The impact of creating backward and forward linkages between lead firms and SMEs in conflict settings

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Question

What is the impact of lead firms (large or medium processing firms) on small/micro enterprises, smallholders and farmers in Afghanistan and other conflict-affected states?

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1. Summary

This rapid review synthesises the literature from academic, policy, and knowledge institution sources on the effects of lead firm-SME linkages in low- and middle-income countries (LMICs). The review focuses, where the literature is available, on evidence from countries in conflict settings. It focuses mainly on a Business-to-Business top-down approach and intermediary approach, because these initiatives focus particularly on the lead firms as the pro-active drivers for the creation of backward and forward linkages and/or partnerships with SMEs and/or smallholder farmers (for contract farming). Several specific country and case studies are mentioned in the Appendix.

An important conclusion from the literature is that there is abundance of research on SME development in LMICs, however, the literature on linkages between SMEs and large businesses is dominated by theoretical and conceptual papers outlining the benefits (and disadvantages) for SMEs of linking with large businesses. Only few empirical papers exist on the subject, mainly by gathering the data from the side of large firms. No empirical evidence could be found related to these linkages in conflict settings. The assumption is often that by linking with large businesses, SMEs can potentially gain access to technologies, markets, inputs, and knowledge that would not have been available had they operate on their own or only with fellow SMEs. The literature on SMEs mentions horizontal and vertical linkages that could link large firms (lead firms) - SMEs with each other, of which the first is less studied (Canare et al., 2017).

What does the literature tell us about the impact in the context of conflict?

- In the case of conflict-affected countries, lead firms can fuel conflicts because they have elite-ties with government or militias who exploit the conflict for their own economic gain.
- Empirical research on positive spill-overs of foreign investors and multinational corporations is clear that the presence of ‘threshold externalities’ limits positive spill-over effects to SMEs in low-income countries, particularly low-income conflict affected countries.
- Economic literature identifies technology and knowledge transfers as the most important channel through which foreign corporate presence generates horizontal and vertical spill-overs.
- The success of many SMEs in fragile and conflict settings hinges on their ability to rely on personal and social networks, as well as on arrangements with non-state governance actors (e.g. traditional leaders or insurgent groups), rather than on formal institutions (Hoffman & Lange, 2016).
- Many SMEs operating in places of insecurity and high risk deliberately deploy coping strategies rather than realising their growth potential (Hoffman & Lange, 2016).
- The literature shows that higher risk levels and less trust damage horizontal and vertical linkages within the agri-food supply chain.
- Smallholders face difficulties becoming part of upgraded value chains, often because few upgraded value chains exist in countries with conflicts or because specific farmer groups are blocked from access to these chains.

In general, the literature on lead firm-SME linkages comes to the following conclusions:
Dairy, livestock, and food crop (vegetables and fruits) linkage programmes are most likely to be publicly-supported (e.g. focus on bottom-up and/or enabling environment), where private sector-led linkage initiatives are mainly in place for cash crops (cocoa and coffee are common for PPP and lead firm initiatives) (World Bank Group, 2018).

Publicly led programmes (mainly bottom-up approaches) tend to focus on higher levels of processing at SMEs in an effort to increase investment in greater value-added processing capabilities in developing economies. Privately led initiatives and PPPs tend to focus on quality, improving raw material collection and other agro-processing activities (World Bank Group, 2018).

Local SME suppliers benefit from information and technology transfer from the lead firm.

SMEs can contribute to partnerships with foreign lead firms with their often better understanding of the local market.

It is important to mention that the literature, although generally positive about the impact, also mentions that the effect of lead firm partnerships with SMEs are not all positive and not without risk. It is usually the smaller firm that bears the greater risk. These risks could be due to the difference in resources available to the small and large partner and to the development of trust and commitment.

There are also constraints from the side of lead firms, namely: 1) being part of a business linkage programmes require internal commitments of many years involving significant resources, technology, and persistence; 2) lead firms may have difficulty selecting potential SME partners without accurate information that can be used to evaluate their performance and reduce the risks of working with them.

A supportive enabling environment, is a critical foundation for encouraging business linkages between lead firms and SMEs. Governments can address these issue. Particularly, government should focus on connecting different companies through information dissemination and competent delivery of basic services (Botelho & Bourguignon, 2011).

Therefore, it is recommended for any form of lead firm-SME linkage initiative to seek improvements in the enabling environment.

Smallholder farmers are increasingly linked to formal markets (commercialisation pathways) that often include lead firms. These linkages are often contractual arrangements between the producer and the buyer. Evidence on the impact of contract and lease farming suggests:

- The World Bank Group’s (2016) experience in Latin America showed that establishing horizontal alliances is often a prerequisite for successfully integrating smallholder producers into markets and vertical alliances with buyers.
- The success of a vertical alliance is not necessarily guaranteed by a pro forma commercial agreement between producers and buyers, but rather by the commitment of both alliance partners to implement the business plan (World Bank Group, 2016).
- Contract farming (top-down buyer-driven organisations) enjoys increasing importance since more sophisticated value chains require a high degree of coordination between producers and buyers.
- Contract farming respond more quickly to changing market conditions due the formalised quality control system, the close relation to the international market, and the
possibility to employ their extension system to introduce new standards that can include new technologies such as new varieties, new fertilisers or pesticides.

- The formal quality monitoring system can also quickly control the adoption of new standards by all group members.

- The development of financial measures or leasing products together with financial institutions can enable members to invest in small-scale production facilities such as drip irrigation, green houses or polyethylene tunnels, which will enable the groups to improve the quality of their produce.

- However, contract farming lacks the desired technical staff that are able to identify alternative markets and buyers for their members in case the existing market channel is not able to absorb all the produce provided by the group members.

- For investors, contract farming arrangements reduce both transaction costs and coordination costs. Through production and marketing agreements, investors are able to gain access to a regular supply of products, which meets some prescribed quality standards.

2. Framing the debate on ‘Lead firm-SME linkages’

Lead firm linkages with SMEs

Development organisations are increasingly using a market-driven approach to spur growth of Small- and Medium-sized Enterprises (SMEs) by facilitating linkages to lead/anchor firms in challenging development contexts. Recent literature on development refers often to ‘lead firms’ or ‘inclusive business’, while often the literature prefers the word ‘anchor’ to refer to important (semi)public institutions and their role to link with local SMEs (e.g. large hospitals and universities, described as ‘anchor institutions’).\(^1\) This rapid review will use the term lead firm.

Research on the impact of backward and forward linkages and partnerships between lead firms and SMEs is part of the academic debate on value chain development, and particularly relates to:

- **Inclusive Business:** Inclusive business models look at the base of the pyramid from two angles: first as clients for services and products, and second as suppliers for raw materials, processed materials and services. Lead firms are businesses that make use of inclusive business models to improve and maintain linkages in their supply chains with SMEs (e.g. Farinelli, 2016; Kelly et al., 2015).

- **Industrial clusters:** To create more efficient food supply chains, coordination among chain actors could affect shared goals and might include shared infrastructure in corridors, zones, or parks. By working in a cluster investment in infrastructure, access to financial services and information, capacity building and investment in innovation and entrepreneurship become more efficient. Therefore, lead firms are often part of a broader industrial cluster, zone or park (e.g. USAID, 2008).

Although lead firms can be domestic, regional or global, in research there is a separate debate on multinational corporations and/or Foreign Direct Investment (FDI) and their backward and

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\(^1\) Based on the observation of the author.
forward linkages in value chains (be it within an industrial cluster or on itself) with SMEs and the impacts on these local enterprises (van Tulder & Da Rosa, 2014).

The World Bank Group (2018, p.6) describes ‘lead firm–SME linkages’ in the agrifood sector as “relationships between large companies (lead firms) and SMEs with agro-processing capacity in which the role of the lead firm is to create a mutually beneficial supply chain structure to penetrate new markets, expand market share, or increase profitability.” Normally, these linkages develop naturally, however, in many low-income countries, and in particular, in conflict-affected countries, there are many obstacles to these linkages. For example, SMEs may not have the knowledge, technology, or capacity to contribute agro-processed products to the lead firm’s supply chain in a cost-efficient way or to adhere to quality standards (World Bank Group, 2018). Supply chain risks and constraints such as logistics gaps, poor infrastructure, poor communications, a restrictive enabling environment, and lack of finance can stifle a lead firm’s attempts to link with SMEs in developing countries (World Bank Group, 2018).

