine the suitability of crop selection.

Step 3:4 Illustrate the growing months and seasonal market demands for all products to show areas of opportunity for producers based on their production cycles and periods of crop availability.

Step 3:5 Conduct an analysis that shows constraints and subsequent interventions that would improve value chain competitiveness.

**Module 4: Defining priority sectors**

Step 4:1 Prioritise value chain criteria by triangulating the interests of various stakeholders. Rank the priorities for each value chain based on production sophistication, number of solvent operators that could be integrated into the strategy, strategy duration, social impact, market appropriateness, existing professional organisations, and existing programs.
Step 4:2 Create a matrix that identifies priority sectors. Put priority levels from the final stage of Step 4:1 in columns, and categorise the rows based on various end markets. Insert sectors into their respective boxes, thus identifying the sectors with the highest probability for success and impact. The matrix can be used to balance strategies for a variety of sectors.

Step 4:3 Organise the priority sectors by area using the regional analysis conducted in Module Three that shows which value chains should be implemented in which regions of the country. This table also provides an at-a-glance view of the crops that can be grown in several regions.

Step 4:4 Create a reference index showing growth and economic impacts for certain priority value chains, highlighting all indicators used during the previous modules of the analysis.

Module 5: Competitiveness planning: putting the analysis into action

Step 5:1 Determine which approach will improve the competitiveness of the sectors in question. In this instance, Geomar recommended that Mali’s competitive strategy include short-, medium-, and long-term objectives, each with pragmatic and obtainable interventions.

Step 5:2 Address the issues with solutions, taking into consideration the constraints highlighted in Module Three and their associated investment needs. For example, “Improve technical skills and human productivity by introducing new technologies and training facilities.”

Step 5:3 Wrap the entire strategy together by providing implementation guidelines and a framework that encompasses standard, specific activities that fall under four stages: provisioning, production, logistics, and marketing. Overlap these stages with cross-cutting activities.


The outcomes of the Mali study are still being evaluated and the authors note that it is too early to conclude whether the value chain programmes emanating from the selection process will be successful or not.

By contrast, the action research approach, such as that followed in the EU LEADER programme, is considerably more direct. In this programme, once a geographic area has been selected, a Local Action Group (LAG) is established. Usually LAGs have a LEADER agent who is tasked with driving the process. The LEADER agent’s first responsibility is getting all area participants together in a workshop. Participants include local government, the private sector, local community members and local farmers. The LAG’s first animation activity is the identification of potential products to be selected for further consideration. In the Welsh and Scottish LEADER programmes which we investigated this initial process took only three months to complete.

The above disparate methodologies suggest that initial product selection can be as simple or as complicated as one makes it, and is probably most dependant on timing, financial constraints and who is driving the process. Insufficient research has been conducted to determine if one approach is superior to the other in terms of final linkage impacts. Rather, the question for our purposes is which methodology will fit best with our framework and strategy options, and if it is possible to develop a strategy where product identification and

---

6 Stamer and Waltring argue that expensive, long product selection undertakings play a role in maintaining a large and profitable consulting industry, especially in developed countries.
segmentation is internalised into a linkage programme, rather than being undertaken as a discrete activity by external bodies.

From the previous chapters, we learnt that the best chances of achieving a high impact and broad roll out of a linkage strategy would be to stimulate the private sector to create and support such linkages. If this is indeed the route followed, then discrete and isolated product selection exercises become redundant as the private sector will determine which products are most suitable for small producers to input into lead firm value chains. As such, it may appear that this foundation chapter is redundant in that a strategy will not need to be developed in relation to how products are selected. While this is accurate from a mechanistic perspective, it is imperative that policymakers understand the implications of product selection so as to form a view on what types of product-based linkages are preferable and what types of product linkage opportunities should be avoided.

We now consider the merits and demerits of certain products and product characteristics by looking at market trends and critical success factors which are most relevant to small producers and our linkage framework and strategy.

**Market trend analysis**

One of the distinctive features of the contemporary production system is that it tends to be market pulled, as opposed to the supplier pushed system of previous decades. This puts a primacy on the characteristics of final product markets in every chain and, generally, presents a high order priority in all value chain studies. As such, irrespective of the methodology or strategy used to arrive at an initial product selection, the value chain and linkage literature is unanimous in its agreement that robust, meaningful and sophisticated market trend analysis is a crucial first step to be undertaken.

The aim of this section is not an elaboration of how to undertake a market trend analysis or which questions to answer, but rather to focus on overall market trends across sectors as they apply to small producers. We know from the value chain foundation chapter that profits and returns, across all sectors of the economy and in all countries, tend to gravitate away from producers and suppliers in favour of lead firms and enterprises which undertake marketing, branding, innovation and logistics. What we learn is that small producers typically face the thin edge of the wedge in terms of the distribution of profits along a chain due to most of their economic activity falling into basic or intermediate output production; and that the types of products traditionally produced by small producers are being squeezed, in terms of market value, via an international trend of commoditisation.

The issue of product commoditisation as it relates to small producers can best be understood in the context of globalisation. Globalisation is the systemic removal of barriers to trade, information and factors of production which have allowed greater flows of goods between nations to be supported. A great many people and nations have gained from this growing openness in markets; however, there have also been a large number of casualties. The losers include those who are excluded from globalisation, and those who have participated in globalisation in an ineffective way.

Poor producers and countries consistently head the list of losers or casualties in the march of globalisation. The reason for this is largely attributable to the types of products and goods which poor producers and developing countries specialise in. Traditionally, poorer nations and poor producers tend to undertake the cultivation and production of primary materials and inputs such as cotton, wheat, rice, coffee and bricks, among others. Since the 1950s, the
price realised for these goods in the international market compared to the price of manufactured imports has systemically declined meaning that even if poor producers and poor nations increase the volume of primary materials and inputs made available for sale, their incomes will continue to decline. Prices for primary inputs have declined consistently over the years due to lower barriers to entry, global over-supply and changing final consumer demands towards value added, differentiated products. Essentially, these traditional small producer products have become commoditised. Due to this trend, economists in the 1960s recommended that poor producers and developing nations focus on industrialisation and move their production from primary production to the production of manufactured goods. The approach yielded positive returns initially, but by the 1990s, it became apparent that low barriers to entry and global over-production in manufactured goods was imitating what had happened to primary goods in the 1960s. Basically, manufactured goods were being commoditised and began to face falling terms of trade, especially as China’s productive capacity grew.

As such Fitter and Kaplinsky and Morris (2001) claim that the “development challenge is, thus, not to move out of ‘commodities’ defined as primary products, but out of all activities which are subject to substantial falls in their terms of trade” (Fitter and Kaplinsky, 2001: 3). Failure to make this shift inevitably will lead to immiserising growth or a situation “when overall economic activity increases, but the returns to this economic activity fall” (UN VC Handbook: 22). An example of this was seen in South Africa in the wooden furniture industry where, between 1991 and 1996, the volume of wooden furniture exports increased by 10% but unit prices fell 20% from US$16 a ton to US$6 a ton, leaving producers worse off even though they had increased exports\(^7\).

A similar experience was felt by coffee producers who saw the price of coffee plummet from US$8 a pound to less than a dollar a pound in 10 years. A price which didn’t even cover production costs.

The catastrophic impact of commoditisation and its resultant decreases for trade result in immiserising growth at all levels of the economy. As shown above, it can occur at a national level, based on exports and imports. It applies equally, however, to specific sectors, firms and individuals.

From this study’s perspective, the need to avoid immiserising growth is fundamental. It is entirely possible that we would be able to create a linkage system where small producers are linked to external mainstream economy value chains, but that they were inserted into chains and positions along a chain such that increased sales volumes did not result in increased returns and, thus, made no impact on poverty levels.

This is a real threat, especially as most small, marginalised producers in South Africa produce inputs and products which are primary products and/or commoditised goods. Given that primary goods, and even manufactured goods, have become commoditised over time, what does this mean for small, marginalised producers and where are the opportunities for these producers?

The answer lies in product selection and the decommoditisation of the products small, marginalised producers will supply to mainstream economy value chains. Products become commoditised and their prices fall because of low barriers to entry and increased supply. The

---

\(^7\) In reality, this was not the case as in the same period the value of the Rand declined, so that even if the dollar price decreased, the Rand price actually increased.
only way to defeat commoditisation is to either erect barriers to entry, by attempts to fix the market through interventions such as producer or buyer cartels, or to create barriers to entry through a process of upgrading and product differentiation.

As the first option is frowned upon by virtually all national governments and international economic organisations, it leaves us with upgrading and product differentiation as the way forward in selecting products which small, marginalised producers could focus on and which are less likely to result in immiserising growth. As Humphrey puts it: “whereas product differentiation was traditionally the domain of lead firms, increasingly producers and suppliers are paying attention to differentiator strategies” (Humphrey, 2005: 10).

As mentioned in the value chain foundation chapter, various product differentiation options exist. Broadly speaking, there are three categories of product differentiation: differentiation based on credence, on standards and on branding. Often all three differentiators coincide but it is useful to consider them individually at this point in our analysis.

Reardon (2001) argues that most product differentiation in the 21st century is based upon “new products with quality and/or safety aspects that cannot be known to consumers through sensory inspection or observation in consumption” (Reardon, 2001: 424). He terms this type of differentiation credence good differentiation and suggests that credence attributes include: (1) safety attributes (how the product was produced, how good the product is for the consumer), (2) authenticity attributes (where the product was produced and by whom), (3) environmental attributes (whether production is sustainable and its impact on the environment) and, finally, (4) fair trade attributes (was production equitable and just).

Credence attributes become an effective tool for decommoditisation as consumers and final demand become more selective, more educated and more sophisticated. Whereas 40 years ago, no one knew about carbon footprints or cared whether their produce had been flown into the country or produced locally, today, such issues are key differentiators which consumers are willing to pay for. In 2008, an IBM survey of 1,000 business leaders in 40 countries and across 32 industries identified changing demands of customers as the most pressing issue facing the enterprise of the future.

Green consumers, socially-minded consumers and information omnivores are creating new hurdles for lead firms to meet before they win their share of consumer dollars but, surprisingly, most CEOs interviewed in the survey viewed this shift as a business opportunity rather than a threat.

An example of a credence good and the benefits of decommoditisation are shown in the box below.
Box 11: Percol coffee

The Food Brands Group in the UK markets a variety of coffees under the "Percol" brand name. The top end of its range is called "Sanctuary™". It claims to be a "bird friendly, single estate, organic Arabic coffee". One of these estates is "in the Altamaya region in the northern Peruvian highland" and consists of a cooperative of 47 small farmers. The packaging makes claims about various aspects of this product:

The product has superior quality because it is grown on a single estate and grown organically. The latter claim is supported by certification from the UK Soil Association, whose logo is displayed on the packet. Information is provided about the precise location of where the coffee is likely to have been grown (with a disclaimer that the coffee may not always come from this location).

The product is "bird-friendly". Shade-grown coffee does not destroy the forest canopy. This claim is supported by certification from the Smithsonian Migratory Bird Centre.

The product has social benefits. While this product does not conform to Fair Trade standards, a claim is made that Percol is committed "to the coffee growing communities and environment" and that the company has "a mission to care for the people and the environment where it is grown". Reference is made to "The Coffee Kids Charity" and "raising money for health and education projects to improve the quality of life for children and their families where coffee is grown".

The result is a product that sells for a 10% premium over other Fairtrade organic coffees.

Source: Humphrey (2005: 6)

Authenticity, environmental and fair trade attributes are all options which small producers in South Africa’s marginalised areas could embrace and use to their advantage in differentiating their output from that of commercial farmers, commercial textile and garment factories or mass building material suppliers. As we will see in the issues section below, although these opportunities exist, limitations do exist on the size of these markets and the premium consumers are willing to pay. In addition, the costs of educating consumers about these differentiators and creating a market based on such differentiators takes both time, finance and effort – all factors which will need to be taken into account when determining strategic options for small producers.

The second option available for product differentiation and decommoditisation is that of branding. Branding has been undertaken traditionally by lead firms, particularly in the retail sector. As shown in the previous chapter, whereas large retailers traditionally sold other firms’ brands, increasingly, in the 21st century, a trend has emerged where retailers brand their own products in favour of selling other company brands. So, for example, all the large grocery and food retailer in South Africa sell other firm brands but all also offer a large and growing selection of in-house brands. Lead garment and home ware stores sell ranges of third party products but also create in house design labels. To try to balance this asymmetry of power created by lead firm branding, suppliers to large firms have increasingly sought to develop their own brands which can be retailed through large lead firms at greater returns than unbranded products. This branding can either be based on the enterprise itself or on the region from which it originates.

Enterprise branding is usually related to some type of credence claim, as shown in the Thandi Wine example, or the coffee example mentioned above. In the Thandi Wine example, the company differentiated itself from other South African wines in the export market by building its enterprise brand on the basis that it was a fair trade entity, owned and operated entirely by previously disadvantaged individuals. Due to this branding along with a
substantial marketing campaign in the UK, Thandi Wines are selling at a 15% premium to other South African estate wines in the UK market.

A second type of branding option relates to branding a product based on its regional origin. For example, the Kenyan Flower Council has spent considerable funds in differentiating its cut flowers in the international market from other suppliers. Differentiating factors are based on water use, labour conditions and the use of pesticides in flower production. Perhaps the best known example of regional branding is the example of New Zealand and the kiwi fruit, shown in the box below.

**Box 12: Kiwi fruit**

The kiwi fruit originated in China, as the Chinese gooseberry, but as its name suggests, its commercialisation on a global scale was achieved by New Zealand growers who introduced the new name in 1959. It is reasonably easy to grow and competition has expanded. By the early 1990s, the largest exporter was Italy, whose production grew to 262,000 million tones in 1998 versus 240,000 million tons in New Zealand. Chilean exporters were also entering the market at a global scale with production growing to 156,000 million tones in 1998. Not surprisingly, global prices have been on the decline. Given that it is New Zealand’s single largest horticultural export crop, with annual sales of US$225m, this represented a real challenge for New Zealand growers.

Their response was to develop:

- A new, gold coloured variety: ZESPRI GOLD™. Marketing began in Asia in 1998 emphasising the fruit’s health properties and linking it to roller board displays in large supermarkets. The New Zealand Marketing Board has copyrighted the variety and organised contract growing in four Italian cooperatives.
- New varieties of organic kiwi fruit which are being marketed at a premium price, with exports doubling in 1999.

Source: IDS value chains and income distribution

The third and most common method of decommoditisation and product differentiation occurs via standards. The literature regarding standards is sizeable and considers public and private standards. Public standards are created by national governments and their agencies or groups of nations, such as the European Union. These standards are essentially focused on safety and transparency issues to protect and inform consumers of the qualities of products they are purchasing. These standards have become increasingly numerous and stringent over the years and create enormous obstacles for small producers, and especially developing countries to access international markets.

Public standards tend to be higher in more developed nations and as a response many value chain analyses which consider developing country access to international value chains suggest that high standard markets such as the EU and US be avoided in favour of international markets with less stringent public standards. From the perspective of our study, for small producers public standards exist as a barrier to enter mainstream economy markets and do not exist as an opportunity for product differentiation, but merely are a price of entry into the market.

Private standards, on the other hand, do create opportunities for product differentiation and potentially higher returns for small producers. Standards are privately adopted for two reasons: firstly, to provide consumer protection, consumer knowledge and consumer choice;
and secondly, to protect business interests by creating enforceable barriers to entry and enterprise differentiation. So, for example, when a retailer secures an organic vegetable supplier, that retailer is meeting consumer demand for safely grown veggies, while simultaneously creating a competitive edge over other retailers who are unable to provide organic options to their customers.

Morrisey claims that in 2000, organic produce received up to a 17% premium over non-organic produce. While private standards create opportunities for small producers, these opportunities come with a high cost which may include: investing in new equipment and systems, obtaining certification and developing capabilities such as management systems and production handling systems. Because of these costs and difficulties in meeting private standards, lead firms may be willing to offer embedded services or upgrading services to small producers to meet these hurdles. But, as we will see in the following section, such support will only be forthcoming if lead firms or their suppliers are unable to source reliable inputs which meet these standards in the open market.

These ideas of decommoditising a product and creating a market niche or market segment, the servicing of which can reward small scale producers higher returns than the servicing of commoditised markets only, gains traction on the ground if there is demand for such products. The linking between developing credence goods, branded goods or goods differentiated by standards into higher returns is achieved via the concept of critical success factors.

Critical success factors

Critical success factors (CSFs) are the factors which producers need to ‘supply’ in order to succeed in a given product segment market. These factors are readily grouped into two categories – order qualifying CSFs and order winning CSFs.

Order qualifying CSFs are the price of entry into accessing a given market, i.e. if the producer fails to meet these standards they will be unable to participate in the market. Order winning CSFs are those factors that allow suppliers to not only access a market but to succeed in that market either by gaining market share or by selling at a premium price.

Order qualifying and order winning CSFs will vary according to sector and final demand. If a lead firm is servicing a low income final market then price is likely to be the most important CSF which suppliers will need to meet. This may not be the unique CSF in this market, but it will be very important. On the other hand, if the final market is a high income final market, then those non-price CSFs are likely to be more important. In such a case, CSFs may include product innovation, customisation or quality.

CSFs can only be determined by on the ground research. Internationally the norm for developing such CSFs requires qualitative data collection achieved by asking supplier and buyers to rank the importance of various factors and to then chart these on a radar chart, such as the chart shown below.

Figure 5 was created during the 2000 Industrial Restructuring Project and shows the different requirements for firms wishing to service the upmarket and the downmarket clothing sectors. Delivery and price CSFs were reasonably similar for both markets, but for the low income clothing markets, participating firms were expected to be less flexible, less innovative and provide lower quality outputs than those serving the high income clothing market. The only CSF more onerous for a producer servicing the low income market is
finance, where lead firms required higher proven levels of supplier financial stability than they did for firms servicing higher income markets.

This is insightful as it shows that lead firms knows that producers supplying the low income clothing market are more likely to be financially unstable than those servicing the higher income clothing market due to the reality that returns earned by the former will be lower than the latter.

**Figure 5: CSFs in the South African clothing sector**

Source: UN Handbook on VCA (2001: 58)

A second, very revealing outcome of undertaking such an analysis is that when supplier and buyer requirements are mapped on the same radar graph, one often sees different perspectives on what is actually important in the market place. This was well illustrated in the CSFs in the South African auto-components industry where suppliers and buyers perceptions were tested, as shown in Figure 6.

**Figure 6: Testing suppliers and buyers’ perceptions in the South African auto-components industry**

Source: UN’s Handbook on value chain analysis (2001: 63)
In this graph, we see that suppliers tended to underestimate how demanding their potential customers really are. Suppliers tended to believe that only quality, price, delivery reliability and conformance to standards were important. In fact, lead firms also had high expectations in relation to innovation, ability to develop new products, modifying existing products and financial stability and location.

Finally, radar graphs are also enormously helpful in benchmarking different producers, regardless of whether they are individual firms or entire countries, as seen in the graph in Figure 7 which compares international buyer associations’ perspectives of Brazil and Italy as suppliers of shoes.

**Figure 7: Comparing international buyer associations’ perspectives of Brazil and Italy as shoe suppliers**

![Radar Graph](image)

Source: Based upon Schmitz and Knorringa (1999: 11)

The chart shows clearly that Brazilian footwear producers matched or exceeded their Italian competitors in the areas of price, quality, delivery and flexibility in adjusting to changes in large orders. They performed slightly worse with respect to flexible adjustment for small orders. The one area where Brazilian companies fell behind was in innovation. The Brazilian industry was built up through strong relationships with North American buyers who supplied the Brazilian producers with their own designs. This market came under threat from Chinese producers. Brazilian manufacturers wanted to move into higher-value market segments — typically those in which Italian producers had enjoyed a strong position. The chart shows that the biggest challenge in entering this new market segment would be innovative capacity — the ability to produce new designs. As a result of this type of diagnosis, the association of footwear manufacturers in the main region exporting shoes from Brazil, the Sinos Valley in the south, began to work with local universities and technical institutes to develop courses in design.

**Issues related to market trends and CSFs**

Our market trend and CSF analysis has focused on what possibilities exist for small producers to develop niche products and segmented products so as to earn higher returns and greater shares of economic rents available across a given value chain. They have not, however, dealt with any of the reality-based issues of how small producers can achieve such differentiation or meet such CSFs. It is accepted in the international literature that niche markets based on
product segmentation are the only viable option for consideration in linking small producers to mainstream economy value chains. This is simply due to the fact that niche and specialty differentiated markets require smaller volumes of final product which sits well with small producers’ supply constraints, and it is only in these markets that producer incomes can be raised above poverty levels. However, such markets provide higher returns to small producers because of their higher CSFs and barriers to entry. In addition, the literature also suggests that CSFs are increasingly variable over time, that market saturation is an issue in specialty goods and that the full potential of product differentiation is hard to establish. We now consider each of these issues in turn.

The first issue to consider is how large are differentiated markets and are they growing. Studies by Lewin, Dankers and Liu, looking at differentiated coffees and organic bananas, respectively, show that in absolute size these markets are small but growing rapidly. For example, in 2002, organic bananas accounted for only 2.5% of the total European banana market and 1% of the US banana market, but that these sales had grown in volume by 300% between 1998 and 2002 (Dankers and Liu, 2003: 33). Similarly, Lewin showed that differentiated coffees based on Fairtrade certification only accounted for 1.6% of European coffee sales, but that this small, absolute percentage supported 600,000 producers in 24 countries (Lewin, 2004: 120). Although, in absolute terms, these markets are small, they are growing rapidly suggesting that they are a viable option for consideration. Shepard, writing for the FAO, suggests that the rate of growth in such niche markets must always be borne in mind over time. His contention is that as supply increases in a particular niche market prices decrease, so, for example, while organic vegetable production is at present a small percentage of total vegetable production, the organic products’ prices are high. As more and more farmers gain organic certification, prices will begin to fall. The point here is the fallacy of composition – by increasing supply one is undermining the ability to achieve higher returns. From our study’s perspective, this argument suggests that in looking at optimal product selection for small producers, we must be aware not only of the size of the niche market but the potential for market saturation and declining prices if our interventions are too successful. This is most likely to be avoided by looking at a large range of differentiated products rather than a focus on a few products.

The second issue raised in the literature which has substantial implications for product selection is the variability of CSFs. The UN’s handbook on value chains raises an interesting example in this regard. Looking at the clothing industry, they note a trend in increasing volatility. Whereas, previously, the mass market clothing firms have only two seasons which they serviced (i.e. winter and summer), this has now grown to four seasons (i.e. winter, summer, spring and autumn), and sometimes even eight seasons (i.e. early summer, late summer, etc.) Indeed, a Spanish retailer with more than 1,000 stores in 30 countries has moved to a 52 season year and produces a new range of clothes every week. These increasing standards and CSFs make meeting these barriers to entry a continuously moving target. While the South African local market into which we are attempting to link marginalised players is less dynamic than the overseas markets described above, it nevertheless holds out a challenge that linking into a mainstream economy’s differentiated market is a dynamic process and small producers will need to receive support which is dynamic and able to respond to changing market demand. Once-off upgrading or any type of static support system is unlikely to be successful over time as a strategy.
The third issue relates to the costs of developing a differentiated product, either through branding, standards accreditation or via credence attributes. The issues here are highly complex and Humphrey divides them into three challenges. The first challenge is the cost of building the original claim on which differentiation is based; for example, the route to organic certification is long, arduous and expensive as is the process of fair trade accreditation. Similarly, developing a brand or a locational identity requires time and money. Narrowly based claims provide more benefit for specific actors, but the costs of developing these claims is likewise borne by fewer agents. Economies of scale exist in developing product differentiation thus it is important on our strategy formulation that we consider how to exploit these economies of scale without encountering the pitfalls of market saturation and declining prices. In almost all of the literature reviewed (which refers mainly to externally catalysed linkage programmes), product differentiation costs were borne by third party players, usually NGOs or governmental agencies, and based on largish producer groupings. If we are searching for an internalised catalysing system, as suggested in the previous chapter, then the strategic challenge is to incorporate the funding of differentiation options into the system.

The second issue is that certain organisational support mechanisms are required in the value chain. Goods which are differentiated on the basis of a credence attribute, or branded in terms of a geographic area, or that meet a particular standard, are not always easily identifiable based on inspection. As such, the products subject to special differentiating claims need to be traceable and have their identity secured as they move along a given value chain. They have to be kept separate from products which do not possess their unique characteristics. This places a responsibility on the entire chain to monitor and trace products at every stage and requires buy-in from all chain participants. This means that small producers cannot enter the differentiation market as a unilateral decision but must have the cooperation of all players along the chain. The role of intermediaries may play an important role here.

This cooperation is highlighted in the third issue of bringing a differentiated product to market, namely, marketing and education. Although the claims of differentiated products are created by producers, these claims are effectively sold in final distant markets by lead firms who have immediate access to consumers. This reinforces the idea that while product differentiation is a supply option available to small producers, this supply can only be realised if lead firms create sufficient market demand for the product. Lead firms will prefer to retain governance power in terms of branding and product differentiation so as to ensure their share of rent distribution across the chain; hence, small producers who create differentiated products will need to negotiate with lead firms over the distribution of rents. Lead firm power will almost always trump small producer power but the asymmetries of power contestation over differentiated products will be more in favour of small producers than in the case of non-differentiated products.

What this third issue points out is that product differentiation cannot be undertaken in isolation by small producers because such differentiated products will need the cooperation and coordination of all value chain players along the way. The need for cooperation along the chain will lessen the power of small producers to secure maximum returns for their products, but will ensure higher returns than those achieved via the sale of undifferentiated products. It also highlights the fact that value chains are demand driven and that supply driven initiatives cannot succeed in isolation. The greater a small producer’s resources
available for marketing and product development, the greater the share of returns it is likely
to secure. But as market and product development are costly and time consuming, it is
unfeasible to suggest that such activities are undertaken on an individual basis. Rather, some
economies of scale ought to be sought in terms of developing differentiated products with
some type of group formation or area focus.

