Value Chain Governance that Benefits the Poor

Martin Dietz, Senior Advisor Business Development and Value Chains

Working paper

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1. Introduction

Experience and learning show that closer integration of poor people with markets carries a high potential for reducing poverty. Providing smallholders with access to well-functioning local or global markets can be an effective strategy to reduce rural poverty. Value chains offer many opportunities for smallholders and rural entrepreneurs to become competitive actors in markets.

A critical factor in ensuring that smallholders benefit from participating in markets is the "rule of the game". When rules are transparent and fair, smallholders can benefit and improve their economic and social situation. Often, however, the rules are such that smallholders find it difficult to gain access to markets, or benefit from participating in markets, or emerging rules may squeeze them out. They may not be aware of the rules, they may not be able to comply with them because of lacking knowledge and skills, or cost of compliance may not allow the operation of a profitable business.

Development organisations tend to focus their interventions in value chains or market systems on increasing competitiveness, performance, and on providing effective technologies to smallholder producers. The area of governance has been given less attention. Good and effective governance in value chains, however, harbours a significant potential for capacity building of smallholders within the value chain through lead actors which will allow small producers to strengthen their position in value chains and get out of poverty.

This paper aims at giving development practitioners an overview on governance in value chains and market systems. It briefly outlines the scope of governance, introduces a typology of governance and explains the determinants and dynamics underpinning this typology. It then proposes areas of interventions in value chain governance systems through which smallholder

producers can benefit. Finally it clarifies issues related to public and private roles in value chain governance.

2. What encompasses governance in value chains?

A considerable amount of research has been conducted over the post years on value chain governance, focusing particularly on the relationships among actors in global value chains. The governance in the wider market system, including rules and regulations set in the external environment is equally relevant. However, it can be expected that lead actors in competitive value chains take up the requirements that are set by legislation, regulations and rules, and enforce them throughout the value chain. Therefore, value chain governance also reflects the requirements by legislation, regulations and rules, apart from the competitiveness and expectations of markets.

The point of view can be expanded to include the relationship with service providers that operate within or influence the range of activities required to bring a product or service from inception to its end use. This paper focuses mainly on value chain governance between private sector actors.

2.1 Key parameters in value chain governance

Governance is about the ability to exert control along the chain for a particular purpose. Firms, organizations or institutions set and/or enforce parameters under which others in the chain operate. The key parameters that are being enforced are:

1. What is to be produced? This includes product design and specifications.

2. How it is to be produced? This involves the definition of the production processes, which can include elements such as the technology to be used, quality systems, product, labour and environmental standards.

3. How much is to be produced, and when? This refers to production scheduling and logistics.

2.2 Who leads value chain governance?

Lead actors in the market system will set rules, and monitor and also facilitate compliance with rules that pertain to each of the parameters listed above. The actor can be a firm (buyer or producer) within the value chain or public or private institutions located in the environment of the chain. In general, a lead actor within a value chain takes responsibility for setting, monitoring and facilitating compliance with the rules in a value chain. The legislator assigns the responsibility to lead actors close to the market (e.g. retail chains) who will have to ensure that all actors in a value chain comply with the rules set by the government.

Lead firms have the power to choose and replace suppliers. A lead firm has the power to explicitly coordinate the activities of the supply chain and to require from suppliers to lower their costs, increase quality, adopt specific equipment or business processes, and purchase inputs from designated vendors. The relationships that lead firms have with their suppliers can either improve the competitiveness of the industry, based on a commitment to long-term, mutually beneficial relationships with suppliers, or they can be predatory and focused on realizing a quick profit in the short-term. More on these differing arrangements is explained in the section on typologies of governance structures.

2.3 Driving forces for governance

What are the driving forces for actors to lead and coordinate value chain activities?

- First, to increase competitiveness by assuring quality and the range of products the market expects. Quality and safety cannot be incorporated into a product at a later stage; it has to be maintained and assured throughout the supply chain ("from farm to fork").
- Second, pressure for outsourcing activities that were previously performed in-house by large, vertically integrated companies has caused the need for value chain governance as opposed to the former managerial control.
- And third, growing pressure from the public for safety, good environmental and social conduct requires increased governance in these spheres. Compliance monitoring is often done in collaboration between private and civil society actors. Process and product standards in value chains are used as strategy for differentiation. Compliance with these standards is monitored by lead firms or by third party bodies on request of lead firms.