When linkages between lead firms and agro-processing SMEs do not occur naturally, the public sector or international donors may wish to encourage the formation of successful linkage initiatives. This engagement in facilitation of these linkages has two main motivations (World Bank Group, 2018):

- **Development practitioners increasingly identify the growth of the agro-processing sector as a way to achieve sustainable economic growth.** The global trend of increasing demand for processed agricultural products has led to growth of agro-processing sectors and offers competitive opportunities for SMEs in new, growing markets (e.g. Reardon et al., 2018).
- **These linkages can be fast, effective ways to improve domestic practices, stimulate agro-processing firm capacity, and expand crop production.** This is based on the agro-processing sector’s potential to create on- and off-farm employment and demand-pull for agricultural production and associated inputs and for support services (e.g. Allen et al., 2018). An internationally competitive agro-processing sector also contributes to more-efficient use of resources and improves food safety.

Based on the literature, support for lead firm-SME linkages is divided between different approaches, each focussing on a different driver:

- **Business-to-Business top-down approach:** Support is channelled through the demands of a lead firm in their efforts to build linkages with SMEs and/or smallholder farmers. Initiatives work backwards in the chain to build the capacity of SMEs to fulfil the needs of lead firms, often within the construction of Public Private Partnerships (PPPs).
- **Business-to-Business bottom-up approach:** Support is tailored through the demands of SMEs as they lack capacity to work with larger corporations. These initiatives often focus on nascent industries and may be implemented in preparation for a top-down initiative. Most bottom-up initiatives are publicly managed.
- **Intermediary approach:** Support is directed to intermediaries that broker a linkage between a lead firm and a group of SMEs. Intermediaries can be consultancy organisations, civil society organisations and producer organisations. This approach is often part of a PPP construction.
- **Industry-wide or enabling environment approach:** Initiatives that promote broader competitiveness in value chains. They are often a combination of top-down and bottom-up initiatives, and business-enabling environment reforms. They are mainly publicly managed.
• **Anchor institution approach:** Support is channelled through important local public institutions, like universities, which create linkages with local SMEs and smallholder farmers to provide services and products. These public or semi-public institutions are often part of a wider industrial cluster, where they could cooperate with lead firms.

This rapid review focuses mainly on the Business-to-Business top-down approach and intermediary approach, because these initiatives focus particularly on the lead firms as the proactive drivers for the creation of backward and forward linkages and/or partnerships with SMEs and/or smallholder farmers.

**The link with the debate on SME development**

Although lead firms could be defined as the drivers to integrate SMEs in (formal/global) value chains, there is little literature on the precise impacts of these linkages on SMEs in developing countries, particularly in relation with conflict affected countries. Canare et al. (2017) showed that the literature on linkages between SMEs and large businesses is dominated by theoretical and conceptual papers outlining the benefits (and disadvantages) for SMEs of linking with large businesses. Only few empirical papers exist on the subject, mainly by gathering the data from the side of large firms (e.g. Ndemo & Smallbone, 2015).

There is abundance of literature on SME development in low-and-middle-income countries (LMICs) of which some relates to the integration within value chains and even less to linkages with larger companies (lead firms). The majority of the literature identified the causes of inefficiencies of SMEs, including access to finance (Harvie et al., 2013; Chittithaworn et al., 2011), access to technology (ADB, 2015), market access (Rogerson, 2013), capacity to compete with larger firms, disruptive regulations (World Bank & IFC, 2013), and lack of entrepreneurial orientation or human capital for the entrepreneur-owner (ADB, 2015).

Often mentioned are the challenges of large business SME clients as they require certain quality certifications. Also mentioned is that large firm buyers have strong bargaining power; SMEs may not be equipped enough to cope with this bargaining power, and, in particular, not be able to dictate the payment terms. For smaller, less capitalised businesses, this could adversely affect their working capital as revenues are not quick to appear. Canare et al. (2017, p.5) summarised it as follow: “Because SMEs are not as highly-capitalised and not as connected to value chains as large businesses, they do not have as much access to inputs, technology, and networks that can make them more efficient and productive.” Such constraints can be linked to the causes why SMEs struggle to naturally develop linkages with larger firms.

Recognising the disadvantages, the literature also provides enablers on how SMEs can improve productivity, grow, and develop. Among these factors are linking them to global value chains, building owner’s management skills and human capital, business networking and getting external advice, building a better regulatory environment, raising awareness among SMEs on linkages, financing, and other opportunities, giving them access to digital platforms or market places such as e-commerce, and other interventions that can help SMEs adapt to or counter the effects of the causes of inefficiencies (Canare et al., 2017). The literature also identifies another contributor to overcoming challenges and disadvantages for SMEs - that relates to all the enablers already mentioned above: linkages with large businesses (Ndemo & Smallbone, 2015). By linking with large businesses, SMEs can potentially gain access to technologies, markets, inputs, and knowledge that would not have been available had they operate on their own or only with fellow SMEs.
The literature on SMEs mentions two types of large firms (lead firms) - SMEs linkages, of which the first is less studied (Canare et al., 2017):

- **Linkages through competition (horizontal linkages):** Large competitors increase the pressure on SMEs to improve their products and services, production processes, and distribution. SMEs will try to imitate their large competitors’ practices.

- **Forward and backward linkages (vertical linkages):** SMEs can serve as supplier (e.g. sub-contractors) or be outsourced by large businesses. Large firms can also serve as suppliers of inputs for SMEs. These backward linkages with large firms can range from basic supplies to leasing of machinery and equipment.

Often part of forward and backward linkages, but not necessarily, SMEs could benefit from large business provision of resources needed to commercialise the small firm’s technology. Mostly, the linkages are based on contractual arrangements between or among firms. Next to sub-contracting and outsourcing, this also includes contractual arrangements for granting a license to manufacture a product, joint venture, strategic alliance, and consortium (Canare et al., 2017). These partnerships between SMEs and large firms are typically industry-specific and involves production and marketing chains. Especially for sub-contracting and outsourcing, it involves a lead firm (the large business) and one or more ancillary firms (the SMEs), wherein the former depends on the latter for timely service delivery while the latter depends on the former for payments (Canare et al., 2017). Furthermore, SMEs can link with large firms through industrial clusters and networks such as production networks.

**Box 1. Example of lead firm-SME linkage initiative in Afghanistan’s dry fruit sector**

Afghanistan is seeking to maximise the potential of raisins to resurge as an export commodity through private sector participation. The lead firm Rikweda is being developed with the support of IFC’s working capital financing and advisory services for a total investment of up to US$3 million and MIGA’s guarantees to cover up to US$7.8 million to cover equity investments and loan guarantees. IFC and MIGA’s interventions are made commercially viable despite the high risks involved in the investment by innovatively using blended finance solutions. The Rikweda investments are linked to IDA’s National Horticultural and Livestock Project (NHLP) with their support of US$190 million. The objective of NHLP is to introduce new agricultural practices and help farmers enhance their productivity levels and comply with international standards.

A large number of raisin drying houses are being constructed—owned by farmers who will eventually be integrated into the supply chain of Rikweda. IFC’s involvement went beyond providing affordable financing by sharing industry comprehensive guidance to the client ranging from advising on plant and storage capacity designs, recruiting a financial and operational management team, to brokering negotiations with potential buyers in potential export markets. MIGA’s involvement in the project provides Rikweda with strong and long-term reassurance of business continuity in such a fragile business environment and helps them reach financial closing.

The objective is that via lead firm Rikweda the country’s raisin processing capacity will be doubled and improving quality by implementing modern processing technology and food safety practices. Local raisin farmers will gain access to global export markets, which will support sustainable livelihoods for close to 3,000 rural smallholder farmers. The project is expected to raise selling prices for raisin farmers in the region by 15-20% compared to current market prices by ensuring uninterrupted sales and eliminating intermediaries in the procurement.