This leads us to our fourth and most crucial issue: how does upgrading and product
development occur on the ground and how realistic is it to base our linkage programme on
small producers selling differentiated products. Very crudely, we have set up an argument
where, on the one hand, we have small producers in marginalised areas producing outputs
which, at present, are unlikely to meet the order qualifying or order winning CSFs of lead
firms in external markets. On the other hand, we have identified profitable markets for small
producers which are based on high CSFs because these higher barriers to entry promise
higher returns and a greater share of economic rents generated along a value chain. In other
words, we have maximised the gap between current capacity and required capacity. This is
totally contradictory to the vast majority of current policy which seeks to minimise such gaps
upfront, usually by “picking low hanging fruits.”

The majority of value chain linkage programming is based on addressing this specific issue,
namely, once one has identified the gap between current small producer capacity and the
capacity needed to meet lead firm critical success factors, how does one bridge that gap.
Many of these options were explored in the previous two chapters. In this chapter, we focus
specifically on when buyers are likely to provide upgrading assistance and who, in a given
value chain, is likely to provide such assistance. Understanding these parameters is useful for
our strategic thinking in that it identifies the capacity building gaps that need to be filled by a
governmental scheme.

One of the advantages of value chain linkages is that they offer the prospect of private sector
knowledge transfer, which should be up-to-date and relevant and exists as a core
competency of value chain players. One of the criticisms of state-funded extension services
to small producers is the failure to keep up with the latest market knowledge and the fact
that outside experts are relied upon to provide such knowledge. As such, private sector
transfers are seen as a preferred option. Knowledge transfer from the private sector is not
automatic. As seen in the value chain chapter, firms only undertake the costly exercise of
providing upgrading services and contracts with suppliers in cases where the buyer is
concerned that they will not readily be able to access products of sufficient quality or
sufficient volume in a timeous manner. As such, there are several instances where lead firms
or firms in a given value chain are more likely to provide upgrading services to small
producers.

Firstly, there is a greater likelihood of mainstream economy upgrading of small producers
where there is a scarcity of supply. Scarcity often appears when new consumption trends
emerge or when new barriers to entry arise. In both cases, the suppliers need for knowledge
complements the buyers need for product and hence a fertile environment for upgrading is
created. This trend was evident in the early 1990s in Europe where demand for organic
produce grew quickly, with demand outstripping supply. The response was to create massive
out grower schemes where organic small producers were tied into large retailers. Humphrey
notes that investments in such schemes may only be temporary. As supply increases to be
better balanced with demand, the use of out growers may need to be justified by factors,
such as cost competitiveness, but in the early stages of new product development investments in capacity will be forthcoming purely based on scarcity.

The second scenario in which knowledge transfer is more likely to be undertaken by private sector firms is where alternative sources of supply are restricted. This scenario most often occurs in relation to land-based outputs, particularly in agriculture. If new land available for commercial farming is restricted and demand for goods exceeds the capacity of commercial farmers, then the only alternative source of supply would be output from small producers. Swinnen (2004) claims that this is the reason for the continued success of small family-run farms in Eastern Europe.

A third scenario where lead firms are more likely to provide upgrading services is when alternative supply sources are restricted by transport costs. Traditionally, these costs were measured purely financially but, increasingly, the issue of environmental costing and the idea of product-miles are coming into play. Essentially, if small local producers are able to supply lead firms with inputs to replace more expensive imported inputs, then firms will be more likely to provide upgrading to such small producers. Once again, this is a temporary measure. As soon as enough local suppliers exist, lead firms will be less likely to continue to support such capacity building.

A fourth scenario where upgrading opportunities are more likely to be accessed by small producers is when particular localities provide advantages over competitors. Extreme examples of this exist, such as in non-timber forestry products where items, such as Marula, can only be sourced in highly specific locations. Less extreme examples exist in relation to availability at particular times of year. As year round supply is an important market offering in the 21st century, lead firms and processors will be willing to invest in small producer capacity in certain locations so as meet year round availability of supply.

The fifth scenario where private sector firms are more likely to provide upgrading to small producers is where lead firms or processors trade on their image as socially responsible or specific supporters of small-scale production. The Body Shop is a great example of this. The beauty and cosmetics firm offers substantial upgrading to small producers to supply their brand, which is based on ethical products and trading and on the development of poor communities.

These five scenarios, when placed along side our discussion of product segmentation and CSFs, and within the findings of previous chapters, suggest a set of guiding parameters within which to base product selection.

As will be shown in our framework and, ultimately, our strategic suggestions, we believe that product segmentation and differentiation is a key element in any strategy aimed at relieving poverty. Meeting the higher CSFs associated with niche product markets, and working out how to develop such markets, attain buy-in from the private sector and secure private sector upgrading, contribute to making our linkage programme’s goals all the more difficult.

However, given that the purpose of our endeavour is to use mainstream economy linkages as a means of improving the income generating capacity of small, marginalised producers so that they can lift themselves out of poverty, it would be disingenuous to suggest that simpler linkage programmes, based on traditional commoditised products, would achieve these aims, even if they are easier to implement.
A VALUE CHAIN FRAMEWORK FOR LINKING SMALL, MARGINALISED PRODUCERS TO EXTERNAL MARKETS

Introduction

In this chapter, we present a framework which helps us understand which questions to ask when identifying the real, systemic obstacles that prevent small, marginalised producers from moving away from local markets and towards external markets. By identifying what the real obstacles are in a consistent and rigorous manner, the framework will lead logically to the development of strategic options to remove or minimise these obstacles. The framework is based on the three previous chapters and draws together the findings from the international literature, conceptual theory and case study experience on value chains, product selection and different types of intermediation, linkages and networks. All of the issues are now brought together and their full impact assessed.

This chapter is complex and dense. To assist the reader in following our logic, the chapter is divided into three sections. There is a section dealing with methodology and parameters. In the methodology discussion, we explain why and how we have used value chain analysis in a non-traditional manner and why we believe this approach is justified, even though it is academically counter intuitive and open to criticism. Specifically, we deal with issues of the chosen level of analysis and epistemological issues related to different research approaches.

In the parameters section, we explain (1) who the beneficiaries or clients of the framework are and the limits of the framework in terms of dealing with a highly heterogeneous marginalised economy, (2) the scope of the framework in terms of different economic sectors in the economy that the framework can be applied to and, finally, (3) the scale at which the framework is created with respect to looking at sub-national, national and international value chain access.

The substance of the framework is the content of the next section and deals with the specific lists of systemic obstacles and challenges which will need to be dealt with if we are to succeed in linking the mainstream and marginalised economies in a successful manner. Because the obstacles and issues identified in the framework are simply a summary of the issues raised and explained in detail in previous chapters, this section will simply list the issues and not explain them again. Rather, the focus of this section is to view these obstacles in terms of their systemic characteristics and identify and discuss the implications of the nature of the obstacles for the development of strategic responses.

The final section in this chapter provides a summary of the framework and its strategic implications. It also highlights why and how the strategic agenda emerging from the framework deviates from traditional value chain lineage approaches, and the priority issues which emerge in the South African context. In its conclusion, the chapter lays the groundwork for the following strategy chapter by explaining how no silver bullet exists to deal with the complex issues at hand and that, as a result, multiple strategic options emerge.

Framework methodology and parameters

Methodological approach

In chapters one and two, we explained in detail why value chain theory was an appealing construct upon which to base our framework and strategic thinking. We can summarise the appeal of value chain analysis in relation to four issues. Firstly, value chain analysis
emphasises the issues of governance and power in markets which provides us with important information on the advantages and disadvantages of entering a specific value chain and different realities which will be experienced at different links within a given chain. Importantly, governance and power also direct our attention towards understanding how and why barriers to entry are created by value chain controllers and how these inhibit, but also potentially create, opportunities for small producers. Understanding how and why barriers are created and who ‘controls’ these barriers is crucial if one wishes to breach or harness such barriers.

The second appealing feature of value chain analysis is that it addressed directly how and why economic and other rents are distributed across a chain. By understanding which activities are well rewarded along a chain, and which activities attract poor returns, we are able to develop a feel for which types of activities, undertaken in marginalised areas, are likely to attract a return from a mainstream economy value chain to positively impact on incomes and returns, and which are likely to result in immiserising growth. A point worth restating is that linking small producers to mainstream economy value chains is not a guarantee that the livelihoods of marginalised participants will improve. It is possible to increase linkages between the two economies without improving income generation or returns to small producers. As such, chain, activity and product selection within a given power and governance environment must be considered carefully to ensure that the created linkages do result in improved circumstances for small producers.

The third appealing feature of value chain analysis is that product and/or process upgrading is an intrinsic part of the theory. As we showed in chapter two, firms go to the trouble and expense of implementing governance structures in order to assure themselves of access to the right goods, of the right quality, at the right time. As such, lead firms often see investing in their suppliers as a sound business decision and may either offer embedded services or facilitate the access of suppliers to appropriate upgrading services. The fact that upgrading to meet standards and critical success factors is tied intimately to governance and the exercise of chain power means that at least some of the supply side issues which will need to be dealt with in relation to small, marginalised producers can be dealt with endogenously, i.e.: a successful linkage programme will, by its nature, incorporate some upgrading within the linkage itself, thereby decreasing the need to provide extensive, external supply side support over and above that provided by the mainstream economy linkage partner.

The final appeal of value chain analysis is the fact that it is a demand side approach. For too long, policies, programmes and strategies in South Africa (and the rest of the world) have been supply driven, often resulting in production and productivity improvements in economic activities which do not translate into improved livelihoods, either due to a lack of final demand or low prices/returns earned. By adopting a demand side approach, we improve fundamentally the probability that if a linkage is created successfully, the activities or products of small, marginalised producers will have an effective market in which to sell their outputs and services at a price which will improve their income and return earning potential.

These appealing features make value chain analysis an appropriate construct on which to base our framework and strategic thinking. They essentially offer us a consistent and rigorous methodology by which to isolate and express the crucial questions that will need to be answered in any attempt to link economic players in South Africa at a systemic level.
At this point that our approach deviates from traditional value chain analysis, and it is this deviation which has attracted substantial criticism. Most of the framework criticism relates to the level of analysis we have chosen to undertaken. Traditional value chain analysis is sectorally and often product specific. It also tends to be geographically specific and time sensitive. Traditional value chain methodologies are empirically driven and the identification of specific actors in a chain is central given that linkages are based on very intimate one-to-one relationships. All of these characteristics mitigate against the idea that value chain analysis can be used at a general, non-sectorally, non-geographically specific level. At an academic and strict theoretical level, this criticism is valid; however, our extensive research of completed value chain analyses in different countries, different sectors and different types of beneficiaries suggest that the same, important issues appear repeatedly irrespective of whether the chain analysis is dealing with export diversification in the agricultural sector, increased participation of informal garment workers in the domestic economy, or linkages in the construction sector at a district level. While we agree that if an ‘on the ground’ linkage programme is to be established, it will require a detailed, empirical, specific value chain analysis to be performed, nevertheless, we contend that a multitude of cross-cutting issues exist that allow us to look at generic value chain obstacles that arise consistently in the literature and field work. Our framework is based on the identification of these cross-cutting issues which are not sectorally specific, product specific or locationally specific. These cross-cutting issues provide a list of systemic problems that pervade all types of linkage programmes and while they cannot inform ‘on the ground’ programme roll out, they do provide the optimal level of analysis to consider strategic options available to policymakers who seek to address systemically how to open up external markets for small producers.

To make this point clearer, consider the diagram in Figure 8. Above the horizontal line, we see the theoretical depiction of a value chain. The individual players (A, B, C) are known, easily identifiable and discrete. The players also relate to one other in a linear manner, with all the arrows pointing in one direction. The theory suggests a simple input – output relationship.

Figure 8: Value chain representation

![Figure 8: Value chain representation](source: Kaplinsky and Morris (2001: 52))
Below the line, however, we see a more realistic representation of an actual value chain. In reality, for a given chain, there may be known and unknown chain participants, the same participants may appear more than once in a chain, and relationships are anything but linear or consistent. It is this very complexity which drives the need for traditional value chain analysis to be empirically driven and highly specific.

Because the purpose of this study is to consider systemic issues facing the linkage of mainstream and marginalised players, the space that our framework and strategic thinking needs to occupy is, in reality, the space between these two depictions of value chains. If we simply created a framework based on the theoretical description of value chains (the depiction above the line), our analysis would be so far removed from the messy realities of value chains that any strategic thinking resulting from such a framework would in all likeliness be unhelpful in developing strategies which would work in the real world. On the other hand, if our framework was based on the depiction of value chains as they actually exist ‘on the ground’, we would be forced into specific sectoral and product chain analyses and would not be able to develop any strategic thinking at a systemic or broad economic level.

The method we have used to bridge these two extremes and create a middle ground framework has been a two step process. In the first step, we have gone through the theory of value chains and noted the issues which the approach identifies as important (e.g. the importance of governance, the role of standards, critical success factors, product selection, among others); while in the second step, we worked through hundreds of actual value chain analyses that have been completed for different purposes, using different sectors, different products and different locations.

From these actual analyses, we have slotted the real ‘on the ground’, specific chain issues under the theoretical value chain issues listed in step one. We were amazed at how often the issues from specific chain analyses were exactly the same. For example, looking at the theoretical issue of concentration and power, the theory tells us that we must account for the existence and dominance of lead firms if we are to understand final market demand. In a value chain analysis of the garment industry in Kenya which sought to see how informal garment workers could be linked into the international garment value chain, McCormick (2007) notes that there has been a global increase in the concentration of the garment industry and that there are now fewer large players in the market than 30 years ago. In 2004, Schmitz looked at African horticultural exports and reported that Africa’s exports of fresh produce to the European Union over the past 20 years had decreased by 75%.

This decrease was not due to anything different happening in African horticulture, but was simple the result of increased concentration in the EU that was driven by the demise of small local greengrocers and the rise of large supermarket chains. Similar stories were found in the livestock sector, in the wood furniture sector, and the construction sector (Lowitt, 2008). What this tells us is that irrespective of sector or location, most value chain analyses completed around the world find that increased concentration and increased power of lead firms is a pervasive reality which will impact on the ability of small producers to access these value chains.

These pervasive realities are not highly abstracted theoretical concepts, nor are they sector specific value chain findings, but are the middle ground space within which our framework is based. This middle ground is situated in (1) more specific than abstracted general theoretical concepts, but (2) with a generalisation of actual specific value chain findings. It
provides us with the ideal level of analysis on which to base strategic thinking on how to approach the challenges of linking the South African mainstream and marginalised economies at a systemic level. The approach lacks methodological finesse and theoretical sophistication but it is consistent, transparent and, most importantly, useful.

McCormack and Schmitz highlight the importance of the usefulness of value chain analysis. In their manual, specifically aimed at empowering less sophisticated and less well resourced researchers to undertake value chain analyses, they emphasise that one does not have to undertake a complete value chain analysis because not everything needs to mapped and quantified. Rather, they suggest that what is important is the isolation and articulation of the questions you need answered and to only undertake analysis of those aspects of a chain which are pertinent to answering those questions. Essentially, they are endorsing the fact that value chain analysis is flexible and can be used for a variety of purposes. This is exactly our thinking in terms of our framework. Instead of being flexible and focused in a specific chain, we are being flexible and focused as to how we use value chain analysis at a broad level.

Given that our key questions are: (1) what are the constraints to systemically improving linkages in South Africa, and (2) what are the leverage points for policy and organising initiatives to deal with these constraints, our value chain framework only becomes useful if it operates in a space between the specific and the theoretically abstract. As such, while our approach may raise some academic concerns, nevertheless, it is consistent with the spirit of value chain analysis, particularly when used as a developmental tool.

A final methodological issue to address is the epistemological debate between ‘analysis before action’ and ‘action based analysis.’ This philosophical issue about the theory of knowledge and the nature of knowing has become increasingly contentious in recent years, specifically in relation to undertaking pro-poor value chain analysis in developing countries. Crudely stated, the ‘analysis before action approach’ is based on the assumption that “most, if not all, of the relevant information for a development activity can be gathered before a strategy is formulated and implemented” (Stamer and Waltring 2007: 28)

The ‘action analysis’ approach is based on “the insight that ex – ante research will only to some extent reveal the information that is relevant to solve a given problem or realise a given opportunity” (Stamer and Waltring, 2007: 30). The ‘action research approach’ suggests that the best way to understand the root cause of a problem is to try to solve it, which naturally leads to a close intertwining of action and research.$^8$

This latter approach of intertwining action and research sits well within the scope of this study (in so far as it is part of a larger initiative of interventions and research into issues related to the second economy), as well as sitting well within the substance of this study. Value chain linkages are all about relationships.

To believe that one could make progress without engaging with actual value chain participants would be unreasonable. As soon as one embraces the idea that collaboration is crucial, then to give such collaboration weight one must allow for this action (collaboration) to influence one’s analysis. As such, we believe that the developmental spiral shown in Figure 9 is the most relevant, logical epistemological basis for our framework and strategic discussion.

**Figure 9: Action research approach**

$^8$ See chapter four for full explanation of the two approaches.
Looking at our undertaking in terms of this diagram, the aim of our framework is to provide some of the initial ‘evolution of context’ while our strategic thinking aims to provide an initial ‘animation’ in this process. As the process continues, the spiral will grow larger and more complex as animation leads to structuring, to consolidation and on to another round of the spiral. Our framework and the strategic implications of the framework merely provide a launch pad for ongoing thinking and policy and programme development. The aim of the study is to think outside the box with respect to this launch pad. This outside the box thinking is supported by considering obstacles at a cross-cutting level (rather than the traditional sector specific level) and demand approaches to linkages (rather than traditional supply side approaches.)

**Framework parameters**

Not withstanding the idea of an iterative spiral of development, as suggested above, and the use of action based analysis, any framework needs to be bounded, meaning it must have parameters established which delineate where the framework begins and ends. We will deal with three parameter issues: (1) who in the marginalised economy is the framework going to focus on, (2) at what types of economic activity is the framework directed, and, finally, (3) what level of linkage is the framework intended to bring about.

When considering these parameters, it is important that the reader keep in mind the introductory chapter of this study which describes the purpose of this study and how it fits into a broader range of activities. This study is one of a number considering a variety of issues and responses to the current realities of the second economy. Fortunately, the parameters of the framework are not oppressively burdened by a need to be all things to all people.

The motivating factors behind developing the parameters of this framework were to be as broad as possible so as to meet the research brief of looking at systemic issues and strategic solutions, while providing strategic thinking that could, in principle, be developed into programmes and policies later. Parameters have been chosen that assist in thinking outside the box while stopping short of delivering blue-sky thinking with limited practical application.
Beneficiaries

Any contribution to a marginalised economy framework, strategy, policy or programme must begin with the complex issue of identifying the target beneficiaries. In our case, the question is: “which small, marginalised producers are we seeking to link with mainstream economy value chains?” Just as the mainstream and marginalised economies occupy different ends of a single continuum of economic activity separated by access to land, capital, finance, skills, markets, so, too, is the marginalised economy a continuum. On the one end of the spectrum, we have the destitute with no assets, capital, and access to markets or services; they are those whose principle endeavour is daily survival. On the opposite end of the continuum are poor producers, with some access to markets, capital and assets, who undertake some type of entrepreneurial activity. Where, along this continuum, is it most appropriate to focus the attentions of this study?

Beneficiary targeting is an enormously complex and emotive issue, including normative and positive aspects, as well as political economic issues related to the role of the state. In his paper, ‘Unpacking the Second Economy’, Aliber argues quite convincingly that in South Africa: “there is no adequate disaggregating of who we are trying to help by way of small enterprise activities” (Aliber 2005: 16). The paper raises interesting issues related to survivalist versus opportunity entrepreneurship, as well as issues of why entrepreneurship is undertaken: it is as a main source of income generation, as a supplemental source of income generation, or production for own use, among others. Additionally, much local work focuses on why informal activity is so small in South Africa compared to countries such as India and Brazil (Valodia 2007). These issues are important in our study. Given its limitations, we have chosen not to enter into a detailed discussion of such targeting and the drivers of beneficiary targeting. Rather, we have selected our target beneficiaries based on a simple filtering process that will work across numerous sectors, in different locations and which is dynamically able to accommodate new beneficiaries as they migrate up the marginalised economy continuum. Very crudely, we are targeting potential winners in marginal areas, namely, those producers who are best positioned currently to benefit from a linkage programme.

We have chosen the work of Janvry and Sadoulet (2004) from Latin America; Eiligmann’s (2005) work for the OECD, and a USAID technique used in SME development to guide our definition of our target beneficiaries. The choice of these three inputs was made primarily due to the ‘middle ground’ which they categorise: not too specific and does not reduce our framework into a project-based tool, yet is not too broad as to avoid the issue of identification altogether.

Janvry and Sadoulet’s work took forward Ravaillon’s (2002) idea that it was crucial to address the geographic and sectoral patterns of growth because poverty is often concentrated in specific regions and sectors. Based on empirical research and field studies, Janvry and Sadoulet made a distinction between two types of locations for rural poverty: marginal rural areas (MRAs) and favourable rural areas (FRAs). In their typology, MRAs tend to be geographically isolated, far from markets and employment centres, and characterised by low population density, poor agro-ecological endowments and have no infrastructural endowments. FRAs, on the other hand, are defined as having higher population densities, good agro-ecologies, some access to infrastructure and relatively good proximity to dynamic product and labour markets.
The researchers posited that the poor in these FRA contexts were poor for one of three reasons: either the individuals had low asset endowments, especially land, education and social capital; or individuals had good asset endowments but lacked opportunities to valorise these assets in the territories where they were located; or, finally, that they were the rural youth, elderly or disabled.

Choosing participants who live in favourable rural areas and who are poor because they are unable to valorise their assets in their current territories is an ideal segment of the marginalised economy to focus on with respect to a linkage programme which seeks to shift small, marginalised producers from servicing local markets towards servicing external markets. An additional benefit of using this definition of beneficiaries is that it allows our framework and strategy to potentially grow in time as the poor in FRAs who do gain access to assets via other initiatives could then be included in the linkage programme.

So, from the Janvry and Sadoulet study, we have made our first cut at defining our beneficiaries: they are those participants who live in favourable rural areas. Additionally, we will focus on those in FRAs who presently have assets but who are unable to valorise these assets in their current location.

The second step in narrowing down our target beneficiaries is to consider this group of beneficiaries in terms of their appetite for risk and specialisation. Here we refer to the work of Eiligmann and attempt to take into account the issue raised by Aliber concerning whether entrepreneurial activity is a main revenue source or a supplemental revenue source for potential beneficiaries and also how willing such beneficiaries will be to undertake specialisation.

Eiligmann’s thinking is shown in the triangle contained in Figure 10 and reflects a common segmentation undertaken by the ILO, UN and OECD. The main issue is that micro enterprise development and market linkage programmes can only be used to assist those who are already proximate to markets, have some assets for undertaking economic activity and who are active in some sort of market activity. These people are represented in the top two layers of the triangle and are entrepreneurs just above or below the national poverty line.

**Figure 10: Classification of the poor**

Source: Eiligmann (2005: 8)
Within this top group of entrepreneurs, the willingness of individuals to specialise and commit their resources and assets to a single, specialised purpose is crucial. Enterprise development and linkage programmes can only work if the intended beneficiaries are able and willing to specialise, and if the activities to be undertaken will be the main source of revenue for the small producer. The second filter for selecting beneficiaries will be that potential beneficiaries are prepared to specialise and their production activities will be the main source of their income generating activities. This becomes important for small, marginalised producers’ risk exposure.

Our final filter is far more pragmatic and specifically tailored to a value chain approach. We assume without our beneficiaries group that we are still likely to have different levels of market sophistication. In a USAID paper on ‘Integrating micro and small scale enterprises into productive markets’ (USAID 2005), we found a decision-making triangle used by USAID to allocate resources and which is useful for our parameter determination.

At the bottom of the triangle are the least sophisticated of the beneficiaries in terms of market preparedness. For these beneficiaries, even though they have met the previous filters, they remain weak in terms of networks and diseconomies of scale. Their size is a major obstacle to link them with mainstream economy value chains. For this group, the creation of horizontal linkages is a crucial first step.

**Figure 11: Market sophistication in the marginalised economy**

In the second tier of the triangle, small producers either have sufficient scale individually or already have sufficient horizontal linkages and networks to make them more sophisticated in terms of market readiness for a linkage programme. At the top of the triangle are the most sophisticated small, marginalised producers, namely, those who already have links with the mainstream economy but these could be strengthened with additional upgrading and improved relationships with lead firms.

We have decided that beneficiaries located at all three tiers of this triangle should be included within our framework, but that our focus should reflect the shape of the triangle; the reality is that the majority of our potential beneficiaries will be at the bottom of the market readiness triangle. Having said this, however, tiers two and three offer important opportunities for our thinking and have been included in our strategic deliberations.
**Sectoral parameters**

As mentioned in our methodology discussion, value chain analysis is predicated on the analysis of specific sectors or products. We have, however, discovered that most value chain analyses demonstrate cross-cutting issues which apply across almost every sector, leading us to our middle ground approach which is not sector specific. Given that our framework is not developed at a sectoral level, the question of whether we need to establish sectoral parameters is moot.

However, two issues are worth noting.

The first point relates to the fact that our selection of beneficiaries is based, in part, upon current activity undertaken within the marginalised economy. Local and international literature finds that the poor tend to be involved in certain sectors and not others. It makes sense to focus on these sectors even though this is not a binding parameter within the framework. In the Second Economy Programme Review (President’s Office, 2007), the sectors most commonly engaged in by marginalised, small producers in South Africa are agriculture, agro industries, the textile and garment industry, forestry and wood products, crafts, retail and construction. We have chosen these sectors (bar one, as discussed below) as the parameters of our framework.

Even though our framework is not sector driven, we need to test that the framework’s cross-cutting issues do apply equally to our focus sectors. One sector identified in the Review did not meet these tests: the retail sector. The retail sector has fundamentally different characteristics from the other sectors listed in the Review of Second Economy Programmes in that it involves no transformation and services a final market demand which is highly geographically bounded. Retail, crudely stated, is the end of a value chain and the opportunities to link a small marginalised retailer into a mainstream economy value chain cannot be dealt with in either traditional value chain analysis or our suggested framework. Retail activity is, thus excluded, from our parameters.