2.4 Instruments in value chain governance

The instruments of governance include among others:
- Contracts between value chain actors
- Standards for products and processes
- Self-regulatory systems in value chains
- Management of producer organisations
- Government regulatory frameworks
- Unwritten norms that determine who can participate in a market as well as expectations from the public

Interactions in value chains run either in vertical or horizontal direction. Vertical linkages are those between actors that have different market functions; horizontal linkages exist among the actors who have the same market function in a value chain. Linkages within a value chain are mostly business linkages, e.g. contracts between sellers and buyers, and can be of formal and informal character. Linkages may include also exchange of information and know-how. Such partnerships can help in the development of products and services as well as developing new knowledge and innovations.

3. Typology of governance systems in value chains

Governance is an important instrument to improve the performance of value chains and sustain / increase their competitive advantage. A particular governance system can either help a firm or a producer group to grow and develop, or it can retard its growth.

For the discussion of governance in value chains it is therefore useful to differentiate between types of governance systems (Gereffi et.al., 2003). These types differ by the relationships that value chain actors have with each other and with the lead firm. The connections between activities within a chain can be described along a continuum extending from the **market**, characterized by "arm's-length" relationships, to **hierarchical** value chains illustrated through direct ownership of production processes. Between these two extremes are three network-style modes of governance: **modular, relational, and captive.**

3.1 Market type of governance

Market governance involves transactions that require little or no formal cooperation between participants, the cost of switching to new partners is low for both producers and buyers. Repeat transactions are possible, but not necessary. Little information is exchanged between firms; interactions between firms are limited and no technical assistance to suppliers is provided. In this case the buyer has no controlling interest in the production, sets few if any standards and

provides producers with little to no information on what the market wants and how to produce it. The parameters are defined solely by each firm (trader) at its point in the chain and the central governance mechanism is price rather than a powerful lead firm.

Box 1: Market type of governance in vegetable value chains in rural Nepal

Smallholders (average landholding of around 0.5 ha) produce vegetables. They either sell to aggregating village traders, or they are organised in producer groups, and supply their produce to a collection centre which is operated by the group. Traders come to the collection point, prices are negotiated and the produce is sold.

Traders have not defined and / or communicated any minimum standards for the produce to producers. Payment is generally made on the spot for the transaction. Smallholders generally do not grade the produce, thus a quality-related pricing is not practiced. They have a choice between different wholesalers/ agents. (M. Dietz)

Figure 1: Typology of governance systems in value chains
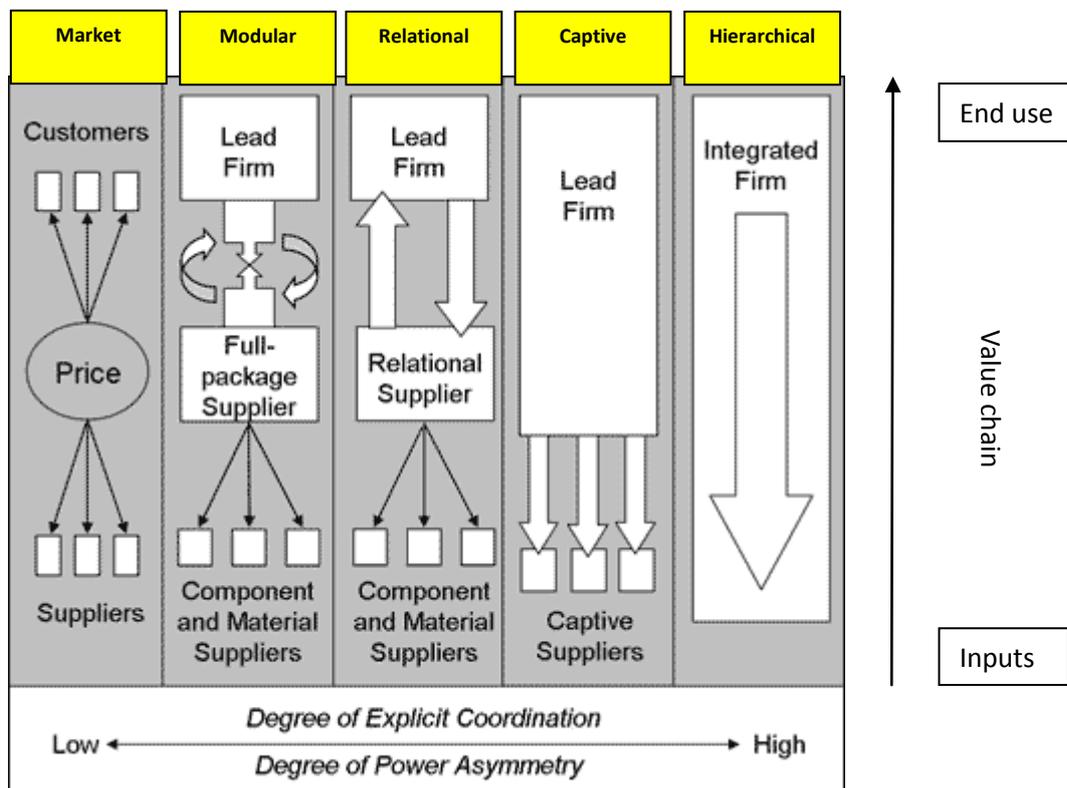
Source: Gereffi et.al. (2003)

