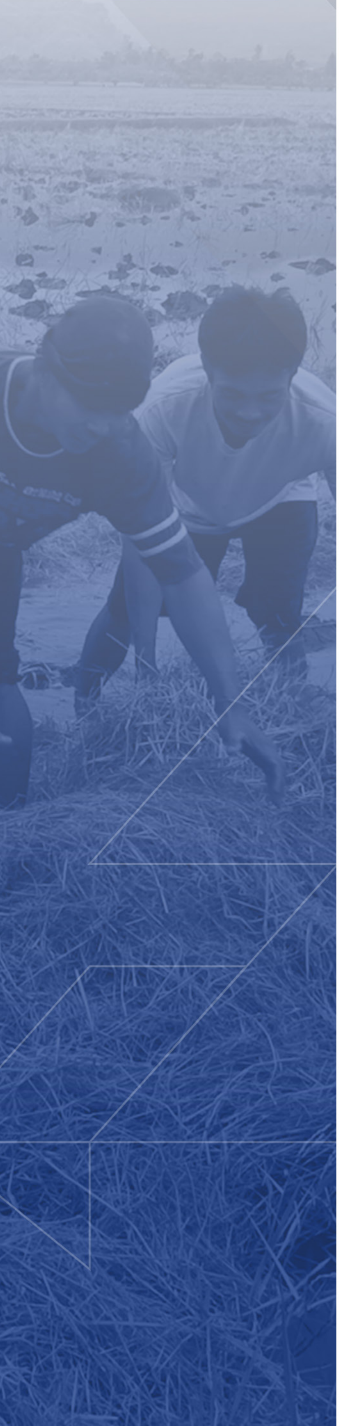

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CENTER FOR INTEGRATIVE AND DEVELOPMENT STUDIES

Program on Escaping the Middle-Income Trap: Chains for Change

**UP CIDS DISCUSSION PAPER 2019-01**

# Levelling the playing field for the rural poor through inclusive agricultural value chains

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## ABSTRACT

Agricultural value chains are non-inclusive due to the breakdown of institutions and markets for goods and services, especially those most needed by the poor. The highest transaction costs are experienced by smallholders at the end of the value chain where the extent of market failures is typically most severe. Lead firms and other powerful players in the value chain have the capacity to influence the governance and the outcome of value chains for smallholders, potentially making them powerful forces for inclusion. Their decision to directly address market and institutional failures instead of merely 'purchasing' efficiency changes the whole dynamics of the value chain. The typical trickle-down growth mindset where efficiency is given priority over equity is reversed, thereby initiating the build-up of social investments for smallholders. This complementarity of private,

[1] Inputs from Rob van Tulder, Emmanuel de Dios, Gisela Tiongson, and Rapa Lopa are gratefully acknowledged. This paper was presented in the EMIT C4C public conference entitled "Chains-for-Change: Emerging Lessons on Inclusive Agriculture Value Chains" on 18 July 2018 at the University of the Philippines (UP) School of Economics Auditorium. The inputs of Atty. Koronado Apuzen, Fr. Granwell Pitapit, and Justine Limocon, who all served as panel discussants, and of Jane Lynn Capacio who served as moderator, are highly appreciated. Photos used in this paper were taken by Noel San Andres for the EMIT C4C Action Research.

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public, and non-profit investments through sectoral partnerships is thus one of the basic pillars of inclusive value chains. This paper examines the transitions from non-inclusive to inclusive value chains and culls several lessons from three cases of inclusive business models in agricultural chains in the Philippines.

KEYWORDS

Inclusive value chains, inclusive business models, agro-enterprise development, social investments, societal partnerships

## Introduction

It is a popular notion that one way to lift the rural poor out of poverty is to allow them to directly sell to markets, thus bypassing traders and lenders that capture the lion's share of their incomes. Many companies sourcing directly from smallholders, or social enterprises and local subsidiaries acting as 'benevolent' intermediaries most likely share this view. This is easier said than done, given the great distance between the poor producer and the end consumer. Here we speak not only of physical distance, but all the hurdles that keep sellers and buyers from directly transacting with each other.