3. Private sector development in conflict settings

No empirical studies or research reviews could be found that focus only on lead firm-SME linkages specific for conflict settings. However, many conclusions from research in conflict affected countries on private sector development, economic transformation, spill-over effects of Foreign Direct Investment (FDI) and SME development, contain valuable information that gives, to some extent, insights to these linkages.

In the context of economic transformation

McKechnie et al. (2018) show some characteristics that show the struggle of conflict-affected countries to transform their economies into open, more efficient markets that attract investment:

- The economies of conflict-affected states have, on average, a higher proportion of employment within the agriculture sector, and lower rates of change out of agriculture production and into higher-value manufacturing and services. In 2016, countries transitioning from conflict had twice the proportion of employment in agriculture as those with limited conflict.
- Conflict can significantly affect the distribution of production across sectors and vice versa. At the conclusion of a conflict, it is the construction sector that tends to grow fastest for the first few years, followed by transport and telecommunications and mining. Manufacturing tends to grow more slowly, and takes on average five years to catch up with the others.
- Apart from mobile telecommunications, early recovery and growth are heavily influenced by the public sector and foreign aid, but far less by the private sector. Foreign aid tends to increase rapidly and substantially at the conclusion of a conflict before returning to close to normal levels a few years later.
- Economic transformation is generally associated with export diversification, increased domestic value addition in exports and upgrading in value chains. In general, countries with limited conflict have the lowest export concentration scores, suggesting more diverse export composition, whereas states transitioning from or currently experiencing severe violent conflict have the highest export concentration scores.
- Conflict-affected countries are less productive on average than non-fragile states. GDP per capita (constant 2010 US$) in states with limited conflict is almost five times greater than states transitioning from conflict. Despite a low base, states in transition have also recorded lower growth rates.

Key factors that explain why conflict-affected countries struggle to transform their economies are well-known in literature, namely pervasive insecurity, governance inefficiency and inadequate infrastructures (hard and soft). In regard to firms, some very different dynamics are also at play. Local firms in conflict settings are typically elite-owned and can only survive with informal relations with government or armed groups (McKenchie et al., 2018). When there is armed conflict or a risk of criminal violence or expropriation of property, firms seek protection from armed groups, or armed groups themselves are heavily involved in business ventures. In general, governments in conflict-affected countries seek to manage a market for loyalty that depends on an invisible political budget to grant favours to potential spoilers (de Waal, 2015). “Under these conditions, it may be unrealistic to expect the government to be a facilitator of business activity”, concluded McKenchie et al. (2018, p.).

McKechnie et al. (2018) go into more detail with two key issues related to private sector development in conflict settings:
1. **Meso-level or sectoral deficiencies that constrain inter-sectoral and inter-firm activity, which sets back productivity and growth:**

Experience from Asian countries show that institutional capacity is required to implement structural policies, and to fulfill the state’s coordination function to spur economic transformation. Many conflict-affected countries lack such capacity and focus instead on **investment promotion agencies**; ‘one-stop-shops’ to resolve coordination issues, and to streamline state–investor relations. However, these have been used to promote FDI rather than local businesses seeking to invest and expand. **Industrial parks** have also been used as a solution to the problems created by lack of security, inadequate infrastructure, and land availability in post-conflict countries where land records are unreliable. Overall, finding a first mover willing to accept high risks without perpetuating economic rents is difficult in conflict settings, despite potentially high profits. One strategy is that external partners provide **seeding assistance** to establish business associations that deepen rather than distort markets and facilitate linkages with similar organisations in other countries (McKechnie et al., 2018).

2. **Micro-level characteristics of firms in fragile contexts that constrain their productivity and contribution to economic transformation:**

Economic transformation depends not just on the enabling environment, but also on how firms themselves are able to modernise. Although there is not yet enough supporting evidence, it is often assumed in the literature that actions by governments and partners that affect firms’ incentives and support **in-firm capacity-building** (e.g. in lead firms) – for example: management skills, accounting systems, and corporate governance could have significant payback in terms of productivity and growth of these firms, particularly in conflict-affected countries, if taken to scale. One indicator why it is important to increase in-firm capacity in lead firms is that **management and leadership practices** are strongly linked to the level of development. Large firms tend to be better managed than small firms, since their product market has allocated a greater share to them, and they are more able to employ professionals in management and operations and to implement modern management systems. However, size alone is not necessarily beneficial to productivity if it leads to overconcentration of ownership, lack of competition and rent extraction through political connections. In low-income and conflict-affected countries, there may be strong pressures from incumbent firms and their political patrons to restrict new entrants and to monopolise trade using the powers of government officials and informal power-holders and militias, which affect economic transformation and competitive private sector development (McKechnie et al., 2018).

**The spill-overs of FDI and multinational enterprises (MNEs) for SMEs in conflict regions**

The overall belief that FDI is good for economic growth, employment and capital accumulation in LMIcs rather comes from theory than what the evidence shows. In macroeconomic theory, FDI helps host countries integrate into the world economy, as foreign firms are engaged in exporting and use their global sales and supply networks, and, thus, stimulates trade in the long-run. At the microeconomic level, the theory shows that FDI can benefit local suppliers directly through increased demand for intermediates, thus raising their output, profits, and possibly investments and labour demand. FDI can also give local producers access to cheaper, higher quality, and more reliable inputs (Farole & Winkler, 2014).
However, empirical evidence has suggested otherwise. Capital from foreign investors was found not to flow from rich to poor countries, but rather from poor countries to the rich (Gourinchas & Jeanne, 2013). Evidence also shows that FDI tends to lead to an upsurge in imports, in particular for investors clustered in Special Economic Zones, which can only be gradually reduced after local companies acquire the skills to serve as subcontractors to the entrant corporation (OECD, 2002). Also, the literature shows that there is evidence that positive effects of FDI are for a large part mitigated by a "crowding out" of domestic investment (Farole & Winkler, 2014). What is less clear from the literature is whether FDI is inherently more important than alternative types of investment, specifically domestic investment. Some studies even find that the net contribution of FDI to economic growth is lower than that of domestic investment (e.g. Tang et al, 2008, for China).

In the case of conflict-affected countries, foreign investors or multinationals who do business in these countries (e.g. brewery, telecom or mining corporations) can fuel conflicts by cooperating with local businesses that have elite-ties with government or militias who exploit the conflict for their own economic gain (see Box 2). It is important that foreign investors and MNEs understand the complexities of the conflict by working with local businesses (Oetzel & Miklian, 2017).

**Box 2. Business linkages and potential risk of becoming an actor in local conflicts**

Heineken bought the DRC local beer brand Bralima back in the 1960s. It uses local SMEs and smallholder farmers in the value chain. However, being active in the conflict region, makes them vulnerable for informal rebel checkpoints, which are primary sources of revenue for rebels placed on nearly all rural roads throughout the country. The company pays over US$1 million per year to such groups (Miklian and Schouten, 2013).

These checkpoints served as a significant source of funding for M23, which was in turn used to purchase weapons, pay insurgent salaries and even deliver social aid to eastern Congo’s poor in exchange for allegiance (Miklian and Schouten, 2013). Bralima used a subcontractor model whereby independent truck drivers pick up the beer and are responsible for delivering it across the country. Any expenses, damages or conflict along the way is considered the sole responsibility of the drivers to avoid charges against making such payments.

*Source: Oetzel & Miklian (2017).*

World Economic Forum (WEF, 2016) industry agenda on multinationals working in conflict settings, showed some examples of first movers and the conditions of success. The development of a coffee export market by Nespresso in South Sudan, Roshan’s catalysing of the mobile telecoms market in Afghanistan, the establishment of farmer collectives in Uganda by Mercy Corps, and the redevelopment of abandoned communications infrastructure in the Niger delta by Chevron all contributed to the bottom line for business, while simultaneously generating new employment opportunities for local communities and increased tax revenues (WEF, 2016). Both large and small enterprises with invaluable knowledge of local actors and conditions should provide essential last-mile services and, more importantly, provide opportunities for youth, women and excluded communities through vocational and other training, as the work of Nespresso in South Sudan, Roshan in Afghanistan shows (WEF, 2016).