3.2 Modular governance

Typically suppliers in modular value chains make products or provide services to a customer's specifications. Suppliers in such value chains tend to take full responsibility for the process technology. This keeps switching costs low. Linkages are more substantial than in simple markets because of the high volume of information flowing across the link between firms but at the same time complexity of interactions can be kept simple as the information required by value chain actors can be codified for instance through product and process standards.

Examples for this type of governance are value chains where lead actors require from their suppliers products of a defined product or process standard (see box 2). These are voluntary standards (not government-set mandatory standards) which are often defined by the private sector. The process standard may include for instance organic or fair trade production systems. Legal contracts (supply contracts) are often part of the system (Boselie, 2002).

Box 2: Vegetable supplies for supermarkets

Driven to close the gap between their supplies and their requirements, supermarket chains in developing regions have been shifting over the past few years away from the old procurement model based on sourcing products from the traditional wholesalers and the wholesale markets, toward the use of four key pillars of a new kind of procurement system: (1) specialized procurement agents; (2) centralized procurement through Distribution Centres (DCs), and regionalization of procurement; (3) assured and consistent supply through 'preferred suppliers'; (4) high-quality and increasingly safe products through private standards imposed on suppliers. Contract use is increasing and supermarket chains have implemented "lead" or "preferred" suppliers programs. These programmes involve setting benchmarks and entering into annual contracts with suppliers. Ahold, an international supermarket operator based in the Netherlands, undertook a vegetable supply chain improvement program in Thailand. This programme has evolved from the objective of optimizing chain performance by reducing handling losses to concepts of HACCP (Hazard Analysis Critical Control Points) management and environmental land-use practices, including reducing pesticide use. (Reardon, 2006)

3.3 Relational governance

Relational governance occurs when buyers and sellers rely on complex information that is not easily transmitted or learned, and where quick adaptation may be required. Such form of governance is practiced in value chains in which uncertainties and changes are a constant factor. Close working partnerships with suppliers play a key role in survival and success of a firm in turbulent environments. A sector in which relational governance is commonly practiced is for instance the fashion apparel industry (see box 3).[1] Rapid changes create considerable uncertainty in the downstream market. For example, as a result of continuously changing consumer tastes, retailers face uncertainties in terms of both product design

Box 3: China's textile industry is in a relational value chain

Textile producers in China do not function as "export-processing zones" industries only assembling imported inputs and supplying end products to the lead firms. They have developed full package production involving more complex forms of coordination, knowledge exchange, and supplier autonomy typical of relational value chains. They have thus acquired skills to interpret designs, make samples, source the needed inputs, monitor product quality, and guaranty on-time delivery.

and volume needs. The inherent characteristics of such markets have important implications for the relationships between the firms that serve the end consumers (i.e., retailers) and the firms that supply them (i.e., apparel or textile companies).

Joint planning, joint problem solving, collaborative communication and legal contract are the most important elements of relational governance. Specifically, legal contract is a major governance mechanism that a company could use to deal with interdependence. It specifies promises and obligations to perform particular actions. For both parties, legal contract mitigates the uncertainty associated with dependence on the other party for critical resources (Shaohan et.al. 2009).

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[1] Example taken from Gereffi et.al. (2003).

3.4 Captive governance

In these chains, small suppliers are dependent on a few buyers who often wield a great deal of power and control. Such networks are frequently characterized by a high degree of monitoring and control by the lead firm. The asymmetric power relationships in captive networks force suppliers to link to their buyer under conditions that are often specific to that particular buyer. This leads to thick linkages and high switching costs all round. Yet these lead firms are also the most likely to invest in the product and process upgrading firms of their suppliers. Since the core competence of these lead firms tends to be in areas outside of production, helping their suppliers to upgrade their production capabilities does not encroach on their core competency, but will rather benefit the lead firm by increasing the efficiency of their supply chain. Competent ethical leadership is important in such cases to ensure that suppliers receive fair treatment and an equitable share of the market price.