**External market parameters**

Traditional value chain analysis is rooted firmly in the idea of linking small producers or developing countries into global value chains. Increasingly, however, international literature is beginning to take into account the potential of value chain analysis aimed at linking producers to domestic markets where excess demand conditions exist and barriers to entry are lower than in export markets.

This study is premised on shifting the trajectory of small, marginalised producers away from local markets towards external markets. Local and external markets are not, in this context, purely based on geography. Local markets are characterised as thin’ in terms of low absolute spending power, highly variable spending power, aspirational purchasing and as limited reach in terms of potential buyers and products which limit volumes, margins and returns. External markets are defined here as any market ‘other than’ the small, marginalised producers’ current local market, in other words, a market which has more participants, higher purchasing power, more stable purchasing patterns, more varied demand patterns and higher volumes. These characteristics, most often found in mainstream economy markets, support the potential for small, marginalised producers to earn higher returns and increase sales volumes.
External markets in practical terms can, therefore, include sales from small, marginalised producers to mainstream economy firms in a nearby town which may be in the retail or craft sector, hospitality industry or any other sector. External markets could also include sales to a provincial contract grower of agricultural products or a provincial agro processor. Moving further away, an external market for a small, marginalised producer could involve sales to a distant urban centre or even sales to a foreign country via export agreements. We believe that all of these options must be included within our framework and that a characteristic driven definition of external markets will be more appropriate for our purposes than a geographic definition of external markets.

However, our framework distinguishes between ‘proximate external markets’, with mainstream economy characteristics, and ‘distant external markets’, with mainstream economy characteristics. This distinction is adopted simply due to the strategic implications of supporting relationships based on a face-to-face relationship versus a long distance, impersonal relationship. So, for example, a small producer selling horticultural outputs to a mainstream economy hotel 50km from where the small producer undertakes his agricultural activity would be a ‘proximate external market’ linkage; whereas a producer selling his output to a national hotel chain 500km away would be a ‘distant external market.’

This approach allows for maximum flexibility given that we are dealing with a broad range of sectors, favourable rural areas and potential beneficiaries. As long as an external market has the potential to offer small, marginalised producers access to a market which will support higher levels of returns, income and employment, then we consider it important that it be included within the framework.

The framework

The purpose of developing this framework is simply to use value chain analysis to identify systemic obstacles which prevent small producers from successfully accessing mainstream economy value chains on terms which will help them valorise their assets and lift them out of poverty. By understanding the origins and complexity of these obstacles which occur consistently across sectors, products, beneficiaries and geographic regions, we are able to direct our thinking in terms of potential solutions. Our framework is simple. Firstly, it identifies cross-cutting systemic obstacles as they appear through value chain analysis. Secondly, it considers the implications for the removal of such obstacles. In this way, we are creating a framework within which to think about, discuss and design potential alleviating actions and interventions. The framework is constructed as a problem identification and resolution tool. It is also intended to be easily accessible while still retaining sufficient consistency and rigour so as to make its outcomes relevant. The framework occupies a middle ground between strict value chain theory and the realities of specific value chains on the ground.

- Besides aiding in the development of a logical approach to strategic formulation and thinking, the framework has additional benefits that have specifically been engineered into the approach, including:

- Flexibility: While the framework is an effective tool for listing problems and potential solutions at a broad generic level suitable for strategic thinking, it is equally useful when applied to a particular sector, location or programme. As such the tool has legs and is dynamic.
• Improvability: The tool is easily upgraded. In the event that further research is found, additional obstacles and potential solutions can be added by simply inserting rows in the appropriate table. This will allow the framework to become increasingly deep and remain current.

• Plug and play: The framework has been designed so that it is consistent with the major ‘how to undertake a value chain analysis’ manuals published by the UN, ILO and main donor agencies. If this study leads to a programme roll out, practitioners will be able to easily integrate seamlessly the real, on-the-ground ‘how to’ activities with the content of the framework.

• Holism: The framework is able to play an enormously useful role when reviewing current initiatives in this field. It can identify gaps, potential misallocations of resources or the supporting activities necessary to maximise the benefits of existing initiatives.

We believe that we have met all the major goals established for us in developing a useful framework which will inform our strategic thinking related to linking small, marginalised producers with mainstream economy value chains. In this study, we use the framework to inform a very ambitious strategic option, namely, systemic change. Yet, the framework could easily be applied to less ambitious strategic goals, such as an individual project or a provincial SME strategy.

Presenting a framework of this complexity in an accessible, usable manner has only been possible by separating out the nuanced detail of the cross-cutting value chain issues and the broad, systemic issues. As such the ‘systemic issues’ raised in the tables below are summaries of the issues. For more detail, the reader will need to return to the relevant foundation chapter. Similarly, the ‘strategic Implications’ are only summary implications which are explained in greater detail in the text below each table, and in the next section.

The strategic framework tables are presented in the same order as the foundation chapters to assist referencing. Numbering is continuous to aid in ease of use and referencing.

Table 4: Systemic issues arising from chapter two’s content on value chains

<table>
<thead>
<tr>
<th>No.</th>
<th>Systemic issue</th>
<th>Strategic implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>The rise of large lead firms as a dominant characteristic of demand in the 21&lt;sup&gt;st&lt;/sup&gt; century.</td>
<td>The nature of first economy demand has changed and not in favour of small producers. Higher barriers to entry for small producers than at any other time in history. Lead firms offer great potential but must consider linkages to non lead firms as well as less systemically hostile to small producers. Need broad approach</td>
</tr>
<tr>
<td>1.1</td>
<td>Large lead firms demand increasingly large volumes from suppliers</td>
<td>Volume requirements imply need for horizontal integration. One-to-one linkages between lead firms and small producer groupings not an option</td>
</tr>
</tbody>
</table>
1.2 Large lead firms tend to shift away from being resellers of other enterprises products and produce their own brands. Brands are used as market differentiators using: innovation, quality and standards. High standards, innovation etc imply need for upgrading small producer output. Degree of upgrading required and how it is provided will be crucial.

2 Concentration at lead firm level has cascaded down value chains to increasing concentration at all points along a value chain.

2.1 Input suppliers are more concentrated and usually now offer one stop shops. Input supplier concentration is advantageous for small producers, can reduce transaction costs.

2.2 Processors, packers, manufacturers etc. are becoming increasingly more concentrated and they are shifting towards contractual relations rather than sourcing inputs on the open market. New opportunity for small producers to link into value chain at this point of entry, rather than lead firm as point of entry.

3 Standards have become increasingly important and apply not only to actual product standards, but also social and environmental standards. On the downside higher standards equate to higher barriers of entry for small producers. On the upside (a) it is in the firms best interests to assist suppliers to meet these standards, (b) standards create opportunities for niche products, and (c) price is longer a key determinant in accessing markets; niche markets are the way to go.

4 Profits and returns are gravitating towards points of concentration along Small producers, even if horizontally integrated, will always face tight margins and continuous margin squeeze.
Profits and returns are gravitating towards logistics, branding, marketing and design activities and away from production inputs.

Appropriate product selection and niche market development will be crucial to capture acceptable returns for small producers.

Lead firms increasingly only want to deal with large competent suppliers.

Current behaviour of lead firms does not provide a supportive environment for small producer linkages. Need to consider if this behaviour could be modified?

Lead firms are increasingly relying on codification and certification to decrease governance costs.

Lead firms are continuously seeking to decrease the number of hand over points in a chain.

Lead firms are increasingly delegating additional activities to lead suppliers.

These six systemic issues show that the intrinsic characteristics of the type and nature of capitalism that has developed in South Africa and around the world in the past 40 years is not highly conducive to the inclusion of small producers. This is not particular to South Africa, nor is it a phenomenon that is sector or product specific – it is the new, 21st century modus operandi of capitalism – and is not a fertile environment for small producer linkages. It must be appreciated that developing linkages between small producers and mainstream economy value chains will always be an uphill battle and need to be exogenously catalysed because the current capitalist system is biased against such linkages. We believe this is an important mindset change which needs to be embraced by South African policymakers.

Asymmetries in power and market access, and the concomitant marginalisation of small producers in South Africa, exist not only as a legacy of apartheid but also are as an expression of the development of capitalism itself. This is a crucial point because it stresses an inherent demand obstacle for small producer output; even if small producers had their supply and infrastructure constraints removed, they would still face difficulties in linking with mainstream economy value chains simply because they are small. When thinking about linkage strategies, we must embrace the reality that any strategy must be driven by a final
demand approach, and not a supply approach, and that meeting supply standards will be a necessary condition, but not a sufficient condition, for winning contracts. We cannot push a value chain, we can only pull it. This will determine the fundamental nature of the strategies we consider.

Having considered what real value chain behaviour on the ground implies for the nature of our strategic approach and the mindset with which we approach linkage strategies, the issues identified in the table also offer more detailed implications for the development of linkage strategies.

While the overall trend of large lead firms dominating final demand provides an infertile environment for small producer linkages, this overriding trend also creates important opportunities for small producers.

The first opportunity arises in the form of lead suppliers shifting away from sourcing inputs in the open market towards contracting to source inputs. This creates an opening to position small producers’ entry points into value chains at the level below that of the lead firm in the final demand market. These entry points will still entail high barriers to entry but, importantly, may be more flexible in terms of required volumes, and may more readily deal with the smaller volumes. Secondly, increasing concentration at the input level creates an opportunity for small producers to source multiple inputs from a single source which may reduce transaction costs and the size of the network necessary to be put in place for small producers to supply output to a given value chain. The final opportunity for small producers is the fact that price is no longer a key determinant in accessing mainstream economy value chains. As diseconomies of scale are an inherent characteristic of small producers and can never be fully compensated for, the opportunity for small producers to compete on variables other than price opens avenues of potential which otherwise would not exist. The fact that the new demand system supports and rewards differentiation means that niche markets are the obvious target market for small producer linkage programmes.

In contrast to these three opportunities, the new, lead firm concentrated-demand structure holds its fair share of challenges for linkage strategy. The two paramount challenges are those of meeting standards, codification and certification, and the unfortunate reality that small scale producers of primary or intermediate inputs will usually attract low shares of economic rents.

The issues of standards, codification and certification imply for that any linkage programme must place the issue of upgrading front and centre; this is the price of admission into mainstream economy value chains. Our framework suggests that we should only consider linking small producers to parties along a value chain who will assist in such upgrading. These mainstream economy value chain players do not need to be the sole suppliers of upgrading knowledge transfer but they must play some active role in this upgrading process.

With respect to the finding that in almost all value chains profits and returns gravitate towards intangible activities, such as logistics, design, marketing and branding, and away from the production of tangible primary and intermediate inputs, we see that securing high returns for small producers will be a consistent uphill battle. It warns us that even if we create successful linkages between small producers and mainstream economy value chains, these linkages do not guarantee higher levels of returns. Any strategy which is considered must have product section and niche market development as its core focus if it is to ensure that linkages result in meaningful poverty reduction.
A final point to be emphasised is to suggest two very broad and different strategic options. Just as the marginalised economy is highly heterogeneous, so, too, is the mainstream economy. The mainstream economy in South Africa is dominated by large, lead firms operating in highly concentrated markets and in the manner described in the framework table above. On the fringes, however, smaller owner manager enterprises continue to exist within the mainstream economy and, due to their lower levels of market power and smaller size, do not tend to exhibit all of the characteristics described in the framework table. These enterprises offer a more fertile environment for small producer linkages. Our strategic options must weigh up carefully the advantages and disadvantages of different external mainstream economy markets. Focusing on the ‘top end’ of the mainstream economy demand market, such as the large retailers (e.g. Truworths, Woolworths), the large processors (e.g. Koo, SAPPi), or the large construction companies (e.g. Murray and Roberts, Group 5), provides the largest scope for change but will be the most difficult to achieve. Focusing on the ‘bottom end’ of the mainstream economy (private game lodges, specialty retailers, and family-owned construction companies) provides smaller scope for change but will be easier to achieve\(^9\). The sophistication or size of the external market segment chosen will, thus, influence the types of strategies required.

In summary, our strategy should:

- Identify which external final market it wants to access. Non-lead firm external markets will be easier to penetrate;
- In large lead firm dominated demand markets, it should strive to link small producers into chains at levels below the final lead firm;
- Linkages should only be formed with value chain parties who will contribute some assistance in small producer upgrading;
- Niche markets should be sought and commodity markets steered away from;
- Product selection will be the crucial determinant in determining the small producers return and any strategy must deal with how product selection support can be packaged.

These framework guidelines are general. Greater specificity is provided in the next two framework tables. Although these guidelines may appear self evident and not particularly useful, they already provide some substantial deviations from existing programmes and strategic documents in South Africa presently.

Table 5: Systemic issues arising from chapter three’s content on linkages

<table>
<thead>
<tr>
<th>No</th>
<th>Systemic issue</th>
<th>Strategic implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Contract based linkages (captive network) provide better returns and greater</td>
<td>Captive market contracts offer enticing advantages to spot market linkages but increase the risk exposure of small producers</td>
</tr>
<tr>
<td></td>
<td>opportunities for upgrading for small producers than spot</td>
<td></td>
</tr>
</tbody>
</table>

\(^9\) This point is not strictly accurate because dealing with large lead firms is organisationally easier than dealing with smaller enterprises, simply due to the fact that large industry is better organised in South Africa. Dealing with small firms would be more resource consuming. These issues are dealt with in detail in the next chapter.
<table>
<thead>
<tr>
<th>Section</th>
<th>Text</th>
<th>Target Beneficiaries Must Be Very Carefully Selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1</td>
<td>Continuous supply is often incompatible with the rural and cultural life of small producers.</td>
<td>A linkage strategy must explicitly deal with small producer transaction paradigm shifts and education of small producers about commercial realities of legal contracts.</td>
</tr>
<tr>
<td>8.2</td>
<td>Small producers and their contractual relations often cannot survive worst case scenarios.</td>
<td>Face-to-face linkages will have a greater chance of success than long distance linkages.</td>
</tr>
<tr>
<td>8.3</td>
<td>Small producers are predisposed to indulge in extra contractual marketing.</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Linkage programmes must address financing. Internal financing is preferable to external financing. Financing individuals is preferable to financing group formations.</td>
<td>Financing arrangements can impact on the need for group formations. Linkage programmes can be structured with limited government funding.</td>
</tr>
<tr>
<td>10</td>
<td>Horizontal aggregation (grouping) of small producer activities is necessary to overcome high transaction costs, but group formations fail more often than they succeed.</td>
<td>Facilitation of group formation activities or equivalents will be a key element of a linkage strategy. A top down, external approach will not work.</td>
</tr>
</tbody>
</table>
10.1 Group formation fails if not commercially driven and competently directed in an appropriate legal structure

Cooperatives may not be an optimal route to follow

10.2 Group formation fails if it is inconsistent with rural social systems and hierarchies

11 Small producers are unlikely to be able to negotiate contracts on favourable terms by themselves

A linkage strategy will need to develop a mechanism to assist small producers in contractual negotiations on scale.

12 Externally catalysed linkage programmes are not scalable.

Either need to endogenise catalysis or accept incremental approach; or combination of the two.

The six cross-cutting issues related to establishing linkages between small, marginalised producers and mainstream economy value chains raise strategic and practical considerations. It leads us on to some real ‘out-of-the-box’ strategic thinking which challenges many of the traditional mainstays of linkage programming.

Issue seven raises a core issue which is often overlooked in strategic thinking, that of risk. The framework identifies that across sectors, products and regions, on-the-ground experiences consistently support a finding that small producers will earn better returns by entering into contractual relationships with a value chain player rather than by selling their output via arm’s length transactions in the spot market. In addition, a small producer involved in such transactions will not benefit from any upgrading or embedded services which often accompany captive network contracts, nor will they benefit from a predictable revenue stream and credit extension that often characterise contractual relations. For small producers in South Africa, access to upgrading, higher returns and predictable revenue streams and credit are all highly desirable outcomes and are the driving force behind this entire study and framework. It seems a no-brainer to report that the framework supports strategic options which are based on developing contractual relationships in preference to spot market linkages.

In reality, this no-brainer is fraught with philosophical dilemmas for strategists and policymakers. Captive network contracts are great when they work; however, contractual non-performance and the risk of specialisation are commercial realities. The framework table identifies contractual non-performance as a particular threat with respect to linkage programmes. The framework identifies small producer behaviours which occur consistently across time, space and sectors such that they must be accepted as systemic. These systemic behaviours undermine successful contracting at a systemic level and, thus, create systemic risk for a linkage strategy. Any linkage strategy needs to establish a view on this systemic
risk. The first possible view would be to accept the commercial realities of the trade-off between risk and return and accept that if a small producer fails to meet their contractual obligations or has a consignment rejected the small producer must accept the consequences. These consequences may simply be the cancellation of the contract, but may be (and usually are) more punitive if, for example, the assets of the small producer have been put up as collateral in a contact where credit is extended to the small producer. In a worst case scenario, a small producer may end up worse off by entering into a contractual relationship and not performing than they would have been by not entering into such a contract in the first place. In most strategies and policies, beneficiaries are protected to the degree that even if a programme fails, the beneficiary will be no worse off than if the programme had not been implemented. This is not the case in captive network contractual relations; small producers enjoy the possibilities of higher returns and upgrading opportunities, but they risk losing everything if they fail to perform. Given that we have identified systemic behaviours that do not support contractual performance as a systemic obstacle for small producers, can we develop a strategy that will be sufficiently successful in addressing and changing these behaviours to mitigate this risk; or are we setting up small producers potentially to fail and be materially worse off by participating in a mainstream economy linkage programme? Humphrey notes that very often “commercial realities sit uncomfortably with social equality” (Humphrey 2005: 37). Given that the purpose of the strategy is to address issues of social inequality, how do we deal with these commercial realities?

As we will see in the next chapter, the implications of this issue for our strategic thinking is not merely the need to operate a substantial education and skills development programme in the attempt to deal with systemic behaviours of small producers that are contrary to good contractual performance, but, importantly, to think about whether a linkage strategy should accept the market realities of contractual non-performance or whether some form of soft landing protection should be afforded to small producers who fail to meet their contractual obligations.

Turning to less conceptual, philosophical issues, the linkage framework table raises a series of highly practical, operational systemic obstacles that will need to be addressed in a linkage strategy. As ever, various strategic options arise.

Issue eight is a cross-cutting issue that value chain linkage programmes are based on intimate, person-to-person relationships and must be founded on trust and symmetrical information. Trust is not easy to establish or maintain, especially when mainstream and marginalised parties are divided by a wide chasm of transactional and business sophistication, culture and, often, language. The implication of this for our strategic thinking is that a linkage strategy in South Africa will be more likely to succeed if linkages occur on a face-to-face basis rather than on an impersonal, long distance basis. Strategically this has two implications. Firstly, we must bring this issue to bear when considering which external markets we identify as target markets. External markets and chains proximate to small producers will be preferable to external markets which are far away from small producers. Secondly, given that external markets proximate to small producers are likely to be small and quickly saturated, and that we do not wish to exclude external markets that are distant from small producers because of the demand they represent, we must consider mainstream economy regional representation in favourable rural areas and middlemen as important intermediaries in a linkage programme. Any intermediation which assists in developing face-to-face relationships will be a worthwhile investment even if it does create additional
handover points in a chain. Traditional linkage programmes, where a mainstream economy
party negotiates a contract with a small producer and then has limited face-to-face
interaction with them thereafter, are unlikely to succeed in our environment.

A final systemic contracting issue is that small, marginalised producers are unlikely to be able
to negotiate successfully contracts on favourable terms by themselves. Given the risks raised
above, the importance of resolving this obstacle is a key to any linkage strategy programme.
Dealing with this systemic obstacle can only be achieved in two ways. Either a strategy must
be developed to protect the rights of small producers at a system level via rules, regulations
or possibly legislation. The alternative would be to develop a direct support service to small
producers whereby they could access legal advice and negotiation assistance. Strategically,
this access to negotiating services could be run as a discrete service offered by the
government or it could be a programme developed by the government in conjunction with
the private sector whereby existing private sector negotiating and legal services are made
accessible to small producers. Whatever the practical decision is to tackle this issue, the
point which is necessary to emphasise is that a linkage programme must explicitly take into
account and plan for the reality that small producers will be unable to negotiate contracts on
favourable terms by themselves and that a failure to provide relevant assistance in these
matters will fundamentally increase the risk exposure of small producers.

Issue nine deals with systemic issues related to the financing of linkage programmes and
signals that the nature of financing relations will be paramount in determining the
contracting relationship, the risk exposure of the small producer and the ability of the small
producer to meet final demand standards. Essentially, the systemic issue is that financing
arrangements external to a specific linkage contract are less likely to succeed than financing
arrangements which are an integral part of the terms of the contract. If the contracting
mainstream economy party in a linkage arrangement makes funding available to the small
producer they are contracting with on a drawdown, offset basis, then this arrangement is
more likely to succeed than if funding is made available to the small producer by a external,
third party. Moreover, if this financial assistance takes the form of a drawdown of inputs and
services rather than credit *per se*, then these relations alter fundamentally the need to
create group formations. This is a radical departure from traditional linkage programme
thinking and is explored in detail in issue 10.

Group formation has always been a central issue in any linkage programme between small
producers and mainstream economy value chains. This is due to the reality that small
producers, because of their size, face diseconomies of scale and high transaction costs which
can be ameliorated by some type of horizontal integration providing them greater
purchasing power, when sourcing inputs and services, and greater market access when
seeking to sell to the mainstream economy with its larger volume requirements. Group
formation is often the starting point and delivery vehicle through which government linkage
programmes are designed and structured. This is surprising because experience shows that
group formations invariably fail across different countries and sectors. Issue 10 in the table
suggests that while group formation can be advantageous, externally imposed or top-down
group formation programmes or, for that matter, linkage programmes which are designed
around group formations as delivery vehicles for policy, are doomed to fail.

Systemically, we see that group formations are enormously difficult entities to develop and
run successfully and are only successful if they are commercially driven, appropriately
structured, skilfully managed and consistent with the goals and expectations of the individual
members and the broader community. If we know that group formations suffer from systemic weaknesses, especially when embarked upon by unskilled, unsophisticated market actors, then strategically we have to ask ourselves whether such small producer aggregation formations are a necessary component of a strategy or whether alternatives exist. The strategic implication from the framework appears to be that if a linkage programme can be created which eliminates the need for small producer groupings to be formed, then the linkage programme will have a better chance of success.

The diagram in Figure 12 illustrates two different paths that may be considered: where aggregation is driven by small, marginalised producers and where aggregation services are driven by the mainstream economy value chain players. We accept that aggregation is a requirement. What is not accepted is that the driver of aggregation activities must be small producers. Due to the systemic weaknesses of small producer groupings, they are not viewed as the optimal level at which aggregation activities should be considered. Rather, mainstream economy value chain actors are the preferred drivers of aggregation activities given that they do not suffer the same systemic weaknesses as small, marginalised producers. Strategically, this implies that resources which would have been assigned to small producers to develop and run group formations, such as cooperatives, should be diverted to assisting mainstream economy value chain players to offer aggregation services. Although this appears to be a major departure from traditional linkage strategy, in reality, it is the approach which is most often rolled out on the ground and numerous successful examples of such systems exist in South Africa (see SAPPI and TSC examples in chapter three).

**Figure 12: Aggregation options**

![Aggregation Options Diagram](source: own design)

This approach deals with the systemic obstacles of group formation and sits comfortably with the financing options raised by the framework in issue nine. The strategic significance of this and, hence, the major departure point in our thinking, is that the main beneficiaries or target audience of a linkage programme are mainstream economy players, not small,
marginalised players. In other words, we must consider a linkage programme designed to assist established value chain operators to transact with marginalised producers, emphasising the role of developed players to pull small producers up into a chain, rather than focusing on how we push small producers into an existing chain. This is a fundamental mindset change and shift in perspective.

This view has received vociferous criticism.

The criticism arises from case studies where networks of producers, such as those in the dairy industry in India, have been remarkably successful. In these cases, small producers retain full control of their own businesses and production and agglomerate only in terms of accessing market and product channels, similar to the old agricultural marketing cooperatives of South Africa.

This study does not suggest that such networks and agglomeration is not enormously advantageous, merely that such networks come into play later in the development cycle than that which we are contemplating.

Essentially, the first order priority is to improve small producer production in terms of quality and meeting critical success factors and that this is best achieved by aggregation services being offered by lead firms and their suppliers. Once such enterprises are established and meeting such standards, then, and only then, will small producers be in a position to create group formations to enhance their market power and improve their opportunities. At the point where small producer enterprises have developed to the point where such cooperative behaviour is feasible and likely to succeed, then a role exists for third parties to support such initiatives.

A substantial volume of literature exists regarding the nature of this support (see Fields, 2002 and USAID JOBS Programme, 2003) but is not covered in this study as it covers issues which occur in the second or third phase of a sustained, strategic linkage programme.

This leads us to, possibly, the most important issue in the entire framework: issue 12 or the issue that externally catalysed linkage programmes are not scalable. Issue 12 must be considered in conjunction with issue six (which states that lead firms wish to deal with large competent suppliers). Issue 12 tells us that worldwide experience shows that externally catalysed linkage programmes are not scalable or replicable, nor do economies of scale exist when rolling out multiple linkage programmes.

The important descriptor here is ‘externally’ catalysed, meaning a linkage programme driven by a third party that is not a small producer and not a mainstream economy value chain participant. Third parties are usually government, a governmental agency, a multi-national or a donor agency. Strategically, this is a nail in the coffin for our study given that our terms of reference required a non-project, scalable, systemic approach to linkages. The only strategic option to deal with the creation of a large scale linkage programme in South Africa is to shift our mindset away from thinking about externally catalysed options and to embrace the idea of internalising this catalysation process. Strategically, this implies that we are seeking an intervention which will make mainstream economy value chain actors and small producers want to develop relations with each other. We can assume that small, marginalised producers will be willing partners in this arrangement, but we can also take as given that mainstream economy value chain participants will not be willing partners in developing such relations due to issue six.
The strategic hurdle is, thus, how to influence the demand behaviour of mainstream economy value chain players so that they want to increase their transaction with small, marginalised producers. Ideas related to this strategic implication are dealt with in detail in the next strategy chapter and are the cornerstone of the strategic recommendations of this study.