Modern production of even the simplest of products is organized in the context of value chains, which link numerous stages of processing and consolidation before final goods reach end consumers. Ever increasing demand for quality and variety has further raised the level of product sophistication, making the stages of production more and more elaborate. The race to deliver these products at the lowest price possible has led to continuous efforts to increase the scale of production so as to drive down the unit price of each product sold. This, in turn, triggers an ever-finer degree of specialization among producers leading to the continuous fragmentation of the production process. The more sophisticated a product is (e.g., electronics) or the higher is the quality demand (e.g., bananas for the Japanese market), the longer is the value chain of production.

Hence, even in well-functioning markets, the variety of inputs needed and the numerous ways to add value to a product have increased the distance between farm and markets. This is further magnified in situations that are characterized by the breakdown of markets and institutions—environments where smallholders typically find themselves in. The status quo, which creates an uneven level playing field for the rural poor tends to be resistant to change because smallholders are seen by the rest of the market players as high-risk and too marginal in the overall calculus of short- to medium-run profit. Even governments, prone to the same myopia, would estimate the returns to social investments in the rural areas as being far too low, and thus tend to focus on high income-generating populations, sectors and regions instead.

There are certainly efforts to help smallholders by bringing them closer to markets, but these are often ineffective largely because of the sheer magnitude of interventions needed to make a meaningful and long-lasting impact. This is especially true when individuals or organizations act alone, but it is also true in coordinated efforts when a critical element, such as financing or market access, would be missing. Just as it takes a village to raise a child, it takes all the key players of a value chain to raise smallholders out of poverty.

Thus, in the context of the 'wicked problems'[3] of smallholder agriculture in the Philippines, how can one envisage the process of building a more inclusive value chain? How could value be created and redistributed in the value chain towards smallholders so that they are eventually lifted out of poverty? What motivates lead agents in value chains to aim for the inclusion of smallholders?

This paper is underpinned by the one-year action research project carried out by the Escaping the Middle-Income Trap: Chains for Change (EMIT C4C) team on the agricultural value chains of Jollibee

[3] According to Rittel (1972) wicked problems are those that are difficult or impossible to solve because of: (a) incomplete or contradictory knowledge; (b) the number of people and opinions involved; (c) the large economic burden; and (d) interconnected nature of these problems with other problems.

Group Foundation (JGF), Unifrutti, and the Saradit ng Kristiyanong Komunidad (SKK) Farmers' Cooperative. It aims to define key concepts, elaborate on the analytical framework used, and introduce the preliminary themes emerging from the action research.

## What are value chains and what makes them non-inclusive?

The term 'value chain' was first introduced in a 1985 piece by Porter, and has greatly evolved in relevance and definition since then. In the current era of outsourcing and multi-firm collaboration, it could be understood as the interdependent production process geared to create value for end consumers. It involves a whole universe of suppliers and service providers, from the producers of raw materials, to consolidators, processors, logistics providers, packagers, product developers, administration, management, marketing organizations, wholesalers, and retailers.[4]

Value chains can be buyer-driven, where the lead firm controls the access to the end consumers, or producer-driven, where the lead firm possesses the key technological know-how and other IPR assets linked to the production of the final good. It could also be intermediary-driven, wherein NGOs, government agencies, and other form of social enterprises build alternative routes for smallholders to reach final consumers or act as conduits to other bigger players in existing value chains.

So what makes value chains non-inclusive? The starting point in understanding the problem of non-inclusion is to consider the

[4] Sturgeon (2001, 2) differentiates between the concepts of value chains and supply chains, with the former referring to the whole network of suppliers and buyers that lead to, and support the end use of a particular product or service, while the latter pertains to the same vertical sequence of activities but less the activities of the lead firms. Supply chain analysis therefore involves a more technical understanding of production process with the end purpose of maximizing efficiency, while the study of value chains considers the whole interaction and interdependence of multiple actors and firms, with the lead firm being principally responsible for the governance of the entire system of production.

predominance of market and institutional failures in agricultural chains. These are manifested in the failure to provide the most critical public goods and services especially in the rural areas. Numerous socio-economic and political factors connive to keep the vicious cycle of low productivity and poverty in motion, explaining why these problems are considered wicked, or systemic.