Typical **examples** for captive governance systems can be found between sugar mills and sugar cane growers, but also tea planters and tea factories. Some form of contract farming can also be put in that type of value chain governance.

3.5 Hierarchical governance

Hierarchical governance describes chains that are characterized by vertical integration and managerial control within a set of lead firms that develops and manufactures products in-house. This usually occurs when product specifications cannot be codified, products are complex or highly competent suppliers cannot be found.

Hierarchical structures provide regular employment, guarantee quality and build producer capacity. Less tangible social benefits may also be associated with hierarchical (patriarchal!) relationships: influential business people may offer a measure of protection to local communities

> **Box 4: Production of shrimps for the export markets**
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> CP Bahari produces shrimps on Sulawesi Island for European and US markets. The company must ensure food safety: no use of antibiotics and other chemicals or drugs. The company operates its own feed mill, a hatchery for the fry and a processing plant. Over 3,000 farmers are sub-contracted to produce the shrimp in their ponds. The company supports farmers to build ponds. They provide the fry, the feed and extension services to support the farmers in managing the ponds. The company will also do the harvesting of the shrimp.
>
> Though, formally, the land which is required for the shrimp ponds is owned by small farmers, de-facto, the operation is completely steered by the company. All what the farmer provides is his land and his labour. (M. Dietz)

for example or provide schools, health facilities or consumer credit. These benefits can be important to the livelihood strategies of the vulnerable but the prioritization of social considerations over industry competitiveness represents a potential trade off between economic upgrading and social upgrading. An example is provided in box 4.

3.6 Summarising

The five types of value chain governance systems described above are drawn from the experience with transnational value chains. Their principles, however, are also relevant to "shorter" and less complex value chains that operate within a country or a region. They provide a useful structure for the analyses and discussions on relationships between value chain actors, and what determines and influences them. What mostly differentiates the governance types is the degree of explicit coordination and the degree of power asymmetry.

The type of governance is determined by three main factors: 1. the complexity of transactions, 2. the ability to codify transactions and 3. the capabilities of suppliers (see definitions in section 4).

Thus highly complex transactions, a limited capability to codify transactions (i.e. explain what standard is needed and how to comply with a standard) and lesser skilled suppliers will lead to a **hierarchical** type of value chain, where one firm integrates all value chain transactions. On the other hand, when transactions are simple and codification is easy, as for example in local food crop value chains, the governance structure will be of the **market** type. Relationships between buyers and sellers are loose and temporary, and information flow is limited to price and quantity. Another typical feature of environments where pure market-type governance systems occur is when government enforcement of compliance with rules and regulations is weak.

The **modular** type of governance is used when lead firms or other value chain actors determine voluntary standards for processes and products (for example organic or fair trade standards). In these value chains, the supplier takes the full responsibility of the production technology, and, where competition exists, costs of switching between buyers are low. Relationships between lead firms and suppliers are determined by short term contracts. In the **relational** type of value chain, suppliers and their lead firm have closer collaboration than in the modular type. For example they have joint planning moments and continuous information exchange. This type is seen in value chains where consumer preferences change quickly and suppliers have to adapt constantly, like for example fashion apparels and electronic items. In **captive** governance, lead firms do a close monitoring of suppliers and have a high degree of control over them. They set the conditions and suppliers have to comply, thus creating high level of dependency.

Additional to the main three above mentioned determinants of value chain governance, other determinants like local and national structures and institutions, spatial and social proximity of local industrial agglomerations, national level rules and institutions and their enforcement capacities (finance, corporate governance, education and training), and global scale value chain regulations.