In the event that the idea of internalising catalytic behaviour is viewed as too radical or impractical, issue 12 leaves us with adopting an incremental approach to developing wide scale linkage programmes across South Africa on the basis that few economies of scale will exist. These strategic options make up the second section of the next chapter and show that while opportunities for scalability and replicability are limited, process methodologies and support institutions are available options to support an incremental approach in an optimising manner.

In summary, this second framework table suggests that when considering strategic options for linking small producers to mainstream economy value chains, our strategy should:

- Strive to develop market access via captive market contracting rather than via spot markets;
- Develop a view on how much risk we are willing to accept for small producer participants in a linkage programme;
- Seek to develop linkages based on face-to-face relationships rather than distant relationship, thus, highlighting the need to develop intermediaries;
- Explicitly take into account the need for education regarding contracting and provide negotiating services to small producers;
- Seek to develop linkages where financing is provided by mainstream economy linkage partners, rather than by external financing sources;
- Move away from the idea of group formation at the producer level and consider aggregating activities driven by mainstream economy chain participants;
- Move away from thinking about externally catalysed linkage programmes and shift towards changing the buying behaviour of mainstream economy lead firms and their suppliers.

These strategic guidelines will challenge even the most open-minded policymakers. The framework suggests a fundamental shift away from traditional linkage programme thinking. Essentially, this framework argues that the key focus of a linkage programme is the mainstream economy actors in value chains and not the perceived primary beneficiaries (the small producers). This shift is due to the fact that we are seeking systemic change and not merely a massive initiative based approach to establishing linkages in various geographic regions and across five different sectors. By seeking systemic change, we are forced to focus on demand behaviour in the mainstream economy and to identify ways to change this behaviour and support such behaviour.

The mainstream economy becomes our primary target audience and our strategic thinking must focus on how to create and support mainstream economy behaviours which create systemic opportunities for marginalised producer participation in these markets. Essentially, we are looking at creating an enabling environment across the whole economy which supports increased participation of small producers in external markets.
Table 6: Systemic issues arising from chapter four’s content on product selection

<table>
<thead>
<tr>
<th>No</th>
<th>Systemic issue</th>
<th>Strategic implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>Traditional commodity products face decreasing terms of trade and lead to immiserising growth Most small producers produce traditional commodities</td>
<td>Need to decommoditise commodity products or need to shift small producers away from commodity production towards niche market production.</td>
</tr>
<tr>
<td>14</td>
<td>The lower the level of critical success factors necessary to win a contract the lower the income share distributed to producers</td>
<td>Need to ensure upgrading is integral to linkages or else linkage will not result in poverty reducing income distribution.</td>
</tr>
<tr>
<td>15</td>
<td>Product segmentation is crucial</td>
<td>Need to consider avenues for differentiation so as to develop niche markets</td>
</tr>
<tr>
<td>15.1</td>
<td>Small producers are ill equipped to undertake strategic product segmentation</td>
<td>Need to develop a system to support small producers’ segmentation decisions.</td>
</tr>
</tbody>
</table>

Our final framework table, based on our foundation chapters, deals with product selection and the three, seemingly simplistic, systemic issues contained in the table must be emphasised. Suspend reality for a moment and assume that we have designed and rolled out a systemic linkage programme whereby we are able to link small producers to mainstream economy external markets on a consistent and sustainable basis using captive market contracting, and which includes upgrading services, aggregation services and financing. In addition, we have resolved all issues related to contractual non-performance. In this idealised scenario, would the increase in sustainable transactions between the mainstream and marginalised economy constitute success?

On the surface, perhaps this would constitute success, but given that the basis for the initial intervention was to shift small, marginalised producers from supplying local markets to supplying external markets (as a means of increasing the returns and incomes and job creation potential), then success would only have been achieved if the linkages result in increased incomes and returns for small producers. The ability of a successful linkage to deliver increased incomes and returns to small producers depends on the product selected. Appropriate product selection and segmentation is crucial to developing linkages that deliver small producers an escape from poverty rather than the opportunities to increase outputs and transactions which may fail to improve small producers’ circumstances.
Before we enter into a detailed discussion on product selection it is necessary to qualify our discussion. Earlier, we segmented the external market into the top end of the market (involving large lead firms in remote markets) and the bottom end of the market (involving small owner/managed enterprises in closer proximity to small producers). The issues of product segmentation pertain mainly to linkages with the former, as we assume that smaller, bottom end market linkages will be product self selecting. Having said this, the same principles do apply to product differentiation and returns to producers even when servicing proximate mainstream economy external markets which are not dominated by lead firms.

A second qualification is that even though our framework endorses strongly the idea of moving small producers into niche markets and away from traditional commoditised markets, the reality is that this will not always be viable; hence, a dual approach to product segmentation will need to be adopted.

Issue 13 reveals that across primary and secondary production sectors, the outputs that have become commoditised face decreasing terms of trade. If small producers specialise in the production of these types of goods, and then sell their output to the external domestic market, this increase in supply will drive prices down and small producers’ returns and incomes will fall as the race towards the bottom results in immiserising growth. This implies that a successful linkage programme based on commodity outputs will result in small producers being worse off than they were prior to a successful linkage programme. The strategic implication of this is that we must steer away from commodity products and shift towards niche markets, or must allocate resources to decommoditise commodity products wherever possible.

This argument leads us to issues 15 and 15.1 which show that across sectors and regions the need to develop niche markets based on product differentiation is crucial but, unfortunately, not a task easily undertaken by small producers. Systemically, small producers do not have sufficient market intelligence, final market demand understanding or access to resources to develop markets to allow them to distinguish between various niche market options. The implications for our strategy, therefore, is that we must incorporate options available to policymakers to support the activities necessary to segment a market in such a way that final demand is sufficient to earn small producers an income and return that is sufficiently able to lift them out of poverty. Systems which identify and develop credence goods, branded goods, novel or new products, trademarked goods and other market differentiators need to be put in place so as to ameliorate the asymmetries of power and, hence, income distribution in value chains, as was highlighted in issue five.

Key to thinking through the implications of this issue is whether such a system should be internalised within the system (i.e. part of the linkage between the first and small, marginalised producers and sellers) or external to the linkage relationship. Placing a system outside of a linkage relationship provides a key lever in the hands of policymakers to address the fundamental asymmetry of power between lead firms and their suppliers and to counter the issues raised in issue four. This is not as radical an idea as it may first appear and sits comfortably with the thinking which drove the creation of the National System of Innovation, for example. It is, however, a major departure from current thinking, particularly in the crafts, forestry, wood products, agriculture, agro-processing and textiles sectors, where traditional commoditised products are often the main focus of small business development initiatives and poverty reduction programmes.
One of the implications of is that small producers often face competition in these sectors from commercial large scale producers, making market entry increasingly difficult. The idea of specialisation and niche market development for small producers, as an alternative approach, not only addresses the systemic issues of power and profits gravitating towards lead firm activities, but it also impacts on the competition small producers will face in the market place.

The issue of competition leads to issue 14 which reveals that, systemically, small producers will earn higher returns and shares of distributable income along a value chain with higher critical success factors for them to win a contract. These critical success factors which are determined by lead firms and lead suppliers and are barriers to entry; hence, the higher the barrier to entry, the higher the returns for a small producer who manages to access the chain. Strategically, this raises an important question: which critical success factors are small producers most likely to be able to deal with and which of these success factors are most likely to reward small producers with higher income levels? Traditionally, strategic thinking in this area tends to begin by asking the question: how can small producers meet these critical success factors and gain entry into markets where barriers to entry exist?

Thinking outside of the box, we should consider how we can create barriers to entry for small producers so as to assist them in earning higher returns and protecting those returns over time.

Simply, which critical success factors are we most likely to be able assist small producers to meet systemically? We know from issue 8.1 that continuous supply, reliable supply and flexibility will always be difficult critical success factors for small producers to compete on simply because of their size and the environment within which production occurs. Price is no longer a key determinant in accessing markets, especially non-commodity markets. We also know from issues three and five that product innovation and meeting standards will attract increased returns and that the challenges facing small and large producers to meet these critical success factors are essentially the same. This suggests to us that of all the critical success factors necessary to win a linkage contract, the factor which a strategic intervention would be best be able to assist with, and which would provide the greatest impact in terms of returns to small, marginalised producers, is assistance with product innovation, design and standards compliance.

Most linkage programmes focus on providing small producers with assistance in securing supply, increasing output volumes and increasing efficiencies to decrease production costs. While all of these traditional approaches will improve market access, they do not address the paramount issue of the distribution of income across a chain and the returns to small producers of primary or intermediate outputs, nor do they address issues of returns over time and the ability of small producers to protect their returns in the face of competition.

Given issue 15.1, which suggests that small producers will not systemically undertake appropriate product segmentation themselves and some assistance will be required in this area, it make sense to take this assistance a step further and provide segmentation assistance for meeting critical success factors established by lead firms and as the foundation of an entire linkage strategy approach which seeks to partner small, marginalised producers with mainstream economy value chains and ameliorate the asymmetries of power between lead firms and small producers.
As discussed in the next chapter, the strategic implications of the cross-cutting product identification issues identified in this section open up a new way of thinking about the essential nature of linkages. Appropriate product segmentation and the allocation of resources towards developing barriers of entry for small producers, via product design and innovation, opens the door to small, marginalised producers entering external markets with confidence. This approach can only succeed if final demand for these specialised products exists or can be created. Essentially, this approach is reminiscent of a gap analysis and infant industry approach to small business development.

In summary, the third framework table suggests that when considering strategic options related to linking small producers to mainstream economy value chains our strategy should:

- Move away from thinking about linkages which are based on the production of commoditised traditional products;
- Embrace the idea of small producers producing for niche external markets;
- Consider the idea of allocating resources towards product standards, design and innovation so as to create barriers to entry for small producers and ameliorating the asymmetry of power and profits enjoyed by lead firms in a given value chain.

**Summary and conclusion**

Our three framework tables have raised 15 cross-cutting issues related to various aspects of value chain linkage programmes. These issues are termed systemic issues because they occur consistently across geographic locations, sectors, products and beneficiaries, and have their origins in the nature of the mainstream economy’s capitalist market system’s current modus operandi and the realities of production and production systems in the marginalised economy.

These 15 cross-cutting issues raise a substantial list of strategic implications for the development of a strategy aimed at lifting small marginalised producers out of poverty by linking them to mainstream economy value chains in external markets.

In thinking about the implications of the identified issues for a South African strategy, we have been afforded the opportunity, by the terms of reference of the study, to think outside of the box. Caution, though, is necessary.

On the one hand, ‘new takes’ on traditional approaches can open the door for innovative or new approaches with potentially advantageous outcomes, but, on the other hand, unless this ‘new thinking’ is tempered with realism, new approaches may remain in the realm of intellectual indulgence with no impact on issues on the ground. Although this study seeks to influence overall strategic thinking needed to deal with the highly complex issue of linkages, and is not burdened with the need to translate such strategic thinking to programmatic design which can be rolled out on the ground, we have, nevertheless, paid particular attention to the practicality of the strategic implications from the framework.

As will be shown in the next chapter, all of the derived strategic implications can be developed into implementable programmes and various options for such programme design are discussed in detail.

In summarising this chapter and creating a link between it and the next chapter, where we unpack some of our strategic thinking, the tables below show: (1) points of departure between traditional approaches to linkage programmes and approaches supported by this
The study’s framework, and (2) specific strategy ideas that will need to be addressed in a linkage programme.

**Table 7: Traditional versus novel approaches to linkages**

<table>
<thead>
<tr>
<th>Traditional approach</th>
<th>Our framework approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector specific, geographically specific</td>
<td>Generic across sectors and regions</td>
</tr>
<tr>
<td>Beneficiaries occupy the ‘top end’ of the marginalised economy participant triangle</td>
<td>Beneficiaries occupy the ‘top end’ of the marginalised economy participant triangle</td>
</tr>
<tr>
<td>Focus on captive network contracting</td>
<td>Focus on captive network contracting</td>
</tr>
<tr>
<td>Link small producers to lead firms in distant markets</td>
<td>Link small producers to proximate markets and in the second instance to lead firm suppliers further down the value chain</td>
</tr>
<tr>
<td>Develop educational and skills programmes to support understanding and consequences of contracting at a distance</td>
<td>Develop educational and skills programmes to support understanding and consequences of contracting at a distance. But seek to reduce distance by establishing intermediaries to support higher levels of face to face interaction.</td>
</tr>
<tr>
<td>Focus on internal upgrading as part of linkage</td>
<td>Focus on internal upgrading as part of linkage</td>
</tr>
<tr>
<td>Strive for internal financing</td>
<td>Strive for internal financing</td>
</tr>
<tr>
<td>Aggregation activities based on group formation at small producer level</td>
<td>Aggregation activities delivered by mainstream economy value chain players</td>
</tr>
<tr>
<td>Programmes based on externally catalysed projects</td>
<td>Programme based on internalised behavioral changes at a systemic level, not a project level</td>
</tr>
<tr>
<td>Substantial direct third party involvement</td>
<td>Seek to minimise direct third party involvement</td>
</tr>
<tr>
<td>Product selection usually does not take into account distribution of income across a chain</td>
<td>Product selection driven by income distribution across a chain</td>
</tr>
</tbody>
</table>

Source: own design
Table 8: Strategic issues which need to be considered for developing implementable programming

Strategic issues

How will we deal with the commercial risk of non contractual performance?

How can we support the delivery of educational and skills development to increase market sophistication of small producers?

How can we support the delivery of contractual negotiating support?

How can we entice the mainstream economy to change their purchasing behaviour?

How can we provide product selection, product differentiation and market development services?

How can we support the creation of intermediaries?

How can we facilitate mainstream economy value chain actors to provide financing, upgrading and aggregation services to small, marginalised producers?

Source: own design

From Tables 7 and 8, we can see where this study’s approach deviates from traditional approaches of value chain linkages and how it attempts to develop a value chain linkage strategy at an economic level, something which is not readily embraced by existing theories and practices. By structuring the framework at (1) a generic level rather than a sector specific or location specific basis, and by seeking (2) systemic solutions, not project based solutions, we find ourselves in uncharted territory.

The key to unlocking the potential of this uncharted territory lies entirely in changing mainstream economy purchasing behaviour. Whereas traditional value chain analysis takes this behaviour as given, in our framework, the idea of being able to change this behaviour is vital. Much of the next chapter is devoted to unpacking the issue of exactly how mainstream economy value chain buying behaviour could be changed and what the role government would need to play to facilitate and support this change.

The remainder of the strategy chapter is devoted to other strategic options based upon the traditional assumption that mainstream economy buying behaviour is taken as given.

A final point to be noted is that our framework deviates from traditional approaches and fails to highlight certain issues which are viewed as important in traditional linkage programming. For example, in our framework, issues of transaction costs do not feature significantly, neither do issues of access to infrastructure.

These ‘gaps’ arise because of the level of analysis we use and the movement away from project-based strategies towards systemic level change. Essentially, this shifts some ‘first order priority’ issues to second and third order priority ones. We do not suggest that such issues are unimportant, rather, that in a system wide approach to linkages, the prioritisation of issues which require resolution will be different from issues identified in narrower, project-based approaches.
STRATEGIC THINKING

Introduction

Chapters two to five have lead us to our penultimate chapter where we unpack the options available to policymakers in the arena of value chain linkages. It is useful to restate the terms of reference of the study before embarking on our strategic discussion. The purpose of the study was to:

- Bring fresh thinking and new ideas to the table regarding possible strategies to reduce poverty within the marginalised economy;
- Focus on systemic obstacles which impede small producers from successfully linking with mainstream economy value chains in the external market; and
- Approach the problem from a systemic level and not to focus on specific sectors, geographic areas or discrete projects.

Our three foundation chapters led to the creation of three framework tables containing cross-cutting issues which appear consistently across sectors and geographic areas as obstacles in linking mainstream and marginalised players. These framework tables led to a series of strategic implications and suggested the prioritisation of certain aspect of value chain linkage programmes.

In this final chapter, we delve deeper into the strategic issues identified in the previous chapter and investigate how such strategies could, in principle, be achieved on the ground and what the roles of the private and public sectors could be. Our framework and the conclusions point strongly in one direction: strategies based on changing mainstream economy buying behaviour which can lead to systemic change. We believe that such systemic change is possible to achieve. However, in the event that there is insufficient political and economic commitment to achieving such a systemic change, we thought it best to offer an alternative strategic option, too. In this second option, we take current mainstream economy buying behaviour as given and look at non-systemic but scalable options based on the idea that incremental change can be achieved. These two broad strategy options are shown in the diagram in Figure 13 and serve as a map to this chapter.

It is important for the reader to remember that the framework in chapter five has the ability to lead to an infinite number of suggested strategies created at any level of analysis. The two suggested strategies explained in this chapter are merely two possible examples. Furthermore, the two suggested strategies are framed in terms of generating systemic change. Strategies with more modest intentions would be easier to construct and would look more ‘traditional’ than those suggested in the remainder of this chapter.

Figure 13: Strategic options
Strategies for achieving systemic change

In terms of our framework, a strategy premised on altering fundamentally the purchasing behaviour of mainstream economy value chain players in favour of small producers is the best prize. If large lead firms actively wanted to source products from small producers, this would not only increase the demand for small producer outputs but would create competition between lead firms to source small producers’ outputs, thereby creating opportunities for small, marginalised producers to improve their income generating capacity, employment creation capacity and returns on investment. As seen in previous chapters, the first order, fundamental obstacle in developing linkages between companies in the core economy and those on the margins is that, currently, lead firms increasingly only want to deal with large, competent suppliers. This creates a system wide infertile environment within which to insert small producers into mainstream economy external markets. Only by changing this fundamental behaviour at a systemic level can we create a fertile environment for a broad-based mainstream to marginalised linkage strategy. The idea of changing fundamentally the economic behaviour of mainstream economy players in South Africa is nothing new. Rather, it is the cornerstone of most economic policies, undertaken since 1994, to redress the imbalances created under the apartheid regime. Preferential state procurement legislation, industry charters, Black Economic Empowerment (or BEE) scorecards are all instruments which exist to support previously disadvantaged individuals and enterprises to gain access to mainstream economic assets and activities. Our strategy suggestions lie firmly within this approach.

If the goal of our strategy is to change mainstream economy value chain buying behaviour in such a way that lead firms want to purchase products from small producers, then we have to answer three basic questions. Firstly, and most importantly, we need to determine how we can elicit or induce the desired change in purchasing behaviour. Secondly, what role should the state play in facilitating this shift in behaviour? And, thirdly, what other steps could be taken to support a change in purchasing behaviour?

Before answering these questions we need to first discuss exactly whose behaviour in the mainstream economy we seek to change. Obviously, if all lead firms in all sectors of the economy were to alter their buying patterns, then this would have the largest impact on the
scope of opportunities for linkage programmes. It is, however, more practical to consider a phased-in approach where priority lead firms are identified. If such a suggested strategy works with the priority sectors, the process could be repeated with a larger number of participating lead firms.

In identifying priority lead firms or market segments, we are dealing with final demand market participants (due to the fact that our value chain analysis identifies the reality that chains are demand pulled and not supply pushed). The idea is that by changing the buying behaviour of final demand servicing lead firms one would be able to elicit change along an entire chain, inclusive of all input suppliers, processors, wholesalers, producers, manufacturers and value adding entities. In other words, to shift an entire chain onto a different operational path, the point of leverage must be the final demand servicing lead firms.

Given that the 15 Year Review of Second Economy Programmes identified the construction, crafts, agriculture, agro-processing, wood and wood products, textiles and garments industries as the dominant sectors in which small producers participate, it makes sense for our strategy to focus on these economic sectors. For all but the construction sector, the lead final demand servicing firms in these sectors are predominantly retail sector firms. Therefore, our strategy focus with respect to changing buying behaviour is focused on the retail sector. This focus makes sense in terms of sectoral composition of small producer economic activity and the size of the South African retail sector, its geographic reach and the failure of existing BEE and preferential procurement interventions to impact its behaviour.

**Inducing a change in value chain purchasing behaviour within the developed economy**

Inducing change in demand behaviour can be approached using either a carrot or a stick. Essentially, three options exist to change the behaviour of profit maximising firms in a capitalist orientated economy. Firstly, one could try moral suasion, an economic concept premised on the government asking the private sector to undertake a particular behaviour based on the national interest. Moral suasion tends to be most effective when applied to a well defined, short lived economic crisis, such as when the Mayor’s Office in New York asked the property sector to avoid increasing commercial property rentals immediately after the 9/11 bombing of the World Trade Centre. The South African government and organised business for a have, over the past 15 years, firmly placed on the domestic public agenda the need for the private sector to change its modus operandi in terms of addressing the economic imbalances which arose during the apartheid era. Some progress has been made as mainstream economy players appreciate the need to address poverty, market access and other issues of transformation but, most often, this call is answered in terms of discrete corporate social investment programmes and equivalent initiatives, rather than through systemic change at a broad level. Our view is that moral suasion is insufficient to create the type of change in buying behaviour that we are seeking.

The second option available to government to change purchasing behaviour in the retail sector would be to enact legislation which forces lead firms in the sector to operate in a particular manner; in this case, forcing firms to source inputs from small producers. Compelling a private sector enterprise with mobile capital to act in a particular manner is a dangerous path to pursue, simply because if a firm finds such legislation to be too onerous or unacceptable to its shareholders, it will simply disinvest and remove itself from the
economy. Aware of this danger, the government has enacted legislation to attempt to alter private sector behaviour, but in a weak form, via the *Broad-based BEE Act of 2003*. The *Broad-based BEE Act* is seen as “enabling rather than prescriptive” legislation (ANC, 2008) and provides for the establishment of the BEE Advisory Council, the publishing of codes of practice, the BEE scorecard and the gazetting of transformation charters.

The *Act* seeks to assist firms to develop, monitor and report on empowerment activities in three areas: (1) direct empowerment related to ownership and control, (2) human resource development, and (3) indirect empowerment via procurement, enterprise development and corporate social investment. Of greatest interest to this study are the scorecard issues related to preferential procurement and enterprise development (codes 500 and 600) which will be discussed in detail below. To date, sectoral charters have been gazetted in the mining, financial services and liquid fuels sectors, with negotiations underway in the transport, construction, Information and Communications Technology (or ICT), tourism and a host of other sectors.

Debate regarding the success of the *Broad-based BEE Act* and the success of the conclusion of three sectoral charters has been vociferous. On the one hand, government, business and the African National Congress (or ANC) all suggest that broad-based BEE is a long term initiative with a steep learning curve and that we are only at the beginning of a process with numerous lessons to be learned which will deepen and improve the implementation of the legislation over time. Other critics believe that the *Act* is a “clear divergence, if not contradiction, of the Freedom Charter and relates to the cooption of the few to a project of deracialised capitalism” (SACP, 2008).

This view is driven largely by the fact that most *BEE Act* progress has been achieved with respect to direct empowerment via ownership and control, with less progress being reported on indirect empowerment which has the ability to impact the lives of many. The final group of critics believe that business has not bought into BEE or its role in transforming the economy, and pursue BEE initiatives “half heartedly and don’t appreciate its real value beyond short terms gains of compliance” (ANC, 2008).

The third option available to government would be to incentivise this change in behaviour. Incentivisation is based on the premise that one can motivate a change in behaviour by offering an appealing reward for the desired action. In this case, we would be looking at motivating the retail sector to change its procurement behaviour in favour of small producers. If they did so, they would receive a reward of some kind.

The power of Incentivisation in changing mainstream economy behaviour has been shown to be the most successful of the three options listed. This is clearly demonstrated in the work by van der Heijden (2007) regarding BB-BEE scorecard performance and preferential procurement by South Africa’s top 200 listed companies. The findings of the study reveal a range of issues which are relevant to our strategic discussions, most of which are taken up in detail later in this chapter.

For our purposes, we focus only on the overall finding of the van der Heijden study. Based on the Empowerdex 2007 BB-BEE scorecards, the study found that the main incentive for companies to improve their BB-BEE rating through preferential procurement and enterprise development was to support their own efforts to supply other enterprises. This means that companies who rely on getting business from BB-BEE sensitive clients, such as the government, will be more likely to actively pursue preferential procurement. Companies that
have the general public as their clients, such as the retailers, are unlikely to feel an equivalent pressure and are less likely to commit resources to BB-BEE procurement. So, for example, Pick n Pay earned a paltry 0.05 out of 20 on preferential procurement in 2007, while IT company Bytes Technology, which has government as its major client, scored 11.9 out of 20.

The incentive of winning lucrative government contracts has led ICT sector firms to seek out suppliers who are BB-BEE compliant and, thus, raise their own individual scores, thereby making them eligible to win government contracts. In other words, winning government business is a financially advantageous activity for profit maximising firm; it acts as an incentive. In order to win this government business, ICT firms must meet certain preferential procurement requirements (among other requirements). Government’s procurement standards result in large ICT firms engaging actively in preferential procurement.

The same incentive of winning lucrative government contracts does not exist for retailers. With no incentive to seek out preferred procurement activities, they simply continue to procure inputs in the same manner as they have done in the past; hence, their lower scores on this portion of the BB-BEE scorecard.

Given that moral suasion and compelling legislation are discarded as viable options to achieve change in retail procurement behaviour, we are left with the idea of incentivising this desired change in behaviour. Based upon the ‘success’ of incentivised preferred procurement, as seen, for example, in the ICT sector, it makes sense to contemplate the opportunity to create an equivalent incentive for the retail sector. Our strategic proposal for changing systemically the purchasing behaviour of the retail sector is based on using the existing BB-BEE scorecard approach, but focuses on two specific codes within the scorecard under the heading of indirect empowerment and on motivating firms to want to improve their scores in these areas.