However, empirical research on positive spill-overs of foreign investors and MNEs is clear that the presence of ‘threshold externalities’ limits positive spill-over effects to SMEs in low-income countries, particularly conflict affected countries. Developing countries need to have reached a certain level of development in education, technology, infrastructure and health, which need increased public investment, before being able to benefit from a foreign presence in their markets (Bermejo Carbonell & Werner, 2018), which is often not the case in fragile and conflict affected countries. Imperfect and underdeveloped financial markets may also prevent a country from...
reaping the full benefits of FDI. Weak financial intermediation hits domestic enterprises much harder than it does international corporations. In some cases it may lead to a scarcity of financial resources that precludes them from seizing the business opportunities arising from the foreign presence (Bermejo Carbonell & Werner, 2018).

Economic literature identifies technology and knowledge transfers as the most important channel through which foreign corporate presence generates horizontal and vertical spillovers. For example, Havranek and Irsova (2011) take into account 3,626 estimates from 55 studies on vertical spillovers. They find evidence for positive and economically important backward spillovers from multinationals on local suppliers in upstream sectors and smaller positive effects on local customers in downstream sectors. However, the authors reject the existence of horizontal FDI spillovers. This can be explained with international corporations avoiding spillovers of knowhow and technology to their immediate competition.

The case study literature on FDI spillovers complements the econometric studies by providing more detail on the mechanics by which spillovers occur. This literature is also mixed, but shows some positive outcomes not only for vertical linkages, but also through horizontal intra-industry linkages in cases where such investment is embedded in a broader institutional and entrepreneurial ecosystem (Farole & Winkler, 2014).

**SME development in conflict-affected countries**

The lack of functional institutions acts as a severe brake on the development of the private sector in fragile and conflict settings. Poor regulation, poor corporate governance, and a weak operating environment are major constraints (Davis et al., 2018). Corruption, business regulation, power cuts, political instability, and informal sector competition were identified by Davis et al. (2018) as main constraints for business development. An unstable exchange rate and parallel foreign exchange systems, as well as high inflation, represent major risks to private sector stability. Difficulties in accessing foreign exchange and restrictions on particular types of loans make it difficult for banks to manage risk. As a result, SMEs are particularly unable to access finance.

In practice, large areas of the private sector in fragile and conflict affected countries are not really competitive enterprises, but are controlled by elite groups and derive their profits from rents extracted due to their size and power as well as a distortionary policy environment. There are significant business interests controlled by the army, government ministers, or groups close to either of these (e.g. Egypt) (Davis et al., 2018). In Ethiopia, the government recognises that private companies play an important role in realising the country’s development objectives but there is huge concentration of market power in the hands of party-affiliated companies, companies with military links and public enterprises, while ethnically connected business elites thrive (Davis et al., 2018). The same can be observed in other countries, like Sudan, Myanmar and Lebanon. Elite control also operates in ways other than ownership of companies themselves, as the electricity supply in Lebanon illustrates. Most of the country lacks round-the-clock grid electricity and load-shedding schedules are posted in many buildings. As a result, many people are obliged to pay for additional power from privately owned generation companies, who in turn pay kick-backs to those in political power.

For SMEs this means severe constraints for their development. Hoffman and Lange’s (2016) research findings on SME development in conflict affected countries (Afghanistan, Pakistan, the Democratic Republic of Congo, Sierra Leone and South Sudan) pointed to the following:
The success of many SMEs in fragile and conflict settings hinges on their ability to rely on personal and social networks, as well as on arrangements with non-state governance actors (e.g. traditional leaders or insurgent groups), rather than on formal institutions. This often involves voluntary informal payments to both state and non-state actors in exchange for protection, safe passage, or access to resources or services such as electricity. Hoffman and Lange (2016, p.1) concluded: “This inevitably affects the way these businesses foster or undermine social cohesion and state legitimacy”.

Although equipped and eager to grow, many SMEs operating in places of insecurity and high risk deliberately deploy coping strategies rather than realising their growth potential. A significant share of surveyed businesses in particular in Afghanistan, Pakistan and South Sudan had developed strategies of resilience, while only in less insecure and more predictable settings (Sierra Leone and Kinshasa in the DRC) SMEs have clear growth strategies. It was reported that companies resist growing too large, as the military or other war-related fractions may wish to take a stake in expanding businesses, having a detrimental effect on in-firm investments.

If the structural drivers of business constraints in fragile and conflict contexts are ignored and eventually reinforced by conventional donor interventions, the latter risk reproducing and solidifying the very same structures that cause long-term instability and preclude firms from shifting from a focus on short-term resilience to longer-term growth strategies. By seeking to fix the symptoms rather than the underlying causes, de facto obstacles will remain, as generalised patterns of clientelism and corruption are likely to persist. Hoffman and Lange (2016, p.52) concluded: “[SME development] assistance in such an environment also carries the risk of reinforcing the same structures that prevent small businesses from growing and fragile situations from stabilising. However, the necessity to instigate and sustain a de facto reform process towards a level playing field for SMEs comes with its own challenge, as persistent attempts to transform the power configuration into a more equitable, transparent and fair business environment are likely to trigger strong opposition and potentially violent resistance.”

Furthermore, as Davis et al. (2018) further pointed out, state, military and rebel elite’s access to cheap labour, resources, and influence mean that it has an in-built advantage in any area in which it operates. In effect, it has created several no-go areas for non-connected companies, for example in areas such as construction, energy and cement production. Furthermore, there is a lack of middle-sized companies able to link large ones with small ones, an uneven spread of corporate activity across the country, and a desire to focus on high-profile ‘prestige’ projects rather than on creating job-rich economic development. Davis et al. (2018) showed that most conflict affected countries have a private sector in which there is a missing middle – there are instead a small number of large companies (often preferentially owned by members of the elite) and a large number of small ones (e.g. for South Sudan: Twijnstra & Hilhorst, 2017). The few large, well-established companies appear to grow ever larger and to some extent monopolise key sectors. Newer entrants do not appear to have space to grow as they come into competition with established business, as well as politically connected enterprises (e.g. South Sudan).

There appeared to be hopeful signs of a generational shift in terms of creation of new businesses with the establishment of small creative, highly skilled, and knowledge-based industries, including in ICT, marketing, fashion, the arts, and events in Ethiopia, Myanmar, and Sudan (Davis et al., 2018). These often rely on returning diaspora, or (in the case of Ethiopia) also attracting educated people, who do not see formal jobs available to them and are no longer attracted by the civil service. Such businesses do not impinge on existing business space in
traditional industries. Innovative programmes to support entrepreneurship can help harness energy in fragile and conflict settings, however, in such context a linkage approach with lead companies could become tricky due to the political or military influences that occur within such linkages.

Rather than viewing the entrepreneur’s involvement with dominant power networks as an asset, Twijnstra and Hilhorst (2017) showed that in practice it is a lack of capacity. Furthermore, traditionally, donor organisations work through their development partners, the international NGOs, to ‘build’ the capacity of local non-state actors. A similar discourse exists on capacity building of domestic SMEs, except that donor organisations are looking at international firms instead of INGOs to adopt the role of ‘capacity builders’. “The policy that is meant to support entrepreneurs, could benefit companies that arouse suspicion because of their – inevitable – practices of wheeling and dealing with the government and other powerful actors. The way out of this dilemma is maintaining the story that South Sudanese companies lack capacity and thus need to be guided by international partners” (Twijnstra & Hilhorst, 2017, p.13).

**Agri-food businesses linkages in conflict settings**

The grape sector in Afghanistan shows how the conflict caused the breakdown of trust and social networks and led to high risk aversion. Business owners do not want to collaborate and do not trust their neighbours; this makes it very difficult to improve the linkages in value chain that are needed to improve quality (Hiller, 2014). Increase of risk and reduce in trust levels are important components in the context of conflict (Hiller et al., 2014):

- **Risk:** Risk increases for all actors during and after crisis, increasing transaction costs. As Grossmann et al. (2009, p.72) mention: “At the intermediate and micro levels, financial intermediaries and their service providers may be directly or indirectly affected by violence, for example due to declining business activities and eroding loan repayment discipline. Usually they will withdraw their services from conflict-affected regions. As a result, people’s access to financial services becomes even more restricted” (Cited also in: Hiller et al., 2014).