4. Determinants and dynamics of governance structure

The form of governance can change as an industry evolves and matures, and governance patterns within an industry can vary from one stage of the chain to another. The dynamic nature of governance can be largely accounted for with three variables: the **complexity of information** that the manufacture of a product entails (design and process); the **ability to codify** or systematize the transfer of knowledge to suppliers; and the **capabilities of existing suppliers** to efficiently and reliably produce the product. Additional influences on the governance structure include the quality, stability, and power of the business enabling environment and institutions, as well as other sources of power in the chain, such as suppliers and consumers.

a. *Information complexity* refers to the intricacy of information and knowledge that must be transferred to ensure a particular transaction can occur. This is important when working with suppliers on complicated product and process specifications - the more complex the information, the costlier the effort to control and coordinate production, which increases switching costs. Thus, complex transactions will likely to be associated with one of the three network governance patterns (modular, relational, or captive) or integrated within a single firm (hierarchy).

b. Through *information codification* the lead firms convert tacit, implied information and knowledge into explicit, concrete and situation-specific information and transmit it to producers. It is absolutely critical for lead firms to tell suppliers exactly what they want and how it should be made. If suppliers do not understand what buyers want, they cannot produce to specification and meet standards, and buyers run the risk of losing their

customers. In some industries, systems have been established to codify complex information so that data can be handed off between value chain partners with relative ease. This is generally done through product and process standards (see box 5).

Products specifications may regularly shift as in the case for apparels. In such case, relational or captive governance structures are likely to prevail. With simple specifications, or with easily codified or standardized specifications and capable suppliers, the tendency will be for more relational or modular governance structures.

If suppliers have the competence to receive and act upon such codified information, and

> **Box 5: information codification in computer assisted design**
>
> Computer-assisted designs (CAD) and machinery that can read the CAD files provided by the customer exemplifies how information can be codified. This enables the design function in many value chains to be performed by suppliers with less direct control by buyers. Another example of codification is seen in the development of industry-wide standards, such as the British Retail Consortium Standard (BRC) or ISO 22000. Both standards prescribe in detail processes and practices that companies need in order to assure food safety. This is particularly important for produts which are susceptible to food safety risks, such as animal-based food products. Buyers will require from their suppliers that they operate such systems and have them certified and regularly audited by third parties.

if the codification schemes are widely known and widely used, then one would expect to see modular value chains emerge. If not, then lead firms might either keep the function in-house, leading to more vertical integration (hierarchy) or outsource it to a supplier that they tightly control and monitor (the captive network type) or have a dense relationship with suppliers (the relational governance type).

    c. ***Supplier capability*** refers to the ability of suppliers to meet all transaction requirements. These may include quantity and quality specifications, on-time delivery, and environmental, labour and safety standards. One aspect of supplier capability is often the accessibility of appropriate support services, such as input supply, equipment maintenance, transportation, certification and assistance with documentation and licenses. If available they will rely on external service providers, otherwise suppliers are likely to rely more heavily on buyers to meet these needs.

Suppliers' capabilities frequently improve over time, and this element of learning plays a crucial role in the upgrading trajectories of supplier firms. For example, lead firms may directly invest in upgrading their suppliers' production capabilities and production-related know-how. Suppliers can capitalize on these relationships and acquired assets to further develop capabilities in branding and distribution.

If effective support services are not available from markets, suppliers will rely more heavily on buyers to meet these needs. Only then can the transfer of complex but codified information be achieved (as in modular networks) or intense interaction (as in relational networks). Where competent suppliers do not exist, lead firms either must internalize the function (hierarchy) or outsource it to suppliers that they tightly monitor and control (captive suppliers).

If one of these three variables changes, then value chain governance patterns tend to change in predictable ways. For example, if a new technology renders an established codification scheme obsolete, we might expect modular value chains to become more relational, and if competent suppliers cannot be found, then perhaps captive networks and even vertical integration would become more prevalent. Conversely, rising supplier competence might mean that captive networks move toward the relational type and better codification schemes might prepare the ground for modular networks (see table 1).

Table 1: Determinants of value chain governance

	Market	**Modular**	**Relational**	**Captive**	**Hierarchal**
Complexity of transactions	Low	High	High	High	High
Ability to codify transactions	High	High	Low	High	Low
Capabilities in the supply base	High	High	High	Low	Low
Degree of power asymmetry					

Source: compiled by author

5. Value chain governance as a development tool

As seen before, governance relates to the formal and informal arrangements between market actors; it implies that interactions in the chain are frequently organized in such a way that actors can meet specific requirements in terms of production, processing and logistics. Governance structures are constantly evolving so that firms are able to comply with market requirements and standards and become more profitable.

The analysis of interactions among value chain actors not only identifies how actors are linked with one another, but also the reasons for those linkages and whether the linkages are beneficial or not. Improving the linkages between the different actors in the value chain lays the foundation for improvements in coordination, cost reduction, product quality and marketing. An identification of the benefits (or lack) of interaction helps identify the constraints to effective linkages and trust among value chain participants.