Before focusing on how to motivate this change in behaviour, it is necessary to contemplate the BB-BEE scorecard in greater detail so as to understand the systems and levers available for government to act. The scorecard, by its nature, is highly complex and we deal here only with the most relevant issues. The scorecard is based on seven elements of broad-based black economic empowerment which are given various ratings and added up to a total of 100 points. This is the generic scorecard used by large listed companies. Smaller companies with a turnover of less than R35m are known as Qualifying Small Enterprises (QSEs) and may select any four of the seven elements for their scorecards, with each element carrying a weighting of 25. Some micro-enterprises are known as ‘exempted micro-enterprises’ (EMEs) and are not required to complete a scorecard as long as they meet qualifying criteria.

It is likely that the small producers that we are seeking to link to the mainstream economy in our strategy will most commonly be QSEs or EMEs. Our mainstream economy players will, in most cases, be larger firms completing generic scorecards, as shown below in Table 9.

---

10 For a fuller understanding of the scorecard, the reader is referred to the statements and codes issued by DTI.
Each empowerment scorecard element has various guideline documents and explanatory statements attached to it which complete the ‘Codes of Good Practice’ for each element. For our study, codes 500 and 600 are the most relevant in developing a linkage programme.

Code 500 states that “preferential procurement is used to drive transformation throughout the economy by encouraging procurement only from suppliers that are compliant with the BB-BEE scorecard” (DTI, 2003). Basically, a pyramid system underlies the scoring of preferential procurement. A large firm calculating its preferential procurement score out of 20 earns points by purchasing from EMEs, QSEs and other large firms that have attained a certain level of BB-BEE compliance as reflected in their ‘contributor level status.’ The BB-BEE status of suppliers influences what percentage of spend the lead firm can claim towards their own preferential procurement score.

### Table 9: BB-BEE generic scorecard

<table>
<thead>
<tr>
<th>Element</th>
<th>Points</th>
<th>Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>Management control</td>
<td>10</td>
<td>200</td>
</tr>
<tr>
<td>Employment equity</td>
<td>15</td>
<td>300</td>
</tr>
<tr>
<td>Skills development</td>
<td>15</td>
<td>400</td>
</tr>
<tr>
<td>Preferential procurement</td>
<td>20</td>
<td>500</td>
</tr>
<tr>
<td>Enterprise development</td>
<td>15</td>
<td>600</td>
</tr>
<tr>
<td>Socio-economic development</td>
<td>5</td>
<td>700</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Table 10: BB-BEE recognition levels

<table>
<thead>
<tr>
<th>BEE status</th>
<th>Qualification</th>
<th>BEE procurement recognition level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level one contributor</td>
<td>≥100 points on the Generic/ QSE Scorecard</td>
<td>135%</td>
</tr>
<tr>
<td>Level two contributor</td>
<td>≥85 but &lt;100 points on the Generic/ QSE Scorecard</td>
<td>125%</td>
</tr>
<tr>
<td>Level three contributor</td>
<td>≥75 but &lt;85 on the Generic/ QSE Scorecard</td>
<td>110%</td>
</tr>
<tr>
<td>Level four contributor</td>
<td>≥65 but ≤75 on the Generic/ QSE Scorecard</td>
<td>100%</td>
</tr>
<tr>
<td>Level five contributor</td>
<td>≥55 but &lt;65 on the Generic/ QSE Scorecard</td>
<td>80%</td>
</tr>
<tr>
<td>Level six contributor</td>
<td>≥45 but &lt;55 on the Generic/ QSE Scorecard</td>
<td>60%</td>
</tr>
<tr>
<td>Level seven contributor</td>
<td>≥40 but &lt;45 on the Generic/ QSE Scorecard</td>
<td>50%</td>
</tr>
<tr>
<td>Level eight contributor</td>
<td>≥30 but &lt;40 on the Generic/ QSE Scorecard</td>
<td>10%</td>
</tr>
<tr>
<td>Non-compliant contributor</td>
<td>&lt;30 on the Generic/ QSE Scorecard</td>
<td>0%</td>
</tr>
</tbody>
</table>

*Source (Table 9 and 10): van der Heijden (2007: 21)*

This means that if a lead firm purchases inputs from a level four supplier, the lead firm can apply 100% of the value of these qualifying purchases towards its own preferential procurement score, whereas if it purchases from a level eight supplier, then only 10% of the value of these purchases will be applied in the calculations of the lead firm’s preferential
procurement score. Van der Heijden shows, for example, that if Woolworths spent R2m buying inputs from a black-owned, small food processor, which is a level two contributor, this would be equivalent, in terms of preferential procurement scores, to spending R22m with a large food processor, such as Tiger Brands.

Additionally, code 500 offers two enhancement factors when calculating preferential procurement scores. If the qualifying BB-BEE supplier is a “value adding supplier that beneficiates raw materials or tends to manufacture and/or produce locally”, then spend to this supplier is weighted at 1.25 times the actual spend when calculating preferential procurement. In the second enhancement factor, “qualifying BB-BEE spend” where the supplier is also an enterprise development beneficiary, spend to this supplier is also weighted at 1.25 times the actual spend. This second enhancement factor is important in the development of our strategy.

Turning to code 600, DTI states that their motivation for including enterprise development in the BB-BEE codes is that it “aims to address certain key challenges facing QSEs and EMEs and more specifically black owned entities that struggle to take their businesses from survivalist and/or micro level to a level of sustainability and profitability” (DTI, 2004). This code is far more accessible than the preferred procurement code and is based on lead firms being able to score points linked to the category and amount spent on developing suppliers. These weightings are shown in Table 11.
Table 11: Benefit factor matrix

<table>
<thead>
<tr>
<th>Qualifying contribution type</th>
<th>Contribution amount</th>
<th>Benefit factor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Grants and related contributions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grant Contribution</td>
<td>Full Grant Amount</td>
<td>100%</td>
</tr>
<tr>
<td>Direct Cost incurred in supporting enterprise development</td>
<td>Verifiable Cost (including both monetary and non-monetary)</td>
<td>100%</td>
</tr>
<tr>
<td>Discounts in addition to normal business practices</td>
<td>Discount Amount (in addition to normal business discount)</td>
<td>100%</td>
</tr>
<tr>
<td>Overhead Costs incurred in supporting enterprise development (including people appointed in enterprise development)</td>
<td>Verifiable Costs (including both monetary and non-monetary)</td>
<td>80%</td>
</tr>
<tr>
<td><strong>Loans and related contributions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest-Free Loan with no security requirements</td>
<td>Outstanding Loan Amount</td>
<td>100%</td>
</tr>
<tr>
<td>Standard Loan to Black Owned EME and QSEs</td>
<td>Outstanding Loan Amount</td>
<td>70%</td>
</tr>
<tr>
<td>Standard Loan provided to other Beneficiary Enterprises</td>
<td>Outstanding Loan Amount</td>
<td>60%</td>
</tr>
<tr>
<td>Guarantees provided on behalf of a Beneficiary entity</td>
<td>Guarantee Amount</td>
<td>3%</td>
</tr>
<tr>
<td>Lower Interest Rate</td>
<td>Outstanding loan amount</td>
<td>= (Prime Rate LESS Actual Rate)</td>
</tr>
<tr>
<td><strong>Equity investments and related contributions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minority Investment in Black Owned EME and QSEs</td>
<td>Investment Amount</td>
<td>100%</td>
</tr>
<tr>
<td>Minority Investment in Other Beneficiary Enterprises</td>
<td>Investment Amount</td>
<td>80%</td>
</tr>
<tr>
<td>Enterprise Development Investment with lower dividend to financier</td>
<td>Investment Amount</td>
<td>Dividend Rate of Ordinary Shareholders − Actual Dividend Rate of Contributor</td>
</tr>
</tbody>
</table>

Source: van der Heijden (2007: 34)
The result of using this benefit matrix is that firms that engage in enterprise development are able to fully capture all the inputs they are making, both direct financial support and assistance in kind, such as mentoring. In terms of our study and the desire to internalise embedded services and upgrading within a linkage programme, code 600 deals with exactly the type of behaviour we are seeking to motivate.

On the ground, van der Heijden notes that the top 200 listed companies in South Africa attained very high scores in enterprise development. This finding is viewed with scepticism for two reasons. Firstly, these high scores do not appear to be reflected in on-the-ground activity. Secondly, it is surprising that firms with very high enterprise development scores continue to have low preferential procurement scores. One would anticipate a correlation between enterprise development and preferential procurement, yet Spar, which scored a mere 1.84 out of 20 for preferential procurement, scored 15 out of 15 for enterprise development. Similarly, the Lewis Group scored 7.47 for preferential procurement and 15 out of 15 for enterprise development. It is possible that loopholes exist in accounting for enterprise development in the scorecard and that compliance targets have been set too low, nevertheless, the reality that a system exists to account for enterprise development is crucial to our strategy.

Codes 500 and 600 provide the perfect vehicle for our linkage strategy. Code 500 on preferred procurement sets up a system whereby small producer activity can be captured along an entire value chain, with lead firms potentially being able to influence all their suppliers and value chain partners to improve their linkages with small producers so that the lead firm can achieve the highest possible preferred procurement score. Code 600, similarly, creates a system whereby lead firms and all of their partners along a value chain can achieve credit for their upgrading and enterprise support activities that are necessary to bring small producer outputs up to the levels required by lead firms’ critical success factors. The point to be made is that BB-BEE scorecard sets up the system that our strategy suggests we need to change lead firm purchasing behaviour. The system and mechanism exists but, clearly, higher degrees of auditing would be required than are currently undertaken. The outstanding questions are how do we activate the usage of the system and how do we incentivise lead firms in the retail sector to want to earn higher preferential procurement and enterprise development scores?

As we have shown, government contracts cannot act as an incentive for the retail sector, simply because government is not a customer of the retail sector. Public sentiment is unlikely to act as an incentive because the South African consumer is more likely to be interested in price, quality and availability than in transformation issues when buying retail purchases. A retail charter is also unlikely to address these issues because of the complexity and composition of sectoral charters, as well as a tendency for direct empowerment and skills development initiatives to be prioritised in sectoral charters ahead of indirect empowerment commitments.

To activate codes 500 and codes 600, specifically in the retail sector, in support of creating a fertile environment for the linking disconnected players, we consider providing a financial incentive to motivate retailers to earn higher scores in preferential procurement and enterprise development.

Unpacking the details of the size and method of employing such an incentive are beyond the scope of this paper, but will, hopefully, be picked up in future research. For our purposes, we explain the logic of the approach. Our approach is made up of four recommendations.
Firstly, we suggest that a financial reward be created for retail firms that earn a certain number of points on preferred procurement. The reward should only kick in once a minimum preferential procurement hurdle has been met. Thereafter, the reward should increase as preferred procurement scores increase so as to support as much preferred procurement as possible. A lead firm should be motivated to earn as close to 15 out of 15 as possible; a sliding scale of rewards will ensure that firms strive to attain 15 out of 15 rather than settling for 11 out of 15.

Secondly, we recommend that the incentive be as large as possible based on the principle that the more enticing the reward, the greater the desire for firms to comply with the requirements to attain it. We believe that the reward most prized by lead firms in the mainstream economy would probably be some form of tax rebate. Tax rebates could be considered with respect to zero rating small producer inputs which caps the value of the incentive at 14%; alternatively, the tax rebate could be lower levels of corporate taxation on final profits or even tax rebates on portions of profits or turnover related to small producer inputs. The technical options are virtually unlimited, each with its respective advantages and disadvantages. The key point, however, remains that the incentive would need to be large enough to compensate firms for the effort they would need to apply to secure small producer inputs and suppliers. This effort would need to measure not only financial cost but also the firms’ opportunity costs as securing such suppliers would require enormous effort, time and capacity and would constitute activities outside of their core business. Issues related to decreasing this opportunity cost are dealt with in below in detail. A separate issue relevant in this context is whether the incentive for preferred procurement should be sufficiently large as to ameliorate the need to create an enterprise development incentive as well. Our view is that a single larger preferential procurement incentive would be better than a smaller preferential procurement incentive, coupled with a separate enterprise development incentive; but this debate is held over for the next section.

Thirdly, we recommend that the incentive be designed in such a way as to maximise the potential of lead firms to undertake preferred procurement and enterprise development in as cost effective and efficient a manner as possible. Failure to achieve this control would simply result in increased preferential procurement prices being passed on to the consumer, leading to inflationary pressures and consumers carrying the cost of such an initiative. As such, we believe that the incentive should look at rewarding cost effective preferential procurement and not just preferential procurement.

Fourthly, we recommend that the incentive operate for a fixed period of time; it does not need to be open-ended. Shifting a behavioural pattern and maintaining a modified behavioural pattern are two distinct activities. If an incentive system is set in place such that small, marginalised producers do gain access into mainstream economy value chains, then once these small producers are up and running and meeting lead firm critical success factors and operating within captive network contracts, then these relationships can be maintained even if the incentive is ultimately withdrawn because, at that stage, ‘the working relationship’ has been established. A 10 to 15 year incentive period is probably sufficient to cement the change in behaviour that we seek.

In making these recommendations, we are well aware of the stress they will cause within current Treasury thinking. Before a number-crunching exercise is undertaken, it is difficult to deal with many of the arguments which the Treasury are likely to make. However, we list the following points for consideration:
Although there will be a reduction in tax revenue to the fiscus as a result of such a strategy, (1) some of this loss will be off-set by reduced grant extension as small producers and those they employ become self sufficient and rise above the poverty line; (2) lead firms will provide infrastructure and services to small producers as part of their enterprise development and preferred procurement activities which will reduce the provision of these services and infrastructure which are currently funded through the fiscus; and (3) treasury could with a clear conscience reduce funding for several existing second economy linkage and enterprise development programmes which are currently running at high costs with limited success. This redirection of resources would operate as an off set to lost taxation.

The total exposure of the Treasury in a scheme like this would be limited by the availability of small producers who have access to some assets and capital, and the total volume of goods and services they could supply to the market. These volumes will be constrained by the nature of small producers, thus, exposure in this case will essentially be self limiting.

Finally, one needs to make the normative argument that in terms of ‘bang for one’s buck’, this strategy has greater potential to improve systemically and sustainably the livelihoods of small, marginalised producers than does any other initiative undertaken to date. As the incentive is only ‘payable’ upon successful execution (involving purchases from small producers), this system offers greater value for money than many previous policies in this field.

To summarise: we have suggested that a feasible and potentially successful strategy could be created by changing mainstream economy lead firm procurement behaviours. Specifically, we would be looking at ameliorating lead firms’ current preferences for large competent suppliers. The provision of a sufficiently enticing financial reward for preferred procurement could motivate lead firms to seek out small, marginalised producers and create competition between lead firms to win contracts with small producers. Such an incentive would not only change the landscape in which small, marginalised producers operate, but it would fundamentally shift the asymmetries of power that currently characterise economic activity in South Africa.

The principles and systems to support this change in behaviour already exist in the form of the BB-BEE scorecard. Our proposed strategy would merely seek to activate two particular elements of the scorecard: preferred procurement and enterprise development. The idea of creating an incentive to facilitate such actions already has precedent with respect to the awarding of government tenders. Offering a tax rebate would merely be an equivalent inducement to the retail sector because it is unlikely to ever benefit from governmental tenders.

Our proposal is not as shocking as it may have first seemed; it is merely a more aggressive, concerted and focused application of the principles and systems which underlie the philosophy and methodology of the BB-BEE Act of 2003.

**Strategies to facilitate a change in lead firms’ purchasing behaviour**

In the previous section, we answered our first strategy question: “how can we elicit a change in lead firm purchasing behaviour?” Assuming that a preferential procurement incentive is created which is sufficiently enticing to lead firms so that they are motivated to change their purchasing behaviour, we then face our second strategic question: “what can be done to facilitate this change in behaviour?” Essentially, this question deals with whether a financial
incentive will be sufficient to support the change in behaviour we are seeking, or are additional support measures will be required.

As our framework has shown, even if lead firms wish to source increased inputs and supplies from small, marginalised producers, the reality is that few small producers operate currently at levels which would meet lead firm critical success factors. Additionally, the problems of diseconomies of scale, poor contractual performance, trust and relationship issues, high transaction costs and business informality all pose very real hurdles for lead firms wishing to transact with small producers within a captive network contract. If mainstream economy lead firms wish to increase preferred procurement, someone will need to deal with the constraining issues facing small, marginalised producers; in other words, small producer upgrading in the broadest sense of the term. This section looks at the respective roles of the private and public sector in the provision of this upgrading and improvement in market sophistication.

Our framework tables and foundation chapters indicate clearly that small producer upgrading is addressed better within a linkage contract, where services are provided directly or indirectly by the mainstream economy lead firm, than by external third parties. This creates our first principle in developing a facilitation strategy to support shifting mainstream economy buying patterns: lead firms and suppliers across a value chain should be the main actors in upgrading small, marginalised producers. This suggests that if lead firms in the private sector are the drivers of small producer upgrading, the role of government should be supportive and indirect.

Three issues emerge when looking at what lead firms will need to put in place in order to upgrade small producers to meet lead firm critical success factors and, hence, provide suitable outputs for lead firms to purchase for their preferred procurement scores and earning of their associated incentives.

The first issue is that small producer upgrading is simply another term for enterprise development as conceived in the BB-BEE scorecard. Whereas the scorecard separates out enterprise development and preferential procurement, in our linkage strategy, we regard enterprise development as a necessary requirement for preferred procurement to be realised. Our strategy aims at the development of long term contractual agreements between first and small, marginalised producers and not merely improving the volume and quality of supply from small producers. (This is the idea of a demand pull strategy rather than a supply push strategy). Our second principle in facilitating the shift in lead firm purchasing behaviour is that enterprise development/upgrading and preferred procurement should be viewed as a single empowerment element or activity. We should not seek to incentivise upgrading or enterprise development as a discrete activity; rather, preferential procurement incentive should be sufficiently large and attractive so as to also cover all of the costs related to upgrading and enterprise development.

This approach ensures that: (1) upgraded small producers do in fact have a ready market in which to sell their outputs once they have met a firms critical success factors; (2) it assists in developing trust and building relationships between lead firms and small producers which is necessary for linkages to be maintained once the incentive is withdrawn; and (3) it ensures that the incentive is achieving its desired outcome, namely, access to mainstream economy markets on a sustainable basis and not merely enterprise development as a discrete activity. This approach also mitigates against the potential problems of: (1) creating third party ‘experts’ who could take advantage of an enterprise development incentive and upgrade
small producers without being able to link them to mainstream economy lead firms (i.e. a supply approach); (2) reducing the administrative and auditing burden of such an incentive scheme; and (3) ensuring that lead firms would run their upgrading activities in as cost effective a manner as possible. This third point is extremely important as it is crucial that the strategy not support ineffective, inefficient upgrading – something which has often happened in previous programme of this sort. By only incentivising the outputs and outcomes of an upgrading exercise, one is constructing a system for lead firms in the private sector to provide such upgrading at the lowest cost possible to the firm.

The second issue which we must consider relates to the core competencies of lead firms. As shown in our foundation chapters, firms along a value chain have core competencies related to their particular market. These competencies apply to knowledge of a specific market, product, technical, production and logistical process. Lead firms do not, however, have core competencies related to upgrading the skills of entrepreneurs in terms of understanding the rights and obligations of contracting. Nor do they have expertise in creating group formations among small producers and they would have no competency in dealing with issues, such as tribal and social cohesion, related to group formations within rural communities. Lead firms do not have competencies in these latter areas – and which we have identified as structural obstacles needing to be dealt with explicitly in a linkage programme – plus these issues would probably be highly unattractive to firms that would view them as a risk they could not control. Our third principle is that in areas where lead firms have no core competency, there is a role for government to play, over and above the provision of financial incentives.

If government is to play a role in dealing with issues which arise in enterprise development and linking mainstream and marginalised players which fall outside the ambit of lead firm competencies, then two strategic options exist.

The first option would be for government to undertake these activities itself. The second option would be to assist private sector lead firms to deal with these activities. We propose strongly that the second option be adopted for two reasons. Firstly, it is unlikely that government would have the capacity to roll out such a programme in an effective and efficient manner. Governmental capacity is limited; an intervention where government’s constrained capacity was a limiting factor in what is an essentially private sector driven initiative is not ideal. The second reason for government to assist firms to deal with areas of non-competency is that private sector would be unlikely to support an initiative where it did not have control over all the aspects required to win its incentive. A lead firm would not embark on a path where its ability to succeed and accrue its incentive was dependant on the performance of government for certain aspects of this activity. Our strategy suggests that in addition to creating a financial incentive for preferential procurement, the government will need to offer a service to lead firms to enable them to complete activities in which they have no core competency. The clients for this service are the lead firms in the mainstream economy, not the final beneficiaries. The aim of the service is to: (1) mitigate risks attached with group formation, market sophistication upgrading, community issues and basic contracting and business skills upgrading, and (2) cover the opportunity cost of lead firms to undertake activities outside of their core competency and comfort zone.

The actual form of such a support initiative could take various forms. One option would be to create a state tender, administered by government, which aggregates on a master file a list of preferred providers in the private sector with specific skills and competencies in this field.
Lead firms could then engage the services of these slate tender experts to undertake activities for them within their preferred procurement programme with government footing the bill for such services. It has been suggested that this approach may not be realistic as such skills may not in fact exist in South Africa presently. In such a scenario (which remains to be tested), the government could either engage foreign experts to provide these skills directly or access international skills to build up a pool of local skills in this area. An alternative option to setting up such a tender could be the creation of a special purpose vehicle with a limited lifespan and a mandate to provide skills and support services to lead firms in areas of enterprise development where they lack competency. Such a delivery mechanism would work only if it operated in a highly professional, efficient manner. This approach has worked in the case of Blue IQ in the Gauteng provincial economy.

An important qualifier offered here is that we do not believe that group formation needs to be a large portion of this support services strategy. As shown in our framework and foundation chapter, it is possible for aggregation activities to be undertaken by lead firms and other mainstream economy value chain players, as opposed to such horizontal aggregation occurring at the small producer level. In our analysis of the SAPPi project, for example, we showed that SAPPi ran a linkage programme for 700 small tree growers using head office knowledge, systems and contacts to provide small producers with access to finance, inputs, mentoring, upgrading services and logistical support. Basically, small producers ‘drew down’ from SAPPi’s head office everything they needed to meet SAPPi’s critical success factors; these draw downs were then written off against final payments made to small producers for their final output. By setting up this system, SAPPi removed the need for small wood producers to create a group formation. On the downside, SAPPi found this approach to be effective from the perspective of small producers, but highly inefficient and costly in terms of its own administration and costs. They established a separate entity, called LIMA, which administered their linkage programme and were able to increase the number of beneficiaries from 700 to 2,100. The SAPPi example is exactly the type of model we foresee lead firms and suppliers in the mainstream economy undertaking to upgrade small producers. The costs of setting up these aggregation services must be covered by the financial incentive. The idea of incentivising the final outcomes of the process, rather than the process, itself, will assure the government that lead firms and suppliers set up these aggregation services at the least cost possible to the mainstream economy firm.

To summarise: we have suggested some key principles for determining the parameters of a support intervention which will assist lead firms to actually take up the challenge of increasing their preferential procurement. Our first principle is that upgrading activities should be undertaken mostly by mainstream economy value chain actors. The second principle is that enterprise development and upgrading should not be incentivised as a standalone activity but should be wrapped up in the overall preferential procurement incentive. The third principle is that enterprise development and upgrading of small, marginalised producers will require some activities in which the private sector will not have any demonstrable core competency and which fundamentally increase the risk of such an undertaking. To deal with this lack of competency and high risk, we suggest that government offer a service to ameliorate the risk and expense of such activities. The principle behind the provision of these services is that the client is the lead firm or mainstream economy value chain actor, with government facilitating access to these competencies rather than providing them directly, itself. Our final principle in this section is that we would support the idea of
aggregation services being offered by lead firms rather than adding such aggregation services to the domain of support services which the government must facilitate or provide.

Clearly, our recommendations are biased in favour of the private sector driving preferred procurement and enterprise development, with government’s direct role being limited as far as possible. The framework tables, however, identify two aspects of linkage programmes where direct government intervention could be essential: the negotiating of contracts and issues related to product segmentation and development. What differentiates these two systemic obstacles from the obstacles already mentioned is that they are key to small, marginalised producers’ ability to earn and receive reasonable incomes and returns on their activity and are crucial in improving the balance of power between first and small, marginalised producers. This point is worth emphasising as it speaks to a key gap in the strategic discussions to date. In our strategy, we have set up a system which will hopefully drive lead firms to increase their preferential procurement and develop the enterprise to enable this. Nowhere in the system, however, is there a check or balance mechanism to ensure that small producers are rewarded fairly for their outputs or that their incomes will rise sufficiently to lift them out of poverty even though they may be in a captive network contract. The reality is that our proposed strategy does not incentivise lead firms to act in the best interests of the small producer; rather, they act in their own self interest. It is likely that lead firms wishing to maximise their preferential procurement with the least effort possible would look for “low lying fruit” or quick wins where the least amount of enterprise development is required. This would lead to preferential procurement being skewed towards low value added products, low unit value products and commoditised products. As shown in our framework and foundation chapters, failure to segment product markets correctly can lead to immiserising growth and may offer returns to small producers that are insufficient to lift them out of poverty.

It is tempting to combat this possibility by being prescriptive and qualifying the incentive available to lead firms. This is possible but would probably decrease the attractiveness of the incentive and require a higher value for the incentive to be taken up. Alternatively, the incentive could be tiered, with higher incentives being offered for preferential procurement of high value added, higher return to small producer procurement and with lower incentives applying to commoditised low yield preferential procurement products. Administratively, this may be a nightmare and complicates massively an already complicated strategy. An alternative proposition would be for the government to support product selection and market development activities.