- **Trust:** Trust among key stakeholders can be negatively influenced by on-going political and economic processes. “Conflict damages trust, and trust is one of the principle risk mitigation factors that enable healthy economic relationships” (Channell, 2010, p.2). Socio-economic networks are broken, or reshuffled, by displacement processes. On the other hand, a shared exposure to violence may also increase levels of trust within a community (Besley & Persson, 2012). For example, migrants are able to make effective linkages that did not exist in pre-conflict years, and as such expand the possibilities of reaching new markets.

The literature shows that higher risk levels and less trust damage horizontal and vertical linkages within the agri-food supply chain (Hiller et al., 2014). For example, farmer organisations lack market capacity as they are unable to aggregate commodities from members, suffer from transportation constraints due to bad infrastructure and furthermore lack warehouse and cleaning facilities and access to credit (Hiller et al., 2014). Even though producer organisations increase the horizontal linkages between producers, they cannot overcome their market access problems.

The access to and relationships between farmers and others along the supply chain (suppliers of agricultural inputs, traders and markets) are often damaged, transaction costs are high, and there is little access to credit and information (Cordaid, 2015; Kimenyi et al., 2014). The lack of
access to markets “can lead to a shrinkage of the agricultural sector because there is no incentive to engage in agricultural production beyond the subsistence level” (Özerdem & Roberts, 2012).

As a result of higher production and marketing costs, and very constrained purchasing power, farmers make much less money on their agricultural produce in conflict situations (FAO et al., 2017). Smallholders face difficulties becoming part of upgraded value chains, often because few upgraded value chains exist in countries with protracted crises or because specific farmer groups are blocked from access to these chains. Miller (2008) studied market access in South Sudan, and states that “as a result of the underdeveloped marketing arrangements post-harvest losses at the farm level and within markets are very high, as are food prices”. He also writes that where both agricultural input and product markets are underdeveloped, no effective investment can be made in agriculture in scaling up production: “The period of civil disorder has largely destroyed the traditional market linkages and channels – including the complex set of social and economic relationships between intermediaries necessary for markets to work” (Miller, 2008).

Most farmers deal with traders who buy their products individually. In the Afghanistan saffron chain,中间men visit the farmers before the harvest and make a deal to buy all their different products. For farmers this can be challenging as they get their money in advance and need to fulfil their obligations at the end of the harvest (Hiller et al., 2014). In the coffee chain in Burundi, farmers sell their coffee cherries to the local washing station or to rural collectors who collect the coffee and sell it to the same washing station. The farmers have a guaranteed market for their product, but due to perishability they have to sell their product within six hours after harvesting and thus have no other choice but to sell to the nearest washing station (Hiller et al., 2014). On other occasions smallholder farmers receive a down payment from the traders and receive the final payment after the trader has sold their product leaving the risk with the farmer.

4. The use of lead firms: what do we know?

Because of the lack of empirical studies on the impact of lead firm-SME linkages for small businesses and smallholder farmers in general, but in particular for conflict affected countries, this section will draw on the available conclusions from research for all developing countries. Specific country and case studies are mentioned in the Appendix.

A meta-analysis of lead firms-SME linkages initiatives in agri-food value chains came to the conclusion that dairy, livestock, and food crop (vegetables and fruits) linkage programmes are most likely to be publicly-supported (e.g. focus on bottom-up and/or enabling environment) (World Bank Group, 2018). The same analysis showed that private sector-led linkage initiatives are mainly in place for cash crops (cocoa and coffee are common for PPP and lead firm initiatives). The reason for this may be that (World Bank Group, 2018):

- Food crops often involve geographically-dispersed and weak supply chains, where public support may be necessary as a pre-requisite, due to the lack of initial private sector interest.
- There may be social or political pressure for the public sector to be involved in supply chains that have implications for food security and farmer welfare.
- Where cash crops tend to involve smaller, tighter supply bases, lead firms may see a more direct or obvious entry point.
• Top-down initiatives are interested in differentiating their products in the marketplace and hence seek specialty products such as "fair trade" coffee, shade cocoa, and high-quality jasmine rice.

Processing of food products (e.g., coffee, cacao, oils, nuts, grains, fruits, vegetables) usually entails minimal technological sophistication, with the aim of partially processing or preparing raw materials to make them more transportable for lead firms. However, the World Bank Group (2018) analysis showed that publicly led programmes (mainly bottom-up approaches) tend to focus on higher levels of processing at SMEs in an effort to increase investment in greater value-added processing capabilities in developing economies. Privately led initiatives and PPPs tend to focus on quality, improving raw material collection and other agro-processing activities. Privately led and PPP linkage initiatives between lead firms and SMEs in the agri-food sector tend to focus more on low processed inputs because many lead firms want to source a wider range of suppliers of minimally processed products, which makes it easier to control quality and quantity (World Bank Group, 2018).

However, a new trend is visible and mentioned in the World Bank Group (2018) meta-analysis of lead firms-SME linkage initiatives. Increasingly, SMEs are involved as supplier of niche products for lead firms, like fair trade and organic products, specialty coffee, and indigenous natural products (e.g., hoodia, argan oil). As the World Bank Group (2018, p.21) stated: “In some cases, the product is marketed with place of origin branding initiatives such as Ethiopian coffee and Moroccan (argan) oil to signify a differentiated product with a signature quality or other attributes.” However, although value addition can involve all levels of processing, it still typically involves rudimentary processing.

SMEs are much less involved as suppliers of finished products because this needs inclusion of a wide array of inputs, and often requires greater levels of transformation to cook, cut, pasteurise, and package products for consumption. Greater levels of transformation require larger technology investments and reliable access to forward and backward linkages of goods and services (World Bank Group, 2018). Lead firms in this segment often include hotels, restaurants, and supermarket chains. These lead firms generally do not want to be vertically integrated and depend on suppliers of finished products, some of which are SMEs.

Finally, the World Bank Group (2018) also found evidence that top-down, privately-led linkage initiatives objective is mainly to increase quality, followed at distance by securing quantity, improving organisational capacity, creating more efficient supply chains. PPPs mention more diverse objectives, often concerning about efficient market linkages, improved suppliers income, environmental values, increasing added value and food safety. Publicly-led, often bottom-up linkage initiatives have the most variety of objectives, including the ones mentioned above, but other important objectives are job creation, policy reforms, and increasing investments.

It is important to mention that the literature, although generally positive about the impact, also mentions that the effect of lead firm partnerships with SMEs are not all positive and not without risk. The negative effects of large business linkages through competition (horizontal linkages) are difficult to raise prices, smaller market share, smaller profit margin, among others (Canare et al., 2017). Furthermore, although published some time ago, Alvarez and Barney (2001) argued that alliances between small and large businesses do generate a large sum of economic value, but most of these accrue to the big firm. Alvarez and Barney (2001) studied more than 100 large firm-small firm alliances and found that among their sample, about 80% of SME managers felt that they were unfairly exploited by their large firm partners. Moreover, Sulej et al. (2001) argued
that in a partnership between two different-sized firms, it is usually the smaller firm that bears the greater risk. These risks could be due to the difference in resources available to the small and large partner and to the development of trust and commitment (Canare et al., 2017).

Ndemo and Smallbone (2015) interviewed five multinational enterprises in Kenya to ask whether and how they collaborate with SMEs and the benefits of doing so. Interview results show evidence that there are strong positive spill-over effects in backward linkages (forward linkages from the point of view of SMEs) – local SME suppliers benefit from information and technology transfer from the respondent multinational corporations. While SMEs tend to lack technical capacities, they can contribute to partnerships with international companies with their often better understanding of the local market. Botelho and Bourguignon (2011) showed that tax incentives to attract foreign investors to a region go often hand in hand with programmes to increase supplier capacities. Botelho and Bourguignon (2011) recommended encouraging policies such as strong basic service provision to attract investment over the imposition of restrictive policies such as local content quotas.