This chapter looks at how to identify existing governance structures, how to analyse potentials and constraints of governance structures for economically and socially disadvantaged producers and how to intervene as a development organisation for strengthening the potential benefits.

5.1 Identification of governance structures

Understanding the nature of relationships and the power structure in value chains is crucial when trying to make value chains work for a specific target group. Therefore, it is important to analyse and take into account existing governance structures when designing development interventions in value chains and market systems.

The following questions can be useful when analysing value chain governance structures:

a) What is the situation with regards to the three determinants of governance structures (see Table 1):
   o What is the degree of **complexity of information** that the manufacture of a product entails (design and process)?
   o What is the **ability to codify** or systematize the transfer of knowledge to suppliers?
   o How well developed are the **capabilities of existing suppliers** to efficiently and reliably produce the product?
b) Who are the dominant players?
c) How strong are coordination mechanisms between players?

d) Which power relations exist?

These questions can provide an insight into the type of governance structure that exists in the value chain that is being supported by a development project.

5.2 Assessing potentials and constraints of governance structures

How can a governance system contribute to sustained benefits of smallholders and how can it contribute to upgrading their position in a value chain? When thinking about future visions and intervention strategies, it is important to understand the potentials and constraints that governance structures have for economically and socially disadvantaged producers.

A. Guiding questions to understand poor producers' potential benefits and risks

a) Do poor producers have the opportunity to enter the value chain?

Poor producers have difficulties entering a value chain when entry barriers are high. Such entry barriers can include required capacities and investments, economies of scale, membership in groups, licenses etc. Thus, the potential benefits for poor producers are higher in governance structures that imply lower levels of entry barriers. These are usually characterized by lower complexity and coordination requirements.

b) Does the governance system provide incentives for the lead firm to offer support services to poor producers?

Support services are often essential for improving the situation of poor producers.
- Capacity building, for instance, can improve the productivity of producers and consequently their income.
- Information may be provided on terms of trade, quality standards and pricing structures which enable farmers to improve returns.
- Value chain finance differs from finance provided by a financial institution because it creates a "two way street" for lenders and borrowers that goes beyond the common financial flows. For poor producers, credit provided by traders or input firms is often the only accessible financial service.

For lead firms to provide such support services (embedded services) governance structures and relationships are required which will ensure a win-win relationship.

c) Does the lead firm have an incentive to invest in building trust relationships with poor producers?

Trust is particularly important in buyer-supplier relationships where sanctioning and enforcement is difficult. Poor producers may benefit from trustful, transparent relationships with an ongoing information exchange and increased transparency since this limits the scope for unfair behaviour of other market actors. Lead firms have higher incentives to invest in trust relationship where coordination is required while at the same time power asymmetry is limited.

d) Do transparent rules and/or standards apply to poor producers?

Rules and standards can have a positive impact on the overall performance of a chain, ensuring better quality and consistency of production and reducing transaction costs while supporting transparency. Setting, codifying and monitoring standards can help making the chain effective, efficient and equitable for all parties involved. When rules are transparent and fair, smallholders can benefit and improve their economic and social situation. For instance, clear on-farm management standards are important for promoting sustainable social and environmental practices on the farm. Also dispute-resolution mechanisms – either formal or informal – are crucial of well functioning governance structures. Rules and standards are common in

governance systems with higher degrees of coordination. At the same time, the fairness and transparency of those rules and standards is more probable when power asymmetries are limited.

e) How likely is a fair pricing structure?

The price poor producers receive for their goods is an essential factor for their income. While market forces of demand and supply are usually strong determinants of price, governance structures also have much influence on the pricing structure across the value chain. The more power asymmetry there is, the more risk that poor producers do not receive fair treatment and an equitable share of the market price. Modular governance systems (e.g. supply contract) are often of benefits for both parties, levelling price peaks in both directions.

f) How much certainty do poor producers face in their business relationships?

For poor producers, certainty in their input supply and access to markets is an important factor to mitigate their vulnerability to shocks and to improve their incomes in the medium to long term. Value chain governance structure influence the degree of certainty in business relationships through the extent of coordination, information flow and contractual nature of relationships.

B. Assessment of value chain governance systems in relation to guiding questions

The five governance systems discussed in chapter 3 offer different potential benefits for poor producers. Analysing them in terms of the guiding questions above, helps understand certain patterns. Table 2 compares the scope for benefits between the five governance systems. Where the governance system scores "high", this also implies higher potential benefits for poor producers. Where it scores "low", the potential benefits are lower as well.