This notion sits comfortably within our framework and our understanding of the operation of value chains. We know that lead firms seek niche markets and product differentiation as a means of differentiating their consumer offering from their competitors’. We know, too, that income distribution along value chains gravitates towards rewarding product innovation and design and, hence, niche markets create real opportunities for small producers to escape low returns and low incomes. A strategy to support product differentiation and innovation, thus, provides a win-win situation for both producers and lead firms. Furthermore, such a strategy would also have the added benefit of improving the bargaining position and power dynamics of small producers and, potentially, mitigates the likelihood of preferential procurement being skewed towards low return commoditised products.

Turning this idea into an implementable strategy is fraught with difficulties.
Essentially, the idea would be that government would collaborate with lead firms and value chain suppliers to assess possible market gaps where niche products could be developed and entered into an existing value chain. The government would then cover these developmental costs on the basis that the niche product is owned by the small producer. Development could be undertaken either by the mainstream economy value chain player or by the government or by a combination of both. The end result would be a trademarked product, a credence product, a certified product or an entirely new product which services a market niche. The ‘rights’ to the niche product would rest with the small producer, ensuring the producer a higher return and an improved bargaining position; while the ‘sales’ of the niche product offer to the lead firm a market differentiator which has been developed at no cost to itself. This strategy resolves a host of issues with a single intervention. It deals with income distribution to small producers, barraging power and asymmetries of power between mainstream and marginalised players, and balances out a strategy which, in the absence of such an intervention, would most likely lead to increased preferential procurement but of only low value, commoditised products. Once again, we would advocate that government not attempt to offer this service directly but rather facilitate and fund these services.

The second outstanding issue relates to assisting small producers to negotiate contracts with lead firms on equitable terms. As suggested above, one of the weaknesses of this strategy is that by transferring the responsibility of enterprise development and linkages to lead firms, one leaves small, marginalised producers vulnerable in terms of protecting their interests. The system does not include a check and balance to ensure that the preferential procurement and enterprise development undertaken by lead firms will take the interests of small producers on board; small producers may be taken advantage of in this situation. It is hoped that competition between lead firms for small producer outputs will minimise this potential flaw, but given the reality that the strategy does expose small producer to risks of specialisation, we feel it is important to provide some additional protection to small producers.

Government should not be expected to provide negotiation support services, itself. Rather, it should facilitate small producers’ access to relevantly skilled legal professionals who already operate in the private and public sector. Guidelines and best practice codes could be established for such professionals; and, due to the fact that such services would be paid for by the state, the interests of small producers could be protected. This objective third party support to small producers would not protect their rights and diminish the opportunities for exploitation and risk transference to small producers but it could be an important administrative check for the preferential procurement incentive. In other words, only preferential procurement which arises from a contract that has been signed off by a third party legal representative and adjudged to be in line with the codes of good practice would qualify for the financial incentive.

So, our first strategic option for linking mainstream and marginalised players systemically, based on an approach of shifting the procurement patterns of retailers, is summarised as

- Develop an attractive financial incentive for the retail sector which will motivate lead firms and value chain actors along an entire chain to seek out small producers actively;
- The incentive should cover preferential procurement as well as the enterprise development activities required to upgrade small producer outputs to the required mainstream economy standards.
• The private sector value chain actors should be the drivers of this preferred procurement and enterprise development;

• The government should provide facilitation and support services to this process, only with respect to:
  • Product segmentation and product development;
  • Contract negotiations;
  • Business enterprise development issue in which lead mainstream economy firms have no core competency;

• The incentive should seek to reward mainly final outputs and outcomes and not the processes by which these have been attained.

**Companion programmes**

In our introductory section to this chapter, we suggested that there were three questions that needed to be answered in developing a strategic approach to systemically shifting mainstream economy buying behaviour. The first was how to elicit a change in behaviour in lead firms buying behaviour. The second was what types of facilitating activities would need to be undertaken to support this change in behaviour. These two questions were answered earlier. In this final section, we address the third question of what additional steps could be taken to support this change in behaviour.

The support issue that we deal with in this section are fundamentally different from those discussed above. The facilitation and support services discussed earlier are services which are necessary to activate the take up by lead firms of the preferential procurement incentive, in the absence of the provision of these services, the incentive scheme will fail to get off the ground or will fail to deliver the outcomes anticipated by the strategy. In other words, the support services are part and parcel of the incentive package. The additional steps contemplated in this section are of a fundamentally different nature. These additional strategic options, which we have termed “companion programmes”, are not necessary for the proposed strategy to work. These companion strategies are ‘nice to have’, additional options.

The idea behind the creation of companion strategies is driven by three issues. The first issue is that developing and implementing a strategy as ambitious as the one suggested above would be a time consuming and complex undertaking with a substantial lead time being required. Given that the government is under pressure to deliver progress on development strategies in marginalised areas in the immediate short term, the creation of more discrete, less complex, shorter lead time companion strategies could be an important addition to creating the political space to undertake the longer more complex Incentivisation strategy.

The second issue which has driven our suggestion of companion strategies is that such strategies, which stand on their own merit and provide linkage options in their own right, may, over time, support the preferential procurement options available to lead firms. In other words, companion strategies may make preferential procurement and the required enterprise development (to be undertaken by lead firms) easier.

The third issue is that they provide risk diversification from the government’s perspective. Although our conceived incentive programme will be expensive, and, certainly, a flagship initiative for government if adopted, it is unlikely that government would wish to place all its eggs in one basket. Companion strategies provide some risk diversification, while simultaneously providing potential support for the broader Incentivisation strategy. The idea that these companion programmes are strategically aligned to the broader Incentivisation
strategy, while retaining the ability to deliver outcomes on their own, is an important risk mitigating opportunity for policymakers.

As will be shown next, these companion programmes fit into more traditional approaches of linkage programmes and are generally well known and documented. As such we deal with each programme only briefly, but focus instead on how such a programme could support an preferred procurement Incentivisation strategy.

In this section, we consider three companion programmes: lead farmer programmes; local trader programmes; and cooperative development programmes. These programmes are based on the findings of the framework tables of the previous chapter and the case studies reviewed in the foundation chapters. Of great interest was the fact that although we developed this list of companion programmes based on our generalised middle ground analysis, all three suggested programmes are already up and running, in various forms, on the ground in South Africa. This is interesting because, firstly, it suggests that such programmes can be upgraded easily and extended because much of the preparatory work has already been undertaken. Secondly, they are stand alone programmes which exist on their own merit. However, the third issue is that these existing companion programmes are not operating as optimally as they could because they operate in an infertile linkage environment and in isolation from one another. If a systemic linkage strategy can be developed, the outcomes and outputs of these initiatives would multiply exponentially. This links to the very real issue facing linkage strategy as it is currently undertaken in South Africa. Current strategy tends to be project focused: projects operate discretely and in a systemically constrained environment. These are exactly the criticisms highlighted in the 15 Year Review of Second Economy Programmes and are the exact issues that this study seeks to address. While accepting the merits of companion programmes in their own right, the ability to link these programmes into a broader systemic linkage strategy releases their true potential.

Beginning with the lead farmer companion programme, although this programme deals only with small producers in the agricultural sector, and none of the other sectors specified in our framework, the programme is still worth considering given that the production of agricultural outputs for sale to lead firms in the mainstream economy will be a cornerstone of preferred procurement because many small, marginalised producers are engaged currently in agricultural activity. Presently, there are approximately 50,000 commercial farmers in South Africa and up to 240,000 small agricultural producers. Lead farmer programmes are already being undertaken by the Department of Agriculture at a national level, as well as at a provincial level. These programmes all involve organised agricultural organisations and, in many cases, donor activity, usually through corporate social investment programmes. The idea of the programme is simply to create relationships between large commercial mainstream economy farmers and small farmers who operate in the same geographic area and produce the same outputs. Lead farmers provide to small farmers access to inputs (such as seeds, fertilisers, equipment) as well as mentoring skills aimed at improving the quality of their output. In most instances, the commercial farmer integrates the small producers’ outputs together with his own and sells the single consignment to the market though an existing contract. Reports on a linkage programme of this nature that is running in the Eastern Cape currently show that the participating commercial farmer entered the programme so as to have more security and flexibility in meeting his own contractual consignment volumes with a mainstream economy lead firm. Programmes that are able to return a win-win situation to small producers and commercial farmers is obviously first prize.
However, even if the commercial farmer does not need the additional output of small producers to meet their contractual obligations, commercial farmers could also enter such programmes in order to advance social cohesion in the area and improve relationships with local communities. Finally, it is conceivable that if commercial farmer participation in such a programme was slow in emerging financial guarantees, programme support structures or other business assistance could be offered to commercial farmers, either through the government or via organised agricultural structures that have strongly adopted a transformation agenda.

From our preferential procurement Incentivisation strategy, a lead farmer linkage strategy would assist lead firms to earn preferential credits for that part of a commercial farmers output which is supplied by small producers. Commercial farmers who engaged in such a linkage programme would, therefore, become preferred suppliers over commercial farmers who did not participate in such a linkage programme. A lead farmer programme would be seen as advantageous to a lead firm retailer and, simultaneously, meet the desire of lead firms to increase preferential procurement, thereby creating increased demand for commercial farmers who are part of such a programme. The point made is that we know that lead farmer programmes work and that they are being implemented on the ground, albeit sporadically and in different forms. Presently, there is no mechanism to translate these project based linkage schemes into schemes which operate at a systemic level. Although an expanded lead farmer linkage programme could be undertaken in isolation, the idea of establishing such a programme as a companion programme (to a preferential procurement Incentivisation strategy) improves substantially the dynamism of the programme and its ability to contribute meaningfully to the eradication of poverty in marginalised areas.

The second companion programme we have considered is a local trader programme. This programme could operate across all sectors and has been particularly successful in the textiles, garments, crafts, wood products and agricultural sectors, internationally. The idea behind the local trader programme is threefold and derives from some of the systemic obstacles facing small producers that were identified in the framework chapter of this study. A well conceived local trader programme would seek to create a ‘new profession of middlemen or intermediaries’ who act as a link between small producers and mainstream economy lead firms. These intermediaries/middlemen would serve three functions. Firstly, they would transmit to small producers the critical success factors necessary for them to achieve if they wish to enter external markets. In this role, the intermediaries would act as an information conduit between mainstream and marginalised players in a given value chain. Secondly, local trader would offer some upgrading support in terms of access to inputs, advice and contacts for additional services. In this respect, a local trader would operate as a conduit for advice on where small producers can gain access to support services. This is a crucial role because many government, donor and provincial departments and agencies offer support services but often experience low pick up rates on such programmes because of a lack of information at the level of potential beneficiaries. The third and final role of such intermediaries would be to actually purchase, collect and transport output from small producers to external markets.

A local trader programme is strategically relevant to our undertaking because of the three roles identified above and, importantly, because it deals with issues of trust, relationship

---

11 Several farmers we spoke to said that they would embrace such a programme, simply in order to improve community relations and enhance safety and security in their areas.
building and the systemic issue related to the need for face-to-face relations. Local traders, especially if they come from the communities which they will service, are more likely to bridge language, cultural and trust divides and are, hence, are a powerful instrument in a linkage programme.

Local traders and middlemen are an intermediary system which exists around the world, particularly in developing countries and rural areas. In most countries, this class of economic activity has developed organically and most local trader programmes undertaken focus predominantly on trader upgrading. In South Africa, local traders are all but absent — most probably a result of apartheid legislations which precluded free movement of individuals as well as limited access to finance. A domestic local trader programme would require the creation of local traders, as well as their skills development, and their related business models and service provision.

Three routes exist to operationalising such a programme. One option would be for government to operate such a programme. The second would be for the private sector to operate such a programme and the third would be a joint effort. It is possible that such a programme will arise naturally as part of a preferential procurement incentivisation scheme whereby lead firms establish ‘local representatives.’ Alternatively, a standalone programme would not only yield positive results in its own right but would also support the activities of lead firms who were undertaking enterprise development as part of their preferential procurement activities.

A local trader programme does, however, have some intrinsic flaws. Firstly, it is the weakest form of contracting and small, marginalised producers who develop relationships with local traders will be at the mercy of that trader’s professionalism, constancy and cash flow. This type of contractual relationship is weaker than a captive network contract. Secondly, although local traders can be imbued with some upgrading skills, it is likely that such upgrading will be limited (and less than in a captive network linkage) and that product standards will not be enormously high or products particularly segmented. As such, it is likely that low returns and prices will result. A further disadvantage of this programme is that it will be impossible to monitor local trader–producer relations or to protect the interests of small producers other than through market competition. The only option to deal with this shortcoming is for local traders to be tied to lead firms and value chain suppliers. It is probably more beneficial strategically for such a programme to be driven by the private sector, in which case it will probably fall under the heading of enterprise development.

Our third companion programme is a programme to develop cooperatives. Repeating the point made in our earlier chapters, the development of marketing cooperatives for small producers is not a strategic option which we favour. This is backed up by international experience and case studies, both locally and abroad. The reason for including cooperative programme in our strategy arises simply from the fact that such a programme already exists in South Africa and is well funded at present. To the extent that the current programme can support effective cooperatives, these cooperatives would be a useful source of supply for lead firms seeking small producer output and would produce an existing entity with which lead firms and suppliers could negotiate.
Incremental change option

As mentioned in our introduction to this chapter, we present two fundamentally different strategic options. In the previous section, we offered a strategy for fundamental transformation of the retail sector. Our alternative strategic option is markedly different.

The incremental change option begins with an assumption that mainstream economy purchasing behaviour remains unchanged and a linkage programme is created in an infertile environment where the system remains predisposed against the purchase of inputs from small producers. In this scenario, the goal of systemic change is no longer feasible. Rather, the best outcome to be achieved would be large scale linkage initiatives. As long as individual initiatives are large enough, and if a sufficiently large number of linkage initiatives are designed and implemented, then these linkage initiatives can create incrementally a change in the prospects of large numbers of small, marginalised producers.

The challenges in identifying, designing and implementing initiatives are well documented in this study. The focus of our incremental change strategic option is to look for novel or new ways to approach linkage initiative development: to look at what systems and methods can be developed to support large numbers of large initiatives. Essentially, instead of looking at creating individual linkage initiatives per se, we look at creating a method or system which will effectively deliver linkage initiatives on scale so as to achieve critical mass. We know already that externally catalysed linkage initiatives are not scalable, replicable or transferable and that no economies of scale exist when rolling out initiatives on a large scale. However, a system or method which supports the identification, design and implementation of linkage initiatives can enjoy economies of scale and be replicable, scalable and transferable. Hence, the purpose of our second strategy is map out the key elements in creating a system which will support the development of linkage initiatives across regions, sectors and time.

As will be discussed in the next section, crucial in the development of this system are the points of departure established in the foundation chapters and framework, namely, that we seek a system that is (1) predicated on internal catalysation and not external catalysation; (2) able to work for a large number of heterogeneous beneficiaries in various sectors and regions; (3) able to support the issues identified in the framework as important obstacles to be addressed; and (4) not overly dependant on governmental capacity and government’s direct provision of services.

Driving principles

Before explaining the system we are recommending to support endogenised mainstream–marginalised linkage initiatives, it is necessary to lay out some of the key principles which have driven the development of this approach.

Recapping the four principles, the first principle is that we were searching for a system which supports the creation of linkages at scale, not an individual initiative based approach. Secondly, we want a system which maximises the involvement of mainstream and marginalised value chain actors and minimises the direct role of government, while favouring government playing a facilitative and supportive role. Thirdly, we seek a system which is as broad as possible so as to encompass the activities of participants in all six sectors in which small producer activity is at its highest. The fourth driving principle is to ensure that the system is informed by the framework tables identified in the previous chapter.

There are two other principles that must be highlighted.
The fifth driving principle relates to government’s mindset regarding the purpose and outcomes of successful policy. This mindset issue is included in our driving principles as it hopefully addresses many of the criticisms which our proposed system will attract. The issue of mindset and what government can reasonably expect to achieve with policy and strategic intervention in the arena of the real economy has received much debate recently, particularly following the publication of the findings of the Harvard Group (and specifically the views of Dani Rodrik). Rodrik’s views relate to industrial policy which, broadly defined, includes all aspects of real economy production and, hence, is relevant to our linkage paradigm. He suggests that industrial policy is a discovery process where firms and government learn about underlying costs and opportunities and engage in strategic coordination. On this basis, industrial and strategy policy is as much about eliciting information as it is about implementing appropriate policies. In other words, Rodrik is emphatic that strategic collaboration must be at the heart of any industrial initiative undertaken by government. Rodrik then takes this principle further and challenges South African policymakers into a space which they have historically avoided. He suggests that industrial policy and strategy is not about outcomes which are inherently unknowable ex ante, but is about getting the policy process right. He suggests that government can, will and should make mistakes, but that if the process is correctly designed, then a system should exist to let failure go while continuing to support success. This approach lets the government enter into a discovery process with the private sector and removes the burden of it attempting to create and implement policies and strategies from above and in isolation. The ability of a strong process-orientated approach, however, presupposes a certain degree of governmental capacity which, to date, and from experiences such as the cluster initiative of DTI, appears to be lacking. Rodrik suggests that in any government there are pockets of bureaucratic competence and professional expertise which enjoy some degree of autonomy. He suggests that such institutions or units be identified and supported.

We raise Rodrik’s arguments because they talk specifically to the issue of who should be involved in identifying and implementing initiatives for a system which will support a linkage development. His view is that government should focus on creating the strategic cooperation between the private and public sectors and, thereafter, on the basis of the findings of that collaboration, structure its implementation and strategic programme options. Rodrik’s position is important in our strategy as it suggests that while an incremental change option approach needs to be externally catalysed, the process can become highly internalised and can potentially give our incremental option greater opportunity to impact on a larger group of beneficiaries than would have been the case if a traditional external identification process was adopted. Essentially, this is a refinement of the development spiral referred to earlier in this framework and is adopted as a driving principle for our incremental change strategic option.

Our sixth and final driving principle refers to a more complex and difficult issue, namely, the scope and beneficiary targeting of an incremental change support system. The issue is simple but the answer is complex. In the systemic change strategic option, it was clear that the target client of the strategy was essentially mainstream economy lead firms as they were the major players in the strategy and it was their actions which created linkage opportunities and drove enterprise development. In our second incremental change strategy, we do not have an obvious entry point as there is no systemic instrument around which identifiable actors in value chains can congregate. In this context, we believe that there are two entry
points for our system. Either the system should be created to support initiatives in particular sectors, or it should create support for initiatives in particular geographic locations.

The sectoral versus locational debate of initiative identification does not appear to have been well considered in the international literature. Traditionally, value chains do not have a territorial dimension, even though each actor in a chain occupies a particular geographic location. Value chain analysis is a sectoral analysis. The defining feature of value chains is the pattern of connection between various producers, services and customers; a value chain analysis, therefore, has a functional focus. Most territorial analyses in the literature are found in cluster analysis literature and theory. Cluster analysis has geographic location as its key driver and describes a cluster as “geographic concentrations of horizontally and vertically linked firms, suppliers, service providers and associated institutions operating in a single field” (USAID, 2005: 13). Stamer and Waltring (2007: 18) suggest that “cluster analysis and value chain promotion are not profoundly different in terms of their objectives and instruments.” This is shown in a diagram of their own design contained in Figure 14.

**Figure 14: Value chain and cluster perspectives**

![Figure 14: Value chain and cluster perspectives](source: Stamer and Waltring (2007: 18))

McCormick (1999) does not disagree with the Stamer and Waltring hypothesis but suggests that when one decomposes clusters it becomes evident that only certain types of clustering can be included in value chain analysis. She identifies three types of clusters: groundwork clusters, industrialising clusters and complex industrialising clusters. Groundwork clusters are viewed as laying the foundations for industrialising clusters, by building a productive environment that paves the way for the emergence of collective efficiency through local and, generally, low income markets. Signs of emerging collective efficiency and greater degrees of labour specialisation and differentiation characterise industrialising clusters, while complex industrialised clusters are characterised by high degrees of differentiation and specialisation catering to high value local and international markets.

Value chain and cluster perspectives become more suitable when thought of together as the level of cluster sophistication increases. This is shown in Figure 15.
The marginalised, small producers that we identified as our target beneficiaries are probably positioned in the top right corner of the ground work cluster or the bottom left corner of the industrialised cluster. Thus, in terms of McCormick’s theory, they would just be the cusp of potentially meeting the requirements of being eligible for value chain linkages.

A USAID (2005) discussion document which directly broaches the issue of value chain analysis versus cluster analysis brings the above issue into absolute clarity. It states that “although the distinction [between the two approaches] is not clear...practitioners need to make a decision about how to allocate scarce resources ...and are required to adopt either a value chain or cluster approach.” (USAID, 2005: 13-15). This suggests, rightly, that in our strategic decision-making we need to determine explicitly whether we will approach initiative identification based on geographic location or on sector. Even though the two are highly interconnected and the intellectual distinction may appear esoteric, at the end of the day, we are talking about a process which will include getting potential initiative players into a room. The question is: do we compile our invitees’ list based on a geographic area or do we compile our list based on a sector? It is a real question which requires a definitive answer.

Before we argue in favour of a particular approach, it is useful to scan briefly South Africa’s past and present views on the issue. From a national government perspective, industrial policy and small business development have most strongly been approached from a sector perspective. Initially, this was formalised in the 2001 Cluster Strategy, which, although it uses the word cluster in its title, was designed in terms of sectoral activities looking at the ‘clustering of firms’ necessary for a single industry to improve its competitiveness. Private sector support for this initiative was positive initially but the process became a talk-shop with little progress being made in Cluster Workshops and the Technical Committee, such that, over time, industry participation faltered and the programme was eventually taken off of DTI’s books. Following the cluster approach DTI adopted, a Customised Sector Programme (or CSP) emerged where the government interacted with individual industries (more narrowly defined than in the cluster initiative) to deal with bottlenecks and competitive issues. Although the design of these CSPs allowed for the inclusion of issues related to small business development and marginalised producer participation, the programmes mostly focused on the removal of bottlenecks for mainstream economy players in each sector. A
sector approach has also been adopted in terms of the BB-BEE scorecard charter initiative since 2003 and in ASGI-SA where priority sectors have been identified on the basis of their potential to create employment and improve incomes of marginalised participants. Hence, at a national government level, policy has always migrated towards a sectoral approach.

A geographic approach towards growth has been predominant in provincial and local government. This focus is largely due to the reality that provincial and local governments have no constitutional competencies at an industrial or sectoral level, as well as the fact that their accountability to the constituents is more direct; hence, their focus on geographic programmes. These geographic programmes have covered a continuum of programmes, ranging from small scale initiatives, such as local economic development initiatives which involve 10 to 20 beneficiaries in a specific location, through to the other end of the spectrum where large communities, numbering 100s in large locational catchment areas, are organised to develop growth opportunities. Although geographically defined initiatives have been adopted with varying degrees of success by local and provincial governments, some provincial and municipal authorities continue to prefer a sectoral based approach, such as the Western Cape, Gauteng and the City of Johannesburg.

The above provides us with little assistance in answering our question of whether to define a system to support initiatives on the basis of geographic area or sector, bar the inference that the predominance of sector based approaches has had little effect on linkage prospects to date. As such, our suggestion of which approach to follow is based on theory, concepts and thinking outside of the box, rather than a response to current policy approaches.

We recommend that a geographic initiative selection support approach be adopted in preference to a sectoral initiative selection approach. The reasoning for this decision is:

A geographic approach is more appropriate given current levels of market sophistication in the marginalised economy;

A geographic approach is more likely to avoid broad sectoral interests which often derail or crowd out marginalised economy issues in favour of mainstream economy constraints;

A geographic approach moves a linkage programme from an ‘add on,’ ‘trickle down’ initiative (within a sectoral agenda) to a ‘core’ programme in a specific location;

A geographic approach adopted from a national government perspective would be ‘novel’ and ‘new’ and unburdened with the negative baggage associated with sectoral initiatives both previously and currently adopted by government. This should assist with securing private sector buy in;

A geographic approach better suits many of our framework issues, especially the need to support horizontal aggregation (which can no longer be addressed by the private sector in isolation) and to develop face-to-face contract relationships rather than distant relationships;

A geographic approach would bring local and provincial government players into action, which, in principle, increases the capacity of government to roll out such programmes (and public sector capacity becomes more of an issue in the incremental change option than in the previous strategic option);

A geographic approach will support some specialisation given that environmental issues (of climate, land, infrastructure, communications) will be the same for all small producers in a
given area but will, nevertheless, have the potential to impact the lives of all the poor in a
given area rather than only those producing a specific good;

A geographic approach is consistent with our framework parameters of dealing with small,
marginalised producers in FRAs;

A final reason for choosing a geographic approach is based on the reality that a highly
successful example of this approach has been documented, and, although the approach will
be new and novel in South Africa, it is tried and tested internationally and with great results.

As such, our sixth and final driving principle is that our support system for incremental
change should be based on linkage identification and implementation arising from a
geographic approach rather than a sectoral approach. A sectoral approach remains an
option, but not one which we consider in this study.

**Structure of the incremental change system**

The structure of the system which we are putting forward in this section is an adaptation of
the LEADER programme which has been operating in the European Union (or EU) for the past
17 years. A brief history and explanation of the programme is provided in Box 13, although a
full guide to the system is available on the LEADER web site.

**Box 13: EU LEADER programme**

The ‘links between actions for the development of the rural economy’ (or LEADER)
programme was established in 1991 by the European Commission to deal with maximising
the opportunities of rural communities in Europe in terms of: “job creation, skills retention
and upgrading, economic growth, improved competitiveness and environmental
conservation.” More specifically, the programme aims to support sustainable development
which takes into account “the internal opportunities and constraints of rural areas as a result
of the environmental, economic, social and cultural factors of the past, as well as the
external opportunities and constraints that arise from opening up local economies.”

The model is based on CONVERGENCE between players, activities and local components and
the creation of LINKS between players, activities and areas. The model seeks to move away
from classical development approaches which are based on top down, undifferentiated
sectoral interventions and usually designed to apply to urban modalities. Rather, the LEADER
model embraces the distinctive features of rural areas and the activities, skills, know how,
latent potential, culture and history that define them.