Although the main emphasis in the literature is on the challenges for SMEs to start and maintain linkages with lead firms, it is often overlooked that large lead firms, too, face challenges in their pursuit of better and more linkages with SMEs, for example (Canare et al., 2017):

- Business linkage programmes require internal commitments of many years involving significant resources, technology, and persistence. Internal firm policies should be geared towards institutionalising commitments to fostering linkages.
- Lead firms may have difficulty selecting potential SME partners without accurate information that can be used to evaluate their performance and reduce the risks of working with them.
- Lead firms can be hindered by challenges systemic to SMEs, i.e. lack of capacity and skills, limited access to finance, and an ineffective or unwelcoming public policy environment such as that in many developing countries.

The ADB (2015) surveyed enterprises on 19 policy items that could encourage greater participation of SMEs in Global Value Chains by linking them to lead firms. The top five comprised of tax incentives for small suppliers (now tax incentives mainly include lead firms), trade facilitation measures, simplification of trade procedures, improving domestic infrastructure, and reforms in ICT and transport. The study (ADB, 2015) noted that SMEs that succeeded to link with global markets were significantly ahead of their counterparts in sourcing of inputs and suppliers, production capacity, technology use, and networking. Although SMEs stand to benefit from participating in global markets many of the SMEs lack confidence to enter the global market (ADB, 2015).

A supportive enabling environment, therefore, is a critical foundation for encouraging business linkages between lead firms and SMEs. Governments can address these issue by focusing on building SME capacity, offering them financial incentives, helping smaller firms keep up with international standards for product quality, reducing red tape, improving infrastructure, and prioritising education (ADB, 2015). Enabling conditions such as ease of starting a business, contract enforcement, ease of hiring and firing employees, absence of corruption (e.g., bribes), and transparent taxation are important to SME and lead firm operations. Instead of mandatory or restrictive policies such as imposing local content requirements on MNEs working with SMEs,
government should focus on connecting different companies through information dissemination and competent delivery of basic services (Botelho & Bourguignon, 2011).

Specifically for the agro-processing sector, reliance on linkages for its agricultural raw materials exposes sector actors to a wide array of enabling factors along the entire supply chain. This includes access to agricultural land (land tenure, property rights), access to production inputs (seed, fertiliser, irrigation, farm machinery), provision of transport and logistics infrastructure and services, access to potable water and electricity, and clear policies and efficient public service provision for product-specific quality standards and regulations (World Bank Group, 2018). Therefore, it is recommended for any form of lead firm-SME linkage initiative to seek improvements in the enabling environment (see box 3).

**Box 3: combining linkage initiatives with efforts to improve enabling environment**

When SMEs are weak in capacity, the risks and costs for lead firms increase. Therefore, a number of linkage initiatives have started or expanded based on improvements in enabling environments. Examples are Alquería’s dairy supply chain in Colombia and DFID Food and Retail Industry Challenge Fund (FRICH) tea sector linkage initiative in Kenya. The FRICH final report stated: “Though the challenge fund did not target policy change in its design, there were several policy environment changes that allowed certain FRICH supply chains to be particularly successful” (DFID, 2014, p.). For example, a lead firm (supermarket chain) directly lobbied heavily for the liberalisation of the tea sector in 2010 from the Tea Amendment Act, which led to the FRICH tea sector linkage initiatives in Kenya. Liberalisation allowed suppliers to choose to sell to a factory of their choice and set up supplier agreements — both of which create incentives for SME supplier upgrading. As such, the linkage initiative was able to take advantage of the improvement in the environment.

The Alquería dairy case in Colombia is an example of a private initiative whose success depended mainly on improved security and macro-economic stability in Colombia in the mid-2000s. This made expansion of its supply chain into new regions possible. For years, Colombia’s profound political, economic, and security crises emanating from guerrilla wars and the drug trade hindered Alquería’s growth. Only under these circumstances was Alquería able to work on linkages with SMEs for improved milk collection remote areas that previously were under guerrilla influence, such as El Meta.  


### 5. Linking smallholder farmers with buyers

A linkage between smallholder farmers and larger corporations can take different forms:

1. **Lease contract with smallholder farmers for agribusinesses without engagement in primary production:**

   A lease or management contract overcomes dependency on land, while minimising the uncertainty for the lessee in transacting with the landowner. The sequential relationship between smallholders on whose land crops are grown, and an agri-business who processes or markets the produce, is characterised by a higher level of power and information asymmetry (Chamberlain & Anseeuw, 2019). A lease contract generally involves a collective organisation of smallholders (e.g. cooperative, producer organisation); this collective can be a combination of individual smallholders. Often lease contracts are combines with equity, which allows the landowning smallholders to maintain power over their land, while sharing the actual control with a skilled agri-business (Chamberlain & Anseeuw, 2019).
Research in South Africa in sugarcane roots processing businesses showed that lease contracts with smallholder cooperatives were combined with supply agreements to secure corporate control over the crop. This set-up safeguards the agri-business' cane input from fragmented land, but limits its transactions to different cooperatives, rather than the several thousand individual members, without company investment in cane roots (Chamberlain & Anseeuw, 2019). Income for individual smallholders fully depends on overall cane production by their cooperative, on the one hand stimulating the smallholders to ensure high production, while on the other hand allowing for free-riding behaviour within the cooperatives (Chamberlain & Anseeuw, 2019).

Lastly, a lease, in particular in combination with supply agreements, is combined with a mentorship arrangement to prepare the smallholders for long-term, independent operation of the farming activities. Uncertainty reduction over time allows for a less vertically integrated coordination mechanism between the mentoring agri-business and mentored smallholder, reducing transaction and agency observation costs, whilst maintaining access to each other’s resources (Chamberlain & Anseeuw, 2019).

2. Supply agreement between smallholders and agribusiness:

This instrument is often sufficient when the farmer is well established and hence uncertainty around the transaction is minimal. However, smallholder farmers in LMICs require support beyond the usual supply of inputs and extension officers. To overcome the large knowledge and experience gap between emerging smallholders and the demands of the commercial value chain, all cases in the Chamberlain and Anseeuw (2019) research for South Africa involving contract farming, have implemented a mentorship arrangement in addition to the supply agreement. A mentor enables the observation of agent (smallholder) behaviour, reducing both adverse selection risks ex-ante, and moral hazard ex-post signing of the contract. However, mentorships are costly to implement, with the agri-business only willing to cover these costs when its dependence on the smallholder’s produce is considerable (Chamberlain & Anseeuw, 2019).

Uncertainty regarding agent behaviour is further managed through shared equity in downstream activities. This aligns the goals of smallholder and off-taker, and incentivises smallholders to enter into, and adhere to, the supply contract. In case of South Africa, Massmart has invested in the refurbishment of a local packhouse, in which the smallholders, as a collective, hold equity. The smallholders thus have an interest in supplying this packhouse, enabling the agri-business to limit extra-contractual sales. The mentor, as implementer of the contract and third shareholder in the packhouse, serves as a safeguard to protect the inclusive business-specific asset investment made by the agri-business. A similar set-up was observed in another case in South Africa, where individual smallholders, as a collective, own a nucleus farm with packing facilities, and a small share in the citrus processor they supply. This down-stream set-up reduced uncertainty and risks for its members, prompting the smallholder to undertake the production of a new crop.

Chaberlain and Anseeuw (2019, p.314) stated: "Interestingly, inclusive business centred on a supply contract do not necessarily incorporate a collective organisation, as was the case for lease-based inclusive business approach. Rather, the agri-business searching for control over produce supply engages an external mentor to reduce its transaction and agency costs […]. Nevertheless, a collective organisation allows for the more efficient inclusion of a larger number
of smallholders, required where dependence by the off-taker is higher and a larger volume of produce needs to be procured from smallholder farmers”.

Research in Tanzania showed that there are various ideas why to choose for a bottom-up or a top-down approach to link smallholder farmers with formal markets (see table 1). It showed that a bottom-up approach by focussing on producer-driven organisations, provides a large degree of autonomy, democracy and independence if structured well and are therefore of immense relevance in facilitating agricultural development (Gramzow et al., 2018). On the other hand, contract farming (top-down buyer-driven organisations) enjoys increasing importance since more sophisticated value chains require a high degree of coordination between producers and buyers. The researched projects in Tanzania showed that contract farming respond more quickly to changing market conditions due the formalised quality control system, the close relation to the international market, and the possibility to employ their extension system to introduce new standards that can include new technologies such as new varieties, new fertilisers or pesticides. The formal quality monitoring system can also quickly control the adoption of new standards by all group members (Gramzow et al., 2018).