Table 2: Comparison of governance systems according to guiding questions

	Market	Modular	Relational	Captive	Hierarchal
Possibilities to enter the market	High →				Low
Lead firm incentive to provide support services	Low →				High
Lead firm incentive to invest in trustful relationships	Low	High	High	Low	Low
Transparent rules and standards	Low	High	High	Low	Low
Fair pricing structure	High →				Low
Certainty in business relations	Low →				High

Source: compiled by author

5.3 Interventions for strengthening potential benefits

Table 2 shows that there is no one governance system that assures benefits for poor producers on every aspect highlighted in the guiding questions. Nevertheless, the analysis highlights that

the most promising types of governance from the perspective of poor producers are the modular and relational governance, and to a smaller extent the captive governance.

When designing development interventions in market systems, potential leverage points can be:

a) *Economic interests:* Facilitate win-win situation between lead firms and poor producers. Assess and promote the lead firm's economic interest and incentives to provide supporting services and invest in trustful, long term business relationships.
b) *Competition and strategy:* Increasing the level of competition or changes in lead firm strategies can pressure buyers, traders and others to change predatory behaviour.
c) *Social structure:* Work with respected social figures, such as key farmers, chiefs and elders who can influence others to adopt or purchase new techniques, technologies, services, inputs or organisational structures. The more competitive and innovative the producers, the more powerful they are in business relationships.
d) *Standards and rules:* Support public and private actors in setting, codifying and monitoring standards and rules that are fair and transparent for poor producers.
e) *Coordination:* Enhance coordination and general performance on the upstream side of value chains.
f) *Assess lead firm behaviour in captive governance systems:* When projects intervene in captive value chains, where power asymmetry is higher, they should ensure that the lead firm has a corporate social responsibility policy which is implemented and monitored.

6. Roles of public and private actors in value chain governance

Governance is about regulating the relations within and between state, civil society and private sector. Governance systems may be public and/or private. Public governance includes government policies such as laws, regulations, enforcement capacities, etc. Private governance includes systems that determine acceptable market behaviour, professional standards and codes of conduct, collective bargaining agreements that define the obligation of firms towards workers, and other non-governmental institutions.

6.1 The role of national governments

Governments set legal foundations for markets and enforce any violations of these. Czada (2007) describes three reasons for the regulation of markets:

- Natural monopolies,
- Negative externalities and
- Information asymmetries

A **natural monopoly** exists in a particular market if a single firm can serve that market at lower cost than any combination of two or more firms. Examples are sectors with a large network structure, such as railways, energy providers and telecommunication. Regulations may include price, quality, and/or entry conditions. The government needs to ensure that all consumers have access to the network at a comparable price (not putting consumers in remote, thinly populated areas at a disadvantage). Network industries remained publically owned and managed utilities for a long time. Only recently, these industries were privatized, with regulation challenges for the government.

Negative externalities refer to situations when the effect of production or consumption of goods and services imposes costs or benefits on others which are not reflected in the prices charged for the goods and services being provided. Pollution is an obvious example of a negative externality.

Chemicals dumped by an industrial plant into a lake may kill fish and plant life and affect the livelihood of fishermen and farmers nearby. Regulatory policy tries to internalize externalities, i.e. force those parties who cause potential damage to pay for preventing them.

Asymmetric information exists between suppliers and consumers of services and products relating to prices and quality features. A consumer of a medical drug may not be able to judge the features of the product and its side effects. Market regulation will require producers to label the product and provide information to the consumer. Consumer protection regulations aim at ensuring transparency of products qualities, and production conditions. Producers often use their own and sector-wide quality labels and certifications.

6.2 The role of supra-national governance systems

Trade in most sectors is operating at a global level. Harmonized standards are a pre-condition for smooth transactions. Many of these harmonization efforts have happened under the umbrella of the World Trade Organisation (WTO). For the food sector, the WTO has chosen Codex Alimentarius as a minimum global food quality and safety standard. However, the export into major consumer blocks is mostly ruled by company-specific and sector-wide private standards which generally are more stringent than public sector standards.

6.3 The role of civil society

A confluence of interests among civil society and government actors forced the private sector to address labour and environmental issues. In the textile and apparel sectors, aggressive campaigns by labour groups and NGOs compelled apparel manufacturers to adopt stringent codes of conducts and establish an independent monitoring. A variety of new "private governance" responses or certification institutions are emerging. These include: individual (firm-specific) corporate codes of conduct; sectoral certification schemes involving NGOs, firms, labour, and other industry stakeholders and third party auditing systems, such as SA 8000 for labour standards or the Forest Stewardship Council certification for sustainable forestry practices.