The model is based on two principles. The first principle is that the model is designed around
the organising principle of local partnerships and bottom up structuring. The model calls for
the creation of Local Action Groups (LAGs) which include private sector operators in an area,
public sector operators and other community economic players in the identified area. The
LAG is made up of a small permanent team who are responsible for defining and
implementing an action plan. The second principle is that once an initiative is defined by a
LAG it submits this initiative to the LEADER programme for financing. Some co-financing is
required; but the LEADER model provides the bulk of funding.

Although initiative qualifying criteria do exist, the model is based on being flexible and the
model builds into the system methods by which initiatives are appraised and funded quickly
and effectively.
The LEADER programme was initially established as an ‘experiment’ to run for four years to “see how it worked.” Its success has been phenomenal and resulted in two extensions to the programme. In the 1991-1994 phase, the model reached 217 areas and 417 million Euros were allocated. In the 1994-1999 phase, 1,000 areas joined the programme and 1,775 million Euros were allocated creating 100,000 jobs. In phase three, in 2000 to 2006, over 2,000 areas participated enjoying allocation of 2,020 million Euros and creating over 250,000 jobs.

Examples of actual EU LEADER initiatives are included in Annexure 1.

Source: EU LEADER website

An overview of our proposed system is shown below. It is a crude simplification of the EU LEADER system. Many of the ideas contained in the system will look very familiar to policymakers, researchers and practitioners who have worked at provincial or local government level; indeed, they are also similar to certain national government approaches. The differences from current practice become visible in terms of the fact that (1) we are suggesting this as a nation wide system, (2) that is specifically focused towards linkages for small marginalised producers, and (3) with financial and drawdown services focused on dealing specifically with systemic issues identified in the framework tables. In this first section on our proposed system, we focus on the concept upon which the system is based. Administration of the system is dealt with in a separate section, albeit briefly, as we did not wish to get sidetracked into implementation details.

Figure 16: System outline for incremental change strategy

Although this is a system based on developing value chain linkages as its final goal, the starting point, as explained above, is based on geographic areas. Because the system is based on a bottom up approach, areas must ‘select’ themselves as the first part of the system. The experiences of the LEADER programme suggest that the drive to establish an ‘area’ to participate in the system varies enormously between locations. Often the ‘driver’ or ‘originator’ is a local authority or municipality. Sometimes, it is a lead firm, chamber of
commerce or a sector association operating in the area. Sometimes, it is a community structure or even a lone individual (or group of individuals) who sees potential in a local area.

The diversity of originators of area selection should be seen as a huge advantage over existing programme systems currently in place in South Africa. By allowing anyone in the public, private or community sectors to begin the process, one is likely to get the most dynamic and robust coverage for the system. The system is also likely to support niche product and market initiatives which as seen in our framework are incredibly important for lifting small, marginalised producers out of poverty.

To support this first step in the system, the government would need to run a substantial marketing campaign to ensure that all potential originating individuals and organisations are aware of the programme. Blanket and focused marketing would be required, using existing and new channels.

Area qualification criteria are the next requirement of the system. One of the strengths of the LEADER programme is its non-traditional and open-minded approach to defining areas which value area characteristics in favour of traditional parameters, such as existing administrative, geographic or infrastructure boundaries. In this programme, areas are not viewed as static, geographic units but as dynamic units based on the integration of geographic, economic, social, cultural, political and other factors. Areas are about collective views and an area “is seen both as a product of its history and a reflection of its present, whilst at the same time harbouring the conditions for its own future” (LEADER, 2005: 6). Following from this, the LEADER programme has two overriding criteria for qualifying areas. The first is that there must be cohesion within the area; the second is that the area must have sufficient critical mass in terms of human, financial and economic resources to support a viable development strategy. The general guidelines within the EU programme suggest areas with populations between 10,000 and 100,000.

The LEADER programme suggests that any prospective area must develop an ‘area profile’ with eight components: physical resources, human resources, current activities, skills and know how, cultural identity; governance; image and perceptions; and external relations. This profile creates an area’s ‘capital’ which will determine the base upon which initiatives can be developed.

We are enamoured with the LEDAER programmes idea of thinking about areas being premised on common characteristics rather than on narrow geographic parameters. We think the idea of cohesion is extremely relevant for our strategy and the idea that areas must support critical mass is essential in moving away from small-scale initiatives and towards scalable ones. Although these qualifying area criteria may appear fuzzy and broad, the mindset of not being prescriptive and of allowing a space for bottom up determination of an area’s potential is crucial in endogenising initiative identification and shared discovery of an area’s potential.

So, for example, if we think about the Marula example covered earlier in this study – that initiative only existed because a few individuals saw the potential for the product and drove the initiative forward in the absence of any systemic support – and if a LEADER type system was in place in South Africa, a group of individuals or communities who saw the potential of non-timber forestry products could establish an ‘area’, which included forestry areas where non-timber products grew and where communities had a historic knowledge of such products and their uses, and could use this as their starting point for entering the system.
Similarly, in areas with a strong tradition of crafts made from local materials, an area could be created using these characteristics. On the other hand, a hospitality player in a given area could see untapped potential in the area in terms of food and food preparation, leisure activities and conservation activities. In such a case, an area could be created based on the servicing of tourists' needs.

The idea of not being too prescriptive or narrow at the initial stages of our system is vital, especially as we are looking for niche markets and new products for small producer participation and for areas of activity in which there is existing activity or latent potential for new activities. An added feature of this approach, which was found to be substantial in the LEADER case studies, is that even if initiatives which arise from qualifying areas are not ultimately funded by the system, the act of identifying the opportunities and getting the buy in of all the players often led to these initiatives going ahead via alternate mechanisms and systems. From our perspective, as long as critical mass and cohesion criteria are met, we believe this is a sufficient initial hurdle.

Once an area has qualified, the next step is to establish a local action group (or LAG). The LAG is a small, permanent team of individuals who are responsible for leading the participatory process which will arrive at an action programme which can submitted to the system administrators for funding and, hopefully, implementation. LAGs appear to be very similar to what South Africa refers to as steering committees but have the added dimension of being responsible for the administration of funds assigned to the initiative. It is at this point that the LEADER programme creates difficulties in the South African context. Firstly, the issue of finding sufficiently skilled, competent and honest operators to enter a LAG in rural areas in South Africa is far more constrained than in Europe. Secondly, the power dynamics within a LAG which represents mainstream and marginalised players is likely to be more volatile and asymmetric than in Europe. And, finally, the capacity and budget of the national government administrators of this system in South Africa is likely to be more constrained than the administrative depth and budget available within the EU. These are very real limitations on the proposed system and need to be explicitly dealt with upfront. Our strategy to deal with these would include: a substantial training programme for LAG members, the provision of ‘field officers’ to provide ongoing assistance to LAGs, and a series of bureaucratic checks and balances (which are discussed in the next section).

Once an area and LAG have been established, the next step is for the LAG and the participating area inhabitants to start the process of developing action plans and programmes for which they seek funding. It is at this stage in the system that our focus on value chain linkages arises, although, as stressed above, it is possible that other non-value chain initiatives may arise from the process and it is hoped that such initiatives can be supported through other channels and means. LAGs will have received training on what the criteria for qualifying initiatives will be. These criteria will be based on the framework tables (contained in the previous chapter). Although the qualifying criteria will need to be developed in detail, for the purposes of our strategic thinking, we have listed the key criteria which could be applied. The key criteria are:

• The initiative must involve mainstream and marginalised actors;

---

12 One of the beneficial but unintended consequences of the LEADER programme has been that many sub-national government programmes have been folded into the LEADER programme, making it an axis point for funding from various departments. For example, the Scottish small enterprise development programme now uses over 90% of its budget to fund programmes arising from LEADER programmes.
• The initiative must result in increased incomes and returns for small, marginalised producers;
• The initiative must be based on a specified value chain which services an external final demand market (and where external refers to a market which is greater than the local market in marginal areas);
• The initiative must seek to deliver ultimately non-spot market contractual links between small, marginalised producers and mainstream economy value chain players;
• The initiative must identify how small, marginalised producer upgrading is going to be provided and must allow for the majority of that upgrading to be achieved by the direct or indirect support of the mainstream economy actors in the initiative;
• The initiative must identify the product and market segment to be serviced and how product diversification and specialisation will be achieved;
• The initiative must identify how aggregation services will be supplied, by whom and on what basis.

The overall idea of the system is that initiative criteria must be sufficiently detailed to let LAGs know exactly what is expected of them in order to attain funding, but it should not be prescriptive as to how constraints and obstacles are dealt with. The system leads LAGs to consider the issues which have been highlighted in our framework tables as systemic issues to be dealt with – albeit without prescription – in all value chain initiatives in our linkage programme. This supports the Rodrik argument where on the ground players are encouraged to find solutions, and where government’s role is one of support. This also supports the idea that was central to our systemic preferential procurement strategic suggestion which seeks to ‘internalise’ enterprise development and upgrading. The key to unlocking good initiative proposals from LAGs which meet the programmes criteria are: (1) the amount of funding the government will make available to successful initiatives, and (2) the reality that the system will have a fixed budget and LAGs will compete with each other to access these funds. The system will operate on a merit basis by comparing and contrasting initiative proposals. Funding the best proposals received in any round is vital. These issues are discussed in detail in the administrative section below.

**Strategic issues of incentivisation, administration and operationalisation of the system for incremental change**

The description of the system we are suggesting as a potential incremental change strategy appears to be filed with promise and seems deceptively easy to organise. The reality is far different and in this section we consider what would need to be undertaken by the government to support such a strategy.

The first issue we need to address is how we get individuals or organisations (public or private) interested in the system. In other words, what will motivate them to establish and area, set up a LAG, and develop and implement initiatives. The key motivator in this strategy is self interest, along with access to funding and support to achieve this self interested goal. Programme participants should see the system as a means to achieving a set of economic activities which will be of benefit to them. So, for example, producers in marginalised areas will see the system as a means to achieving contracts and upgrading from mainstream economy value chain players; lead firms or suppliers may see it as a way of diversifying their supplier network or developing new niche products which will give them a market
competitive advantage; a sector association or chamber of commerce may see it as a means to improving industry standards and certification and increasing industry growth as a result; and a dominant regional player may see the system as a means to upgrading their immediate environment and thus increasing safety and security and stability issues through poverty reduction. Irrespective of the original motivation, the idea is to allow participants to create and implement initiatives which they would not undertake in the absence of a support system because the financial risks are too high, the coordination risk is too great, the opportunity cost is too great, or the financial and human capital requirements are too great.

The foundation of the system is the financial and support resources that the system will make available to qualifying initiatives; as well as the ‘cost’ of participating in the system given that funding is not guaranteed. We deal with participation costs first, before turning our attention to the financing and support of qualifying initiatives.

In our proposed system, substantial activity needs to be undertaken before an initiative is adjudicated and deemed worthy of funding. These preliminary activities will require time, effort and resources and cannot be expected to be undertaken without some support. The system will need to ensure that as many qualifying areas as possible are generated and that as many LAGs as possible are created to ensure that competition occurs at the point where qualifying initiatives are selected. Having said this, the system does not want to over-allocate resources to the idea phase of the system because this limits the resources available for actual initiative support. Our strategy suggestion would be that an area originator should bare the initial costs of identifying an area, with the qualifying characteristics (coherence and critical mass) and go so far as to ensure the participation of potential LAG participants before participating funding becomes available from the system. The shortcoming of this approach is that it makes it very difficult for small producers to originate areas and LAGs, although many may be able to use their contacts with local government, political organisations, community organisations or other cooperative structures. More likely is a scenario where area and LAG origination are driven by mainstream economy actors. While this is not optimal, it does fit in with our overall value chain analysis and our demand driven approach.

Once an initial qualifying area and shadow LAG is presented, the real work begins with developing initiative plans. The initiative planning process needs to be formalised by a LAG, which must be officially constituted, and the planning process will require resources such as area scans, market intelligence gathering, community participation workshops, among other things. The principle is that these participation costs must be co-financed by LAG participants and the system, itself. It is likely that most LAGs in South Africa will have a local government or provincial government representative and it is proposed that some of the funding for initiative planning be provided by these sub-national government structures or mainstream economy participants, with the system administration matching these funds. In particularly, poor areas’ funding may occur on a 60/40 or even 80/20 basis; however, the principle is that there must be joint funding. At this stage, prior to a LAGs initiative being funded, LAG members will be required to work at risk and will not be ‘employed’ and remunerated for their efforts. This step is necessary to ensure that area and LAG originators are committed to their initiatives and decrease the possibility of free-riders who seek to work the system to finance initial research and initiative development which they later fail to turn into initiatives that match the system’s criteria.

Over and above the need to provide some sort of financial funding in the initiative planning process, crucially, the system needs to provide strategic support with respect to how to plan,
run participatory processes and, specifically, focus on initiatives which will be likely to meet the qualifying criteria. Strategically, the government would need to develop a core group of system educators/enablers who could be approached by potential LAGs and area originators and who would receive required training and inputs. The quality of these enablers would have a strong bearing on the quality of initiatives resulting from LAG process planning activities and, thus, an investment by government in such a core service would need to be of the highest quality. These services could be delivered either by government directly or via private sector capacity seconded to the programme for this purpose.

Once an action plan for one or numerous initiatives is completed by a LAG, these initiatives need to be referred to the system administrator for possible funding and support. Assuming that an initiative or group of initiatives in an area do qualify and the system adopts these initiatives that they wish to take further, what types of assistance should the government offer? This really is the crux of the ‘service offering’ of the system and if these benefits are insufficient, then they will not motivate people or structures to enter the system.

Several important strategic options exist for government at this point. The EU LEADER programme is simply a funding programme with the majority of funding being undertaken via direct grants voted to LAGs. The EU LEADER programme provides model support, such as support on how to set up a LAG, how to define an area, but does not offer any supportive or facilitative activities related to actual delivery of initiatives. In the LEADER model, initiative implementation is entirely in the hands of the LAG and occurs only at a decentralised level. This makes sense given the broad scope of initiatives included in qualifying initiatives in the LEADER model, as well as the fact that the LEADER programme operates across all EU countries, each of which have different systems of government, different languages and different economic, social and political issues. A final point to make is that the budget for the EU LEADER programme is massive, even when its scope is taken into consideration.

The first strategic option that a local LEADER type system in South Africa would need to consider is whether government should limit its supportive role to only the provision of finance or whether its supportive role should cover services and financial support. This issue is similar to the one raised in the previous strategic option when we considered whether lead firms would undertake preferential procurement (even with large incentives on the table) if they had to deal with issues outside of their core competence. It also talks to the issue of whether such a system would protect the interests of small producers or if additional activities need to be undertaken by government to assist small producers in mitigating their risk and entering beneficial contracts. Just as we argued before that financial incentive is unlikely to be sufficient to motivate enterprise development associated with small, marginalised producers, so we argue that government should consider offering both financial and non-financial services to LAGs.

Dealing with financial incentives, these will obviously vary from initiative to initiative but the principle is likely to be that private sector who will undertake enterprise development activities as part of their initiative or small, marginalised producers hoping to develop new products or niche products will need to have these activities funded. In the previous strategy suggestion, these costs were ‘sunk’ into the system and carried by lead firms (and recouped via their preferential procurement incentive), no such ‘sinking of costs’ exists in the incremental change system and, therefore, these need to be funded directly. Managing these costs and ensuring that upgrading and enterprise development occurs as efficiently as possible can only be handled by the fact that LAGs are competing for funds, hence,
‘unreasonable or inflated costing’ should, in principle, be avoided as this will increase the likelihood that an initiative will be picked. The same would apply to product development costs. A third area of activity for which LAGs are likely to request funding would be for infrastructure development, Once again, these costs become explicit. Financing all of these elements of qualifying initiatives can be approached in various ways. Looking at case studies of LEADER initiatives we see a multitude of options. These include:

- Direct grant funding where the system makes funds directly available to the LAG for an initiative;
- Partial grant funding where the system makes some funds available to the initiative but offers assistance in raising the additional funding requirement via:
  - Guarantees;
  - Soft loans;
  - Assistance in leveraging funds from other sources; and
- Partial grant funding and seed capital funding where the system makes some grant funding available but also provides seed capital for the creation of a new entity similar to a venture capital scheme.

These options will need to be weighed carefully and additional research undertaken to determine the merits and demerits of each alternative and its variants. The bottom line, however, remains that the funding of initiatives must be sufficiently appealing to make entering the system a worthwhile endeavour for mainstream and marginalised players. The attractiveness of the funding provided must also be weighted against whether or not government will provide services in addition to funding the system.

Strategically, the more limited the range of support services offered to qualifying initiatives, the higher the level of funding required and vice versa. As with the previous strategy, we believe that LAGs will be predisposed, just as lead firms were, to wanting to be directly in control of their initiatives and would favour financial support above facilitating services. Having said this, however, it is likely that the capacity of LAGs will be substantially lower than that of large retail lead firms and, as such, the provision of services from the system might be an appealing option. Services in this respect would apply to facilitative services related to cross-cutting value chain issues, such as product development, establishing aggregation services, either from a mainstream or marginalised economy perspective, assistance in training on markets, contracting and contract non-performance. The client for these services would be LAGs that are able to drawdown these services from the system administrator without charge. These services could be delivered with the same strategic variations as were suggested in the previous section. In addition, companion initiatives would also offer to originators of areas, LAGs and action plans support for their initiatives and, possibly, also create the starting point for a LEADER type system initiative.

Turning to administration and implementation, the EU LEADER initiative provides numerous helpful guidelines on the principles of good administration and accountability for a programme of this nature. These issues are not dealt with in detail in this section because we are focused at a broad strategic level and are not attempting to devise programme that is ready to be rolled out. However, one of the weaknesses of this strategic option is that it will require the government to design and administer a complex system that needs to be characterised by decentralisation, flexibility, trust, and efficient decision-making and
bureaucratic procedures. These are areas of competence in which the South African government has substantial weaknesses. It is suggested that this constraint is substantial and cannot be wished away; it requires a strategic response.

Three possible solutions exist. The first would be for the South African government to outsource the running of the system to a third party. The obvious third party, in this instance, would be the EU, itself. This is a viable option given that the EU has committed enormous budgets to South Africa and would probably be open to using some of these funds to cover the salaries of EU personnel or appointed consultants to run such a programme on behalf of the government. Local representation would obviously be required, but, essentially, the systems necessary to operate the model would be developed using third party expertise and funding. Other third parties could be considered, including local private sector companies.

The second option would be for the government to seek out the most competent existing state and parastatal institutions domestically, as suggested by Rodrik, and to place such a programme within this existing structure. Rodrik, for example, rates the Industrial Development Corporation (IDC) quite highly as an organisation but suggests that it needs to refocus its service offering to maximise its potential contribution to the economy. The IDC could, potentially, be a home for such a system; a system of this type would dovetail with the type of activities the Harvard group suggests the IDC should operate.

The third and least preferred strategic option would be for the government to establish a new institution, specifically to administer this programme, and to run it in-house as a direct government programme.

In summary: it is possible to create a strategy which will support the creation of value chain linkage initiatives based on an incremental change approach. While this approach does not allow for systemic change at the level of changing demand behaviour, it does manage to avoid a discrete initiative-based approach by creating a system which will incentivise and support a broad array of initiatives emanating from a wide range of economic actors in virtually any sector. The key points of departure in this system approach are that: (1) initiative identification is taken out of the hands of government directly and places in the hands of local area participants; (2) solutions to dealing with systemic linkage obstacles are not predetermined but lie in the hands of local areas participants; and (3) the system supports these possible solutions to systemic obstacles both financially and by offering services which can be drawn down by LAGs.

The system has numerous advantages and it meets the strategic requirements of internalising catalysation and supporting scalability while minimising the direct role played by government (even in an infertile operating environment). The system does, however, harbour several important disadvantages. The first, and most challenging, concern is that value chain players may not pick up the system or buy into it. In the preferred procurement strategic option, lead firms would, in principle, be able to calculate the potential upside of participation and complete internal calculations as to whether participation would be beneficial to their organisation or not. In addition, in the preferred procurement option, lead firms maintain a position of power and control over the process of upgrading and contracting, even though checks and balances exist to protect small producers. In the systems approach, mainstream economy value chain players and small, marginalised producers are less able to calculate the upside of their participation in the system and are forced into a more participatory process where less direct power vests with the initiative.
driver. Participants in the system will also factor in the risk of administrator interference, hassle factors and inefficiencies even after an initiative qualifies for funding. These three issues may compromise the number and quality of participants who enter the system. The government can do three things to mitigate these risks. Firstly, it will be obliged to run a transparent, efficient system so that participants can overtly factor in administrative risks which will have been minimised. Secondly, the government or system administrators will need to educate potential participants in exactly how the system will operate. This is an activity that is often overlooked in the marketing of governmental incentive schemes and supply side measures. Thirdly, the government may need to initially ‘prime the system.’

Primding the system is antithetical to the entire philosophy of the systems programme being proposed and runs counter to the bottom up approach on which the LEADER system is premised. However, it may be a strategic option which must be considered. Priming the system simply suggests that government provide initial impetus for potential participants to enter the system. This could either be achieved as a once-off, short term initiative or be set up as a long term addendum to the system. Priming the system as a once-off activity could be achieved by government commissioning research into existing initiatives that could be fed into the system. So, for example, various provincial departments are looking into developing and marketing novel or new agricultural products based on traditional products that have fallen by the wayside over the years. Initiatives like the Marula initiative could be placed into the system as could initiatives such as the ComMark/Freshmark standards programme, where Freshmark (a horticultural wholesaler) is actively upgrading small producer standards. Large retail corporate social investment initiative could also offer priming opportunities.

However, if government believed that pick up of the system would be low, it could prime it on an on-going basis by setting up a ‘niche product development centre.’ As mentioned, product segmentation and niche market development are crucial in linking small producers into mainstream economy value chains and ensuring that they earn a reasonable return. If government, using existing resources such as the universities, the CSIR, private sector experts and industry associations, undertook the development of new, novel, trademarked credence or certified products, then they could then pass these onto suitable participants who could establish an appropriate area and LAG to take such schemes forward. Because this approach moves government into the territory of initiative identification, which the strategy does not support, it is suggested that this option only be considered as a last resort.

While ensuring the generation and flow of good initiatives from the system is the first challenge or disadvantage of the proposed system, the second disadvantage is one of even grater concern. Whereas the preferential procurement strategy only provided financial benefit upon success being achieved, the incremental system approach is based on the provision of finance before success is achieved. The majority of the costs incurred by lead firms in the first strategy are sunk costs which are only recouped once preferential procurement has occurred at a particular level. In the systems strategy, there are no sunk costs and the system finances the majority of costs as and when they are incurred. Thereis no guarantee that spending these funds will result in increased purchases of small producer outputs by mainstream economy value chain buyers. The pre-eminent disadvantage of the system strategy is, thus, that it exposes government to greater risk in terms of its return on investment. In relation to this, it is important to return to the Rodrik argument explained earlier in the chapter. Rodrik argues that government can and will make mistakes in operating a strategy of this type. However, he goes on to argue that as long as a process is in
place to ‘let go failures’ when they are identified, then these failures should be viewed as part of the price of achieving success in other initiatives. This mindset change will be crucial if such a system is to be adopted.

Two other disadvantages characterise this systems approach. The first is that it will be harder (although not impossible) to build in protection systems for small producers in their dealings with mainstream economy value chain players. The second is that it requires upfront finance from the fiscus, as opposed to the previous strategy which required limited upfront funding but relied on lower tax collection. This is not as big an impediment as it may seem. It is possible, and reasonable, to suggest the funding of this system approach could be covered by the reallocation of funds from existing SME development initiatives, nationally sponsored LED initiatives, and land restitution support initiatives, among others. Literally hundreds of schemes, programmes and policies are supported by all three spheres of government related to second economy upliftment programmes. Many of these under-perform or fail to spend their budgets. Resources from the worst performing programmes could be reallocated towards this systems approach, thus neutralising the overall effect on the fiscus.

Overall, this systems approach appears less compelling than the preferential procurement approach. Nevertheless, if it is adopted, it can achieve positive results on an incremental basis. Crucial to this success will be:

Administration: the creation of an effective, efficient administrative system that is transparent and predictable and decreases administrative risk to an absolute minimum.

Initial success: success breeds success and the only way to ensure good pick up of the system by large numbers of areas and LAGs on a continuous basis (i.e. reaching scale) is to demonstrate to the ‘market’ that the system works. As such, substantial financing, sharing success stories, letting failures go early, and serious political commitment and resolve are required. This is also an argument in support of some sort of priming activity.

Flexibility: the value of this system is that it is designed to meet the needs of a wide variety of beneficiaries operating in all geographic areas and under taking economic activity within a broad spectrum of sectors. While qualifying initiative criteria must remain rigid to ensure that the system achieves its intended aims, virtually all other aspects of the system should be flexible and dynamic.

Competition: competition for limited funds is crucial in ensuring that only the most feasible initiatives are undertaken, are of a high standard, LAGs operate in a streamlined and efficient basis, and initiative costs are minimised. The absence of quality initiatives competing among themselves for limited funds will result in the system failing to achieve its intended goals.

Multi-pronged approaches

It has been suggested that the two strategies covered in the study are not in fact two ‘either or’ strategies but are complementary. On the real side of the economy, this suggestion is appealing. Introducing both a more localised or sectoral support system and a systemic change system will certainly reinforce the positive outcomes of such a dual pronged strategy. Initiatives arising through the LEADER system would gain impetus by knowing that market access would be improved via the preferential procurement strategy, while the preferential procurement strategy would benefit from having more viable small producers to interact with via the creation of more localised support mechanisms.

The two strategies would reinforce each other and improve real economy activity and opportunities. In addition, implementing both strategies would improve the likelihood of
pick up rates and the success in both options. The difficulty lies in the financing and administration of a dual approach. Both strategies require substantial funding from the fiscus. While it is true that funding both would reduce overall programme risk, it is unlikely that the Treasury would be willing to earmark funds for two such initiatives simultaneously.