The researched contract farming projects, however, showed no reliable approach to facilitate their member’s investment in production facilities and more expensive inputs. The development of financial measures or leasing products together with financial institutions can enable members to invest in small-scale production facilities such as drip irrigation, green houses or polyethylene tunnels, which will enable the groups to improve the quality of their produce. In particular, contract farming lacks the desired technical staff that are able to identify alternative markets and buyers for their members in case the existing market channel is not able to absorb all the produce provided by the group members (Gramzow et al., 2018). Another interesting conclusion of Gramzow et al. (2018) study is that information channels are more informal in the producer-driven organisations compared to the contract farming approach. However, due to the effectiveness of the weekly meetings in bottom-up approaches, the pace of decision making is not negatively affected by the informality of members’ communication. Furthermore, approaches to link farmers with markets via producer organisations was also able to integrate a voluntary, but very effective management. Effective management is for farmer organisations much more important compared to contract farming, since the groups continuously need to negotiate new contracts with buyers, while contract farmers focuses mainly on only one buyer (Gramzow et al., 2018).

Contract farming is also less bureaucratic as it does not work with memberships (like in farmer organisations) and therefore has no criteria with regard to land size or production volume. Therefore, in case of the researched projects in Tanzania, the quality control system is based on individual responsibility and full traceability, which makes it quicker to integrate smallholder farmers in the system. Also, pre-financing of inputs enables organisations to include resource-poor farmers as members and to link them to markets.

These findings are in line with studies by Alemu and Teklemariam (2016) demonstrated that, depending on external constraints such as production systems and social conditions, contract farming as a buyer-driven approach might provide better outcomes than registered farmer-based. Smallholder farmers engage in contract arrangements because it enables them to achieve higher yields, diversify into new crops and to increase household income. Production risks can be minimized as most contracts include arrangements for the provision of appropriate inputs and technical assistance to help farmers raise productivity and product quality. Most contracts
also reduce the risks of marketing for they usually provide a guaranteed market for that product which meets the buyers’ specifications at a predetermined price (FAO, 2016).

For investors, contract farming arrangements reduce both transaction costs and coordination costs. Through production and marketing agreements, investors are able to gain access to a regular supply of products, which meets some prescribed quality standards. This enables investors to enter into forward selling arrangements with downstream customers or to make appropriate investments in downstream processing facilities in the knowledge that they have an assured supply of raw product (Bijman, 2008). Although older studies have shown that often buyers, when implementing contract farming approaches, prefer contracts with medium- and large-scale farmers to reduce their transaction costs and ensure quality standards (e.g. Key and Runsten, 1999 and Shepherd, 2007: cited from Gramzow et al., 2018) the study of Gramzow et al. (2018) showed for Tanzania that smallholders in inclusive business approaches can be included.

Appendix: Country and case studies

1. Country study on Lead firm-SME linkages in Philippines:

Research in the Philippines on lead firm-SME linkages showed that in particular medium sized and larger small sized enterprises gain access to supply chains of large firms (Canare et al., 2017). Having a smaller asset size means that small firms have fewer resources that could have caused them to respond differently to these linkages. For instance, small firms generally sell a fewer amount of goods and to a less diverse client base, causing its few buyers to have more bargaining power. Smaller firms also have fewer resources that it can dedicate to improving its products to differentiate them from their competitors. Furthermore, Canare et al. (2017) concluded that SMEs have stronger backward than forward linkages with large firms (meaning they link more with large businesses by buying inputs from them than by selling products and services to them), which is not ideal as they will not benefit less from information and technology transfer. Moreover, having weak forward linkages with large firms could mean SMEs would miss on potential large quantity purchasers.

The SMEs with formal partnerships with large firms (being outsourced or sub-contracted; being licensed to produce a product; engaging in joint venture, strategic alliance, or consortium) mentioned in the Canare et al. (2017) study that they benefit mostly from training of employees, along with learning better management practices, learning better marketing strategies, and sourcing of clients. Other common benefits but mentioned less by SME representatives are technology transfer, learning new methods of innovation and research and development, and receiving expert advice. Few identified access to finance as one of the benefits of these partnerships. In particular, medium firms benefit from better access to finance because of these partnerships compared to small businesses.

SMEs working in formal partnerships face several disadvantages. Interviewed SME representatives in the Canare et al. (2017) study mentioned that there is too much bureaucracy in large firms, that decision making and transactions with large firms are inflexible and processed slowly as they have to go through different approval levels, that the SME is doing much of the work and not getting proper recognition, loss of decision-making power, and the large firm insisted that the SME do things beyond what was agreed upon. Nonetheless, despite these disadvantages, a large majority of respondents who engaged in these partnerships consider
them good for the firm. These results further suggest that SMEs with partnership experience with large firms are more likely to respond to stiff competition in ways more suitable for developing competitiveness, which means not only reducing prices, but looking to reduce costs instead.

Another important conclusion is that SME linkages with large firms have different patterns across sectors. Respondents in the Industry sector derive more of their sales from large firms, compared to the Services sector. Similarly, SMEs in the Industry sector sell more to large firms than firms in the Services sector. This is likely because SMEs in the Industry sector produce products that are used as inputs by other firms, whereas SMEs in the Services sector usually target individual clients (Canare et al., 2018). This could also explain why there is a higher share of respondents in the Industry than in the Services sector that experienced any of the formal partnerships and alliances.

2. Country study linkages between FDI and SMEs in Vietnam:

A World Bank Group (2017) study showed that FDI has brought many gains to Vietnam in terms of growth, exports and jobs, however, they are less successful in developing linkages with the domestic economy, in particular with SMEs. This is reflected in low domestic value addition and a weak supplier base to foreign investors in Vietnam. Research showed that foreign corporations as lead firms and their linkages with local SMEs in Vietnam are hampered because of low absorptive capabilities of local firms, the key binding constraints in the enabling environment. The analysis (World Bank Group, 2017) suggested that targeted support for medium sized domestic firms’ innovation activities can be more relevant for backward linkages, as well as supporting joint ventures to boost innovation. In addition, programmes aiming at fostering backward linkages could target market-seeking FDI and promote joint ventures, and should encourage SMEs to focus on product quality, access to foreign inputs, the provision of training to workers, innovation efforts and use of ICT by domestic firms.

In Vietnam the private sector is increasingly involved in government linkage programmes, as well as private sector solutions to address linkage issues. Within Vietnam, as the World Bank Group (2017) study mentioned, early successes of private sector solutions can be found, such as in the case of Thanh Long Electronics Production Company and Tam Hop Company in the electronics and automotive sectors, respectively. These Vietnamese firms have successfully addressed supply-side constraints through the support of FDI-tier 1 suppliers. However, the study did not find other examples of successful domestic companies that have integrated into global value chains, in particular not smaller firms. One of the firms, Thanh Long, also received technical assistance from development partners and governmental organisations, particularly JICA and SIDEC. Overall, public sector and private sector approaches on linkages are not incompatible, as both approaches have the same objective of helping firms overcome supply-side constraints, and seizing latent opportunities rather than attempting to force linkages (World Bank Group, 2017).

Although Vietnam has programmes in place to support SMEs and link them to lead firms, these suffer from shortcomings that limit their capacity to boost competitiveness and foster linkages. The mapping and review of select SME programmes and policies in the World Bank Group (2017) study shed light on the alignment of these programmes with the constraints faced by SMEs and obstacles to linkages, and highlights gaps. These programmes range from technological upgradation, innovation to market development, training and skills as well as standalone financial packages. The analysis finds that while existing SME support programmes appear in theory to address the constraints that firms face in Vietnam, the programmes’
effectiveness is not clear given lack of monitoring and evaluation systems to assess outcomes and impacts.