6.4 Coordination/cooperation between governments, private sector and civil society in value chain governance

Gereffi and Mayer (2004) recognise that with the globalisation of the economy, governments and civil society are not fully able to regulate markets and find a need for new governance institutions, which should play three roles with respect to value chains governance (see table 3):

- *Facilitation* - Governance institutions should play a crucial role in facilitating the operation of value chains by establishing property rights, enforcing contracts, establishing rules of fair competition, providing information, and much more. No market can operate outside of some institutional context.
- *Regulation* – Governance institutions are necessary to regulate the negative externalities of private market transactions. Without constraints or incentives, markets would exploit and endanger workers, pollute the environment and over-harvest natural resources, and generate other negative externalities.
- *Compensation* – Governance institutions play a crucial role in limiting and mitigating the unequal impacts of markets. Social insurance, health care, public education and retraining, progressive tax systems, and other welfare policies all serve to temper the tendency of markets towards highly unequal outcomes.

Table 3: The respective roles of governance institutions

Role of Governance Institutions	respectively	
	Public institutions	Private/civil society

		organisations
Facilitation	Property rights Banking and commercial policy Competition policy	Professional norms and codes
Regulation	Labour law Environmental regulations Health and safety regulations	Voluntary codes of conduct Corporate social responsibility Pressure and consumer protection
Compensation	Social insurance Education / retraining programme Public health policies	Collective bargaining Philanthropy

Source: Gereffi and Mayer (2004)

With the globalisation, civil society organisations and private companies have started to play a more prominent role in governance. The goal of civil society/private institutions is to force the lead firms in global supply chains to set higher standards of corporate conduct than lesser known suppliers would be forced to adopt. The logic of the private governance model is to identify the most profitable and visible branded companies at the apex of the global supply chains, not because the conditions of their suppliers are the worst in the world, but rather because these companies have to protect their reputation with consumers (see box 6).

Box 6: Stronger role of the private and civil society organisations in value chain governance

In the food and beverage sector, governments require the private sector to establish elaborate systems to manage food safety risks. Public agencies monitor and inspect these risk management systems within companies (and less the risk itself). The private sector has developed separate, generally more stringent food safety and quality standards than those enforced by governments. Lead firms require their suppliers to adhere to these standards. The standards have emerged to some extent in response to the regulatory and reputational risks faced by leading firms in supply chains, most notably major food retailers, but at the same time have been employed to facilitate competitive strategies of product differentiation on the basis of an increasingly wide array of food safety and quality characteristics. Private food safety and quality standards have also evolved from being predominantly business-to-business requirements to collective standards as leading firms have made efforts to manage the transaction costs associated with their global supply chains.

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7. Conclusion

This paper aims at presenting and discussing the concepts of value chain governance, in particular the type of relations that exist between firms and their suppliers. Many but not all markets are governed by a lead firm which sets the rules and standards for the whole market. Lead firms have increasing pressure to lead and coordinate value chain activities in order to increase competitiveness of the end-product, ensure quality and respond to the growing pressure from the public for good environmental and social practices.

National and international value chains can have a variety of governance structures, ranging from very loose and temporary relationships between suppliers and customers to very tight and long term relationships (integrated firms). The type of value chain governance is determined by three main factors: the complexity of transactions (products and processes); the ability to codify or explain these transactions, and the capability of suppliers to perform these transactions. Very simple transactions, a high ability to codify transactions and high capabilities of suppliers will lead to very loose relations, while very complex transactions, a low ability to codify these and a low capability of suppliers will lead to hierarchical governance.

Value chain or market development projects aim at improving the position of the poor, who are often but not exclusively small scale farmers. Before intervening in a value chain, it is important not only to understand the roles and functions of the different market players, but also the type of governance which rules the system. Questions like entry barriers for small producers, incentives of the lead firm to provide support to producers (advice and capacity development) and create trust, transparency of rules and standards, fair pricing, certainty of relationships for producers are all crucial to understand the functioning of a market system or value chain and intervene in an effective way. This will also help design the right intervention strategies.

Finally national governments, supra-national governance systems (WTO, trade unions, etc.) and civil society organisations all play an important role in value chain governance, which have to be understood and taken into consideration.

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