A second problem with running both strategies concurrently would be ‘double dipping.’ Lead firms would, in all likelihood, start their relationships with small producers through the LEADER initiative system, as this system exposes them to less upfront investment and risk than if they undertook enterprise development within the preferential procurement system. However, once the bulk of productive capacity and product development has been completed via the LEADER system, lead firms would then switch to the preferential procurement system where they would get a second bite at the cherry to gain a financial incentive for preferential procurement and enterprise development.

As such, the state would run the risk of ‘paying for enterprise development’ twice. It is possible to put in place administrative arrangements to deal with this overlap. An alternative would be to stagger the programmes. In this option, the government potentially could begin with a LEADER initiative system which would operate for a given time and then close off the LEADER programme before moving onto a preferential procurement strategy. By adopting this staggered approach, the LEADER initiative strategy becomes an incubator for small producer development that is taken forward under the preferential procurement strategy.

This staggered option is appealing for a number of reasons. Firstly, the preferential procurement option is highly complex to arrange and will have a substantial lead time for administrators, bureaucrats and Treasury officials to lay the groundwork for its roll out. In this intervening period, a LEADER initiative system could be up and running so as to provide on-the-ground delivery while the preferential procurement strategy is being finalised.

A second appeal of this staggered approach is that the private sector would view this as less risky and more appealing than either of the options in isolation. A third appealing aspect of a staggered approach is that pick up rates in the LEADER programme would, in all likelihood, be higher than in a scenario where the LEADER programme ran in isolation.

As lead firms and their suppliers would only have a given period of time to take advantage of governmental support for such initiatives, and given that they would see these initiatives as incubators for the enterprise development required to be eligible for the financial incentives available from preferential procurement further down the line, pick up rates and, hence, competition between qualifying initiatives would improve.

The reality is quite simple. The more well designed a programme is, the lower the risk to the private sector and the easier it becomes for the private sector to source and develop small suppliers. A complete bundle of companion programmes, LEADER initiative programmes and a preferential procurement programme would deliver the largest impact on the ground.

The decision of what approach is adopted ultimately will depend on political will, political commitment, government capacity and the state’s ability and willingness to fund such programmes and adopt varying degrees of risk exposure.

**Summary and conclusions**

Table 12 summarises the most important aspects of the two proposed strategies. It allows the two to be compared and contrasted, even though they have different goals.
Table 12: Strategic options compared and contrasted

<table>
<thead>
<tr>
<th>Character of strategy</th>
<th>Preferential procurement strategy</th>
<th>LEADER system strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Supports systemic change</td>
<td>Supports development of initiatives and incremental change</td>
</tr>
<tr>
<td>Strategy drivers/clients</td>
<td>Lead firms in the retail sector</td>
<td>Local Action Groups (LAGs)</td>
</tr>
<tr>
<td>Probability of high pick up rate</td>
<td>Higher than LEADER system strategy</td>
<td>Lower than preferred procurement strategy</td>
</tr>
<tr>
<td>Scope of strategy</td>
<td>Narrow</td>
<td>Broad</td>
</tr>
<tr>
<td>Impact on fiscus</td>
<td>Loss of tax revenue; self limiting but exposure is unknown upfront</td>
<td>Direct funding of budget for the system; exposure known</td>
</tr>
<tr>
<td>Reliability of outcomes</td>
<td>Incentive only received upon actual results measured by value of preferred procurement</td>
<td>Incentive available for process and is not based on outcomes achieved</td>
</tr>
<tr>
<td>Capacity demands on government</td>
<td>Lower than LEADER strategy</td>
<td>Higher than preferential procurement strategy</td>
</tr>
<tr>
<td>Diversity of on the ground activity</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Benefit to small producers</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Scalability / reach</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Risk to small producers</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Inclusion of upgrading</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Inclusion of enterprise development</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Inclusion of contracts for small, marginalised producers</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Assurance of reasonable returns for small producers</td>
<td>Maybe</td>
<td>Maybe</td>
</tr>
<tr>
<td>Possibility of companion programmes and support programmes to improve main strategy</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Lifespan of strategy</td>
<td>Limited</td>
<td>On-going</td>
</tr>
</tbody>
</table>

Source: own design
The first point to note is that the actual activities stimulated by the two strategies in terms of small, marginalised producers are identical. This is an *a priori* characteristic as the strategy options were specifically designed to support these activities necessary for a linkage programme.

The differences between the two proposed strategies are most marked in relation to the role of the government, its financial and risk exposure, and the level at which the strategies operate. In the preferential procurement strategy, government does not know upfront its total financial exposure, but the financial cost appears as a loss of revenue rather than a funded budgeted item, and, importantly, bang for the buck is ensured as incentives only kick in once outputs from small producers have been purchased by lead firms. In the LEADER system strategy, government has control over its financial exposure by setting the system budget upfront; however, bang for the buck is not assured as incentives are payable prior to the desired outcomes of the system being realised. Failure to develop a successful linkage in the preferential procurement system is borne by lead firms; failure to develop a successful linkage in the LEADER system is borne by the government.

Furthermore, role of government in the preferential procurement strategy is largely predetermined and its parameters known. The government will be required to offer ongoing support services to bolster linkage activities where lead firms have no competency, but these are discrete and their parameters known. The government in the preferred procurement strategy will not need to set up entirely new institutions or administration mechanisms and ‘administration risk’ is perceived as low. By contrast, the LEADER system places far greater demands on government. Government will be required to set up an entirely new infrastructure and administration system and, while this could be outsourced, the administrative burden and risk of the LEADER strategy is exponentially higher.

Finally, and perhaps most importantly, the preferential procurement strategy supports a systemic shift in the way the South African economy operates so that the system consistently motivates lead firms to change their purchasing behaviour. This creates a fundamental change in how business operates and how the mainstream economy views the marginalised economy. The LEADER strategy does not involve systemic change. It is an incremental change option based on an accumulation of individual initiatives. Hence, it is more of the same, although differently packaged and, perhaps, more effective and focused than existing initiative promotion strategies.

Finally, there are three additional points to make about the criticisms of the study.

The first criticism was that the study had large gaps related to the administration and implementation of the two potential strategies. The reader is reminded that the aim of the study was to provoke debate and catalyse strategic thinking in new or novel ways. Neither of the strategies purports to be a programme which could be implemented on the basis of this study. Rather, they are ideas about how to think about designing future policies and programmes within a strategic framework. In the event that a decision was taken to take either of the strategies forward, a range of follow up work would be required.

The second criticism is that the study makes certain assumptions about the private sector, its capacity, core competencies and how it would respond to either of the strategies. The criticism is that these assumptions may not be accurate and may not apply to all firms. We have a dual response to these criticisms. The first is that the assumption is most probably correct because it is based on the rational economic behaviour of profit-maximising firms in a capitalist economy. However, our second response is that the assumptions about the sector are, to some extent, irrelevant. Government would never develop a programme of work based on the proposed strategies without engaging meaningfully with the private sector beforehand. Rodrik’s thinking related to the public and private sector cooperating strategically to discover opportunities, bottlenecks and potential solutions is taken as given
by the study’s authors and, as such, the strategic suggestions contained in the study would merely act as a starting point for that interaction.

This leads us into the third criticism, namely, that after going to all the effort of identifying the cross-cutting systemic obstacles that small, marginalised producers face when attempting to enter mainstream economy value chains, the strategies fail to address directly these obstacles. Our response is twofold. Firstly, the terms of reference for the study specifically seek to identify systemic resolutions to identified problems. This implies that solutions must be found from within the system and *modus operandi* of current lead firm behaviour. The strategies presented seek to create environments and inducements for private sector value chain participants to address on-the-ground issues of enterprise development, upgrading, contracting, product identification, among others. Moreover, the strategies do not seek to be prescriptive about how the private sector should under take these activities; we leave it to the discretion of the value chain participants who have superior knowledge of these matters. This lack of prescription is seen as an advantage of the proposed strategies.

Our second response to the criticism that the strategies do not directly address the framework table issues is one related to the capacity of government. It was the study’s point of departure that direct governmental intervention should be as limited as possible. It would have been a far easier to develop a strategy based on a traditional, externally catalysed approach to sector based value chain linkages. If this approach had been adopted, all the strategy would have been required to do was to construct mechanisms and channels for government to undertake the list of activities shown in the FAO linkage checklist contained in chapter four. Realistically, however, it would be perverse to assume that government would be able to overcome its delivery and capacity problems. Any governmental limitations would essentially become a constraining factor for the strategy. Given that the strategy aims to operate at scale, it is unlikely that government could undertake a direct programme of linkage work without hitting against considerable constraints.

**CONCLUSIONS**

The birth, growth, maturation and final delivery of this study has been fraught with difficulties at every turn. Even in its final form, the study must still be viewed as a nascent, tentative first step towards thinking about the existing issues related to small producer market participation and poverty reduction in a different light. By approaching this topic from a demand side perspective, by explicitly incorporating issues of power and governance, and by showing the importance of product differentiation, it is hoped that new agenda items have been identified and can be taken forward and debated. We know that there is no silver bullet when dealing with the complex issues of mainstream and marginalised economy linkages in South Africa. New avenues of thought can only assist in the ongoing journey of developing potentially implementable solutions. By seeking solutions at a systemic level, rather than an initiative level, the bar is raised exponentially higher and the agenda items embrace new concerns and issues. Simultaneously, this alternative approach decreases the importance of agenda items which were previously considered imperative. All of which amounts to a highly contentious study.

While we refer to the study as being new and innovative, it is actually based on accepted practices and theories which have been put together in a novel manner. This is important as it ensures that the study is not purely blue-sky thinking, but is something which can be taken further and potentially turned in to programmes on the ground. Recently, a visiting premier,
from a South East Asian country which has grown remarkably over the past 20 years, said in a speech in Johannesburg that South African policymakers need to understand that they do not need to reinvent the wheel. Rather, they need simply to specify the type of tyre and tread that the wheel requires in order for it to work in the local environment. We believe this is sound advice. We hope that our treatment of value chain, linkage and product selection theory and practice amounts to a tyre and tread specification for poverty reduction in South Africa, rather than the creation of a new wheel.

Having said this, we are aware that the suggestions incorporated in (particularly) the strategy section of the study remain highly abstract and broad. In the event that these strategies are picked up, further substantial or additional research and thought will be required. We are aware that gaps exist, that inconsistencies have crept in, and that the approaches raise as many new questions as they answer. This is the very nature of the discovery process of policy development. None of these short comings should mitigate the value of thinking about an old problem in a new way.

Additionally, it is important to remember that all the suggestions contained in this study still amount to only a first step along a journey of changing the power and relationship dynamics between economic players in South Africa. If this first step is successfully taken, new issues will emerge which will then have to be dealt with. This is a dynamic and robust journey and it will morph and change over time as the conditions and power relations alter and bring policy options into play which may not yet be feasible, but which will become feasible over time. A contradictory mixture of patience and drive; steadfastness and flexibility, long term planning and short term delivery, will all be foundation stones of the success of such an endeavour.

BIBLIOGRAPHY


Altenburg, T. (2004). 'Cooperating with the Private Sector in Development Cooperation: Strategic Alliances with Lead Firms in Production Networks’, Annual Conference of Verein fur Socialpolitik, Cologne, July


European Union (2006). Leader Training Manual, Chapters 1 to 9, European Commission, Italy

FAO (2004). Strengthening farm agri business linkages in Africa, Summary results of five country study, AGSF Occasional paper 6, Rome

FAO (2005). Sub Regional Workshop on NGO’s. Farmer Organisations and Agricultural Marketing and Enterprise Development, Kampala, Uganda, July


ILO (2006). Implementing Sustainable Private Sector Development: striving for tangible results for the poor, Annual BDs seminar


Kaplinsky, R. (2000). "Spreading the gains from globalisation: What can be learned from value chain analysis?", Institute of Development Studies, Brighton


Nadvi, K. and Schmitz, H. (eds.) (1999). Industrial Clusters in Developing Countries, Special Issue of World Development, vol. 27, No. 9, September


Rodrik, D. (2003). ‘Interview with Dani Rodrik’, with students from Faculty of Economics of the Universidad de los Andes


Shepherd, A. (2007). Approaches to linking producers to markets, FAO Rural Infrastructure and Agro Industries Division, FAO, Italy


UNIDO (2002). Corporate Social Responsibility: Implications for Small and Medium Enterprises in Developing Countries, Vienna: UNIDO


USAID (2005). Integrating micro and small scale enterprises into productive markets. A discussion paper, micro report 29

USAID (2006). Globalisation and the small firm, micro report 42

USAID (2007). Groups, associations and other horizontal Linkages, briefing paper


Vettas, N. (2007). Market Control and Competition Issues along the commodity value chain, Proceedings of the FAO Workshop on Governance, Coordination and distribution along commodity value chains


Socio-economic development of the stone sector in rural areas

Project context

The four municipalities covered by the LAG Au Fil de la Pierre are Bertrix, Herbeumont, Libin and Saint-Hubert, which are all rural areas characterised by extensive woodlands, and are located in the middle of the Ardennes. This area is very much favoured by tourists because of its natural sites and walks in the valleys of the Rivers Semois, Lesse and Lhomme. Together, the four municipalities have rich natural resources that are very important for the region’s development.

Now, as in the past, the mineral resources are utilised in a wide range of ways by local communities. The use of stone has always had an important impact on the socio-economic and cultural development of the region. Cultural and artistic activities have been developed on the basis of the stone industry and have largely contributed to employment creation and the enhancement of the attractiveness of the region. Stone resources include schist in Bertrix and Herbeumont, kaolin (Cornish stone) in Libin, and sandstone and limestone in Saint-Hubert.

The local strategy builds on the collective historical traditions centred on the stone industry. The strategy includes promotional and pedagogical activities on the basis of the geological heritage, the history of stone, its exploitation and transformation, the development of the utilisation of stone for urban and architectural purposes, and the promotion of the use of stone in the construction and tourism industries.

Facts about the territory

- Population: 19,545 inhabitants
- Surface area: 448 km²
- Population density: 42 inhabitants/km²
- Number of municipalities: 4
who are managing individual projects independently of one another, resulting in a lack of links and synergies between their activities. SMEs generally do not have access to specialised information or professional training, do not communicate with one another and do not carry out joint promotional activities. At the same time, these dynamic SMEs have the potential to create employment opportunities in the local area.

Therefore, this project aims to develop the local socio-economic situation, through:

- the creation of synergies, links and exchange of information and experience among the professionals of the stone industry and other socio-economic actors in the region;
- the development of entrepreneurship in the stone industry, which is of importance in the local area;
- the setting-up of an 'integration network' in the stone industry (through provision of training, improvement of existing activities, socio-professional reintegration, etc.).

2. Main activities

The main activities of the project include:

- providing entrepreneurial tools and knowledge, assisting existing and new enterprises in improving/developing their production through access to specialised information; diversification; developing new skills in order to create new projects and products, and creating a favourable environment for the promotion of new job opportunities for local people (including women and young people):
  - for this purpose, a range of conferences and thematic debates are organised, and personalised services are provided to enterprises, and specific training modules are developed with the participation of IPES (Institut Provincial d’Enseignement Secondaire), employer organisations, the unemployed, workers and employees of SMEs;

- promoting activities about the stone (highlighting its utilisation, knowledge and skills of enterprises and local artists of the industry), the development of a directory, which presents the products of local enterprises, various stone products and materials and their variable use; participation at fairs and exhibitions;
- organisation of training visits and information meetings for builders, architects, etc. on the materials and their main characteristics, their assets, and their technical and architectural features;
- setting up a stone industry network in order to identify complementarities among the various local activities;
- offering specialised training responding to the specific training needs of the enterprises, in line with the special characteristics of the local market and area.

3. Concrete outputs and results

As a result of the project, local enterprises will be provided with tools to improve their competitiveness. The project is expected:

- to create a favourable environment for maintaining and creating new job opportunities in the region, consolidating existing employment opportunities, and creating new opportunities for the target groups, in particular for women and young people;
- to increase the turnover of local enterprises by developing new activities and products;
- to increase the number of enterprises.

4. Problems encountered/lessons learnt

The project has not encountered any major difficulties. The activities are in line with the needs and expectations of the industry and the various socio-economic actors in the area.
Honey processing and standardisation unit

Project context

The island of Leros is part of the 12 major Dodecanese islands along the coast of Turkey, south-east of the Greek mainland. It is located in the north-western part of the archipelago, between the islands of Patmos and Kalymnos. The island has many hills and low mountains and has one of Europe’s richest varieties of flowers. The island has a mild and pleasant climate without great fluctuations and has a varied landscape, clean waters, stunning beaches, large bays and a very attractive capital.

Although the fishing sector is relatively developed, the geology of the island and absence of significant water resources limit agricultural development, particularly in the summer months. The hospital for mental illness is an

Facts about the territory

- Population: 97,520 inhabitants
- Surface area: 2,511 km²
- Population density: 39 inhabitants/km²
- Number of municipalities: 23
important employer in the area; however, recently, the number of patients has decreased. Since Leros is host to a mental hospital for the most intractable psychiatric cases, an asylum for mentally handicapped children and a military base, it is not the archetypal Greek island, although it has recently become a base for sailing trips to the coast of Turkey and the other Dodecanese islands.

The main focus of the territorial cooperation project has been to add value to the local products (i.e., honey), and make best use of the endogenous resources of the island. The project has tried to provide employment and income to an excluded group of local people, it has built on equal opportunities and has enhanced social cohesion by creating links between the local population (many of whom are working in the hospital) and the psychiatric patients.

Why is this project good practice?

The project has had an area-based approach, since the initiative has built on endogenous resources. The area’s profile has been enhanced by supporting local producers, improving the quality and marketing of their products and developing local human resources. The initiative has created jobs for people with psychosocial difficulties.

This bottom-up project was initiated by the honey farmers of Leros. They needed to add value to their raw product through processing, quality control and marketing, but had neither the time nor facilities. They approached the Koi S.P.E. cooperative, which buys their honey and undertakes the processing and certification.

The project has also followed a strong partnership approach. The Ando LAG had an essential role in the development of the project. It assisted KoiS.P.E. (the project sponsor) in the development of ideas, identified a company to assess the characteristics of the honey produced and determined how producers could access certification. Koi S.P.E. members knew little about product quality or marketing opportunities outside the island.

The initiative has managed to improve the operation of the local mental hospital in an innovative way. The project has successfully combined the development of local products with support provided for psychiatric patients, which has been a unique approach.

Furthermore, the project has demonstrated a strong networking and cooperation approach, as it has brought together a wide range of actors (i.e., local honey producers, the state mental hospital and psychiatric patients) for the benefit of all. This has strengthened networking activity on the island of Leros, particularly amongst honey farmers. At the same time, efforts have been made to link the relevant stakeholders from outside the island in order to establish quality certification and improve market access.

Project description

1. Brief history of the project

The project has represented a new pathway to social inclusion for people with psychosocial disabilities and has served both therapeutic and business purposes.

In 1958, the Greek Government established the Leros State Mental Hospital. The hospital had been lagging behind compared with other European hospitals until its reform in 1990, which aimed at improving services in psychiatry. The reform, however, led to the reduction in the number of psychiatric patients.

In 1999, the Greek Government established a legal framework in support of social cooperatives as part of the general mental health reform programme.

The decline in employment on Leros, following the reduction in numbers of psychiatric patients at the Leros state mental hospital, and the desire to find ways of sustaining the recovery of the psychiatric patients led to
the formation of the cooperative KoI.S.P.E. in 2002. Some of the founding members were employees (occupational therapists) of the hospital who wished to extend the scope of therapy by responding to the needs of the patients as they recovered. KoI.S.P.E. began therapeutic activities in agriculture and catering and established contacts with the honey producers’ association of Leros. The island has an abundant amount of premium quality thyme honey, but local producers were unable to organise and afford standardisation, packaging and distribution of the product. The social cooperative together with the honey producers’ association set up the honey processing unit. The honey producers supply the cooperative with honey for a certain price and KoI.S.P.E. processes it according to European hygiene standards (HACCP) and brings it to the market.

Members can be persons with psychosocial disabilities, employees in the mental health sector and other natural persons or organisations. A balance must be established between the business strategy and social targets in order to ensure the future growth and the viability of the new venture. With a membership of 450 and with 40 employees, the cooperative has a firm base with which to extend its activities.

2. Main activities

A honey processing and standardisation unit has been created by the KoI.S.P.E. social cooperative for people with psychosocial disabilities on the island of Leros. The project’s main activities were:

- promotion of KoI.S.P.E. and other social partnerships;
- local honey producers and the whole local economy being supported and introduced into new activities; two new young farmers have already started honey producing activity;
- a new occupation being created for people with psychosocial disabilities;
- increase in and guarantee of quality of the honey (HACCP certification);
- the project being put forward for a national award;
- the competitiveness of the local economy being improved;
- inequalities being reduced by providing quality employment for a disadvantaged group.

4. Problems encountered/ lessons learnt

Problems encountered

Initially, there were difficulties in gaining local support for the cooperative as it was seen as a ‘socialist’ initiative by the conservatives who controlled local politics at the time. They acted only within their legal responsibilities, and did not provide all the support needed.

In addition, the founders of the cooperative were occupational therapists and not business people. They first had to develop new business skills and needed support to learn about rules, priorities and quality standards. It also proved challenging to coordinate the demands for therapy and business. At the same time, exploring markets outside Leros also proved to be a challenge, partly because of the island’s geographical isolation, and partly because of a lack of knowledge of marketing.

Lessons learnt

It is important to seek expert help when embarking on unfamiliar territory, for example specialised help from the LAG regarding quality standards and marketing advice.

5. The ‘Leader+ added value’ of the project

Leader+ provided a framework for development and support that was in line with the social and business aims of the KoI.S.P.E. cooperative, at a time when it was difficult to find the same support from other local institutions. The LAG helped with establishing contacts and provided the necessary expertise without which the project would not have been realised. The use of Leader+ funding to raise
the level of Koi.S.P.E.'s activities in honey processing and related activities has strengthened the local organisation and developed its expertise in management and its ability to concentrate and develop local indigenous resources.

6. Duration

The project’s duration was one year and eight months. It started in May 2004 and ran until December 2005.

7. Budget

The total budget for the project was EUR 45,730, of which EUR 22,850 was from the EAGGF, EUR 6,885 from national public funding and EUR 15,995 from private resources.
OVERVIEW OF RESEARCH

The review of second economy programmes: An overview for the Presidency’s fifteen year review – Kate Philip and E Hassen

Addressing inequality and economic marginalisation: A strategic framework – Kate Philip

Inequality and economic marginalisation

Inequality, unemployment and poverty in South Africa – Fiona Tregenna and Mfanafuthi Tsela

Income and non-income inequality in post-apartheid South Africa: What are the drivers and possible policy interventions? – Haroon Bhorat, Carlene van der Westhuizen and Toughedah Jacobs (DPRU)

How the structure of the economy impacts on opportunities on the margins – Kate Philip

Asset inequality – Ebrahim-Khalil Hassen

Economic development strategies

Energy-based poverty indicators: Meeting AsgiSA targets – Claire Vermaak, Marcel Kohler and Bruce Rhodes

The fisheries sector – Expanding economic opportunities through regulatory change – Feike

Potential for a South African aquaculture industry on the Northern Cape’s Namaqualand Coast – Feike

Labour markets

Employment intermediation for unskilled and low-skilled work seekers Part 1: Overview – NB Ideas, with Strategies for Change and Indego Consulting

Employment intermediation for unskilled and low-skilled work seekers Part 11: Case studies – NB Ideas with Strategies for Change and Indego Consulting

Local labour placement project: Overstrand Municipality – Overstrand Municipality

Understanding inequality: Promoting equity – Paul Benjamin and Nicole Yazbek

Identifying appropriate interventions to support the transition from schooling to the workplace – Miriam Altman (HSRC) and Carmel Marock (Singizi Consulting)

Small enterprise development and the informal sector

Missing the target: Business support to the second economy – Lochner Marais

Hands-on Fish Farmers Cooperative Ltd: A case study – Jacqui Boulle

Business health check: Western Cape Bus Operators’ Transport Cooperative Ltd (Siyakhula) – Karen Harrison

Clothing traders in Gauteng: Motivations, barriers and macroeconomic linkages – CSID

Linking small and marginalised producers to external markets: New ideas for demand-side measures using value chain analysis – Sandy Lowitt

Linking small marginalised producers to modern markets: Are we trying to fit a square peg in a round hole? – Sandy Lowitt
Mediating from the margins: The role of intermediaries in facilitating participation in formal markets by poor producers and users – Marlese von Broembsen

**Rural sector**

Making markets work for people and the environment: Employment creation from payment for eco-systems services – James Blignaut, Christo Marais, Mathieu Rouget, Myles Mander, Jane Turpie, Thami Klassen and Guy Preston

Strategies to support South African smallholders as a contribution to government’s second economy strategy Volume 1: Situation analysis, fieldwork findings, and main conclusions – PLAAS

Strategies to support South African smallholders as a contribution to government’s second economy strategy Volume 2: Case studies – PLAAS

Review of the Eastern Cape’s Siyakhula/Massive maize project – Norma Tregurtha

**Urban development**

Creating access to economic opportunities in small and medium-sized towns – Doreen Atkinson (for Urban LandMark)

The state of land use management in South Africa – Sarah Charlton (for Urban LandMark)

Emergency relief in informal settlements: Proposals for action – Mark Misselhorn and Tanya Zack (for Urban LandMark)

Transport and the urban poor – Mathetha Mokonyama (for Urban LandMark)

Strengthening the impacts of economic development strategies on urban poverty – Glen Robbins (for Urban LandMark)

Access to services for poor people in urban areas – CSIR (for Urban LandMark)

Development of the urban development component for a second economy strategy: Overview analysis – Urban LandMark

How tenure security can increase access to economic opportunities for poor people – Lauren Royston (for Urban LandMark)

Challenges of inclusive cities: Making urban spaces and places for all – Nisa Mammon, Kathryn Ewing and Jody Patterson (for Urban Landmark)

Governance and governability: What are the challenges for an inclusive city – Monty Narsoo (for Urban Landmark)

THIS RESEARCH IS AVAILABLE ON THE TIPS WEBSITE

www.tips.org.za