Furthermore, a key lesson from this review highlights the need for high-level strategic coordination as well as careful programme-level design and implementation to ensure effectiveness and impact. The review suggests that Vietnam would benefit from a consolidation of overlapping programmes; using life cycle stages of firms (start-up, growth, established stages) to identify missing SME support programmes; and ensuring consistent M&E. Programme implementation would also be improved by ensuring programme sustainability (including budget predictability); involving the private sector in program design and implementation; and improving programme processes of the 5-year SME Development Plan (World Bank Group, 2017).

3. Case study of breweries in conflict-affected areas in sub-Saharan Africa:

The study of McKechnie et al. (2018) mentioned that in sub-Saharan Africa, even in conflict affected countries and regions, beer breweries are often key investors. Investment in the beer market and success by breweries in conflict affected countries in sub-Saharan Africa are influenced by several factors: availability of good-quality local suppliers, demand for the products (often low-cost beer markets), and government commitments. The latter, the quality of links between the brewery and government, is one of the most important, which entails the use of fiscal incentives, often justified on the grounds of significant employment creation and links to local sourcing opportunities by farmers. A low-cost beer market has often been created through lower duties, which could replace illicit drinks (McKechnie et al., 2018).

Despite tax incentives, breweries are amongst the largest tax-payers in these countries. For example, EABL in Kenya has a near monopoly position in the beer market and has had links with the government for more than 100 years (McKechnie et al., 2018). Good links between government and brewery are also crucial in the running of Brarudi in Burundi. Brarudi, the largest brewer and soft beverage company in Burundi, has been operational since 1955 and has traditionally played a major role in the country. There is often a two-way relationship between the stability of the countries, in terms of employment and tax revenues, and the success of the company. Several company leaders have links to government. For example, a person close to the regime was appointed chair of the Supervisory Board of Brarudi, owned by the multinational corporation Heineken (McKechnie et al., 2018).

These foreign-owned beer brewery businesses can stimulate local supply chains, for example Brarudi has increased its sourcing of white sorghum locally, from 65 tons in 2009/10 to 2,553 tons in 2014/15 (McKenchie et al., 2018). At first, there was little interest among local farmers in producing white sorghum, but foreign currency constraints made it necessary to source more locally for the brewery. Local production then increased significantly from 2013. The rise of production can further be attributed to (te Velde, 2017):

- Increased demand and higher prices offered by Brarudi – making white sorghum more profitable than other comparable agricultural crops – through introduction of the 100% white sorghum beer Nyongera (a popular local beer) and of white sorghum as an ingredient for other beers (Dietz, 2015);
- Sustained training efforts, support and equipment offered by European Cooperative for Rural Development (EUCORD) and the agronomists of the Direction Provinciale de
l’Agriculture et de l’Élevage (DPAE) and training and equipment from the International Fertilizer Development Centre (IFDC);

- Engagement of non-governmental organisations (NGOs) such as Spark, which have provided training to the cooperatives, facilitated farmers’ access to credit and initiated multi-stakeholder processes since mid-2013.
- There are also political economy issues. The cooperatives around white sorghum are often linked to the ruling party. The management committees of the cooperative overlap with local government and the selection processes within the cooperative are neither based on clear criteria nor transparent.

While many breweries now source locally (e.g. using rice or sorghum, with several donor support programmes in existence), this is harder in the most fragile contexts. In the Central African Republic, for example, the most important firm in Bagui is a brewery. When Islamist militias took over the capital, they stole the stock of local beer but did not destroy the plant. However, this plant now imports everything, as there is no rice or maize available. Beer sales tend to rise in adversity, though, and, despite the conflict, the company has now received the money for modern equipment (McKenchie et al., 2018).

Nile Breweries Ltd. (NBL), the leading Ugandan beer producer and marketer, wanted to develop a competitively priced beer for the local market. NBL saw an opportunity to produce a new, low-cost sorghum-based beer rather than use expensive imported malted barley and developed a supply chain through strategic partnerships with SMEs that could reliably deliver raw material of consistent quality (World Bank Group, 2018). The resulting success created benefits throughout the value chain, with additional SMEs becoming suppliers; fostered knowledge spillovers and replication on a pan-African scale; and improved grain yields and farmer incomes (World Bank Group, 2018). Eagle Extra is now the best-selling brand in the country and the best-selling product of NBL’s mix of brands. In 2017, the company acquired 12,000 tons of sorghum from SME agro-processors and farmer associations representing approximately 20,000 small farmers who received revenue of US$4 million (World Bank Group, 2018).

4. Case study on aluminium smelter in Mozambique

In an effort to build the capacity of SMEs in Mozambique, Mozaal aluminium smelter collaborated with the International Finance Corporation (IFC) and the Mozambican Investment Promotion Center to create the MozLink SME development programme (IFC, 2008). The project involved training batches of 15-20 SMEs over a year-long cycle, focusing on five phases of working with larger companies and using workshops, mentorship, and training. The five phases in the programme are preparation, programme assessment, execution of SME improvement plan, post-programme assessment, and evaluation. At the time, the programme had successfully improved the capacity of 45 SMEs, increasing the number of linkages between Mozaal and Mozambican SMEs and the value of goods and services purchased (IFC, 2008).

The key success factors to improving the capacities of the SMEs in Mozambique were identified as: well-defined roles for each partner in the linkage, the SMEs’ willingness to change business practices, motivated mentors, and a well-planned and coordinated programme. An important aspect of the training programme is an analysis of the SMEs baseline data to identify gaps in their capacity, as well as a formulation of individual improvement plans for the SMEs, including targets for capacity-building and corresponding deadlines. Subsequent training sessions aimed
to fill the common gaps in capacity among SMEs, alongside more concentrated mentoring based on the individual plans (IFC, 2008).

5. Case study World Bank Productive Alliance projects to link smallholder farmers with large processing businesses in Latin America

The World Bank has experienced with programmes that strengthen the linkages between producers, buyers and the public sector within agriculture value chains within a Productive Alliance approach. Lessons from the experiences of this approach in Latin America showed that the establishment of an alliance between the producers and the buyer(s) is a more complex process than establishing horizontal linkages through producer organisations, due to market imperfections (World Bank Group, 2016). The nature and level of the producer-buyer vertical alliance is primarily a business relationship, based on a rational economic arrangement for the supply and purchase of goods and/or services. The World Bank Group’s (2016) experience in Latin America showed that establishing horizontal alliances is often a prerequisite for successfully integrating smallholder producers into markets and vertical alliances with buyers.

Productive Alliance projects conditional on a specific buyer entering an alliance with producers differ in the degree of formality of their commercial agreement. The required formality of the commercial agreement between the two parties varied from direct written contracts to indirect agreements embedded in the business plans. Only the project in Colombia required a written agreement between the producer organisations and the buyers with key product specifications (e.g., product volume, quality and prices) prior to obtaining subproject financing. To a lesser extent, in Guatemala, Honduras and Panama the commercial agreement was a buyer’s written commitment to purchase products from the partnering producer organisation, but without further specifications. In Bolivia, for example, just a letter of intent to purchase was the minimum requirement.

Implementation was often a problem (World Bank Group, 2016). For example, in Guatemala and Panama, few contracts between producers and their alliance partner buyers were formally signed. The success of a vertical alliance is not necessarily guaranteed by a pro forma commercial agreement between producers and buyers, but rather by the commitment of both alliance partners to implement the business plan (World Bank Group, 2016). The results showed that projects generally supported a larger than expected number of alliances, but with fewer beneficiary producers (producer households per alliance) - the actual average number of producer households per alliance ranged from 35 (Panama) to 104 (Guatemala). Achievements can be summarised as follow (World Bank Group, 2016):

- Vulnerable groups like indigenous or producers in post-conflict zones have been able to benefit from the Productive Alliance approach on a par with comparable non-vulnerable producers.
- Available evidence shows that Productive Alliance projects have generated significant positive impacts in terms of increases in production, sales, income and employment.
- The effect of Productive Alliance projects on beneficiary household income has generally been positive, however, is very different per region.
- Dissolution of a vertical alliance between producer organisations and large buyers is not necessarily the result of failures at the side of producer organisations. Results of the CIAT impact evaluation in Colombia showed that following the dissolution of a productive
alliance, 70% of the producer organisations entered into a new vertical alliance with a new buyer based on their experiences.

References


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