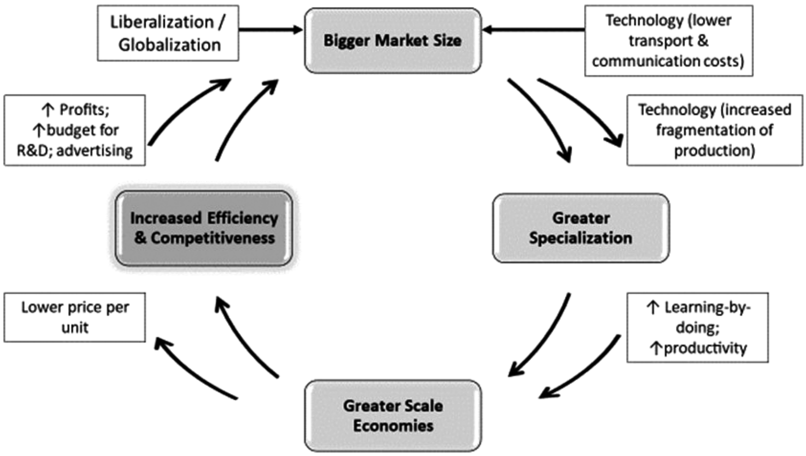
The result of the breakdown of markets and governance is what we call an 'institutional void.' This creates a gap between sellers and buyers than can only be bridged by incurring high transaction costs. In this context, the organization of value chains can be considered as an attempt by the participants within that chain to address market and institutional failures by jointly creating the needed infrastructure, developing governance mechanisms, providing access to information, know-how, and technology, all in order to lower the transaction costs in the production of the final good and be competitive in end markets.[5]

To further understand how value chains could become non-inclusive in the context of institutional voids, we begin by taking on the perspective of the lead firm. The need to reach the level of cost efficiency that will ensure competitiveness cause lead firms to aim for the maximum volume possible in order to push down the production cost per unit of output. The cumulative process of bigger scale, greater efficiency, and productivity, which then leads to even more scale is one mechanism that drives the growth and competitiveness of a value chain. This process, in turn, is triggered by the dramatic expansion of markets (through liberalization of trade, reduction of transport costs, etc.) and technological change that permits greater specialization among producers (*see* Figure 1 on page 6).

There are at least two main strategies for lead firms to overcome the high transaction costs of sourcing and processing the necessary inputs in order to achieve scale economies. One is to link the local

[5] In economics, this is termed as the 'internalization' of the externalities, or solving the problems caused by market failures (e.g., underprovision of public goods, lack of information) within a company or in this context, within the value chain.

**FIGURE 1** Cumulative process of scale, efficiency and growth, and competitiveness



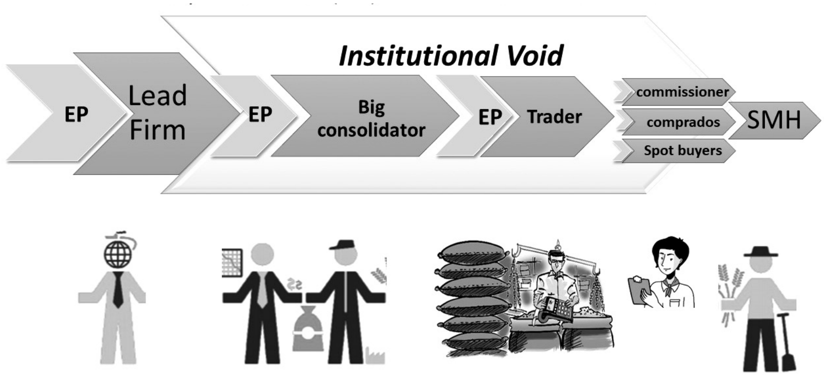

value chain to more efficient producers overseas through imports and outsourcing. The other is to link with big-scale local intermediaries who can internalize the high transaction costs further upstream in the value chain. This is indicative of the efforts of lead firms to 'buy' efficiency and pay intermediaries a premium for allowing it to solve the problems caused by the institutional voids in the local market. In effect, intermediaries shield the lead firm from the consequences of market failures elsewhere in the chain, thereby capturing part of the value earned by the lead firm from the final consumers.

Focusing on local intermediaries, how are they, in turn, able to deliver that degree of efficiency needed by the lead firm? One option is to buy the inputs directly from the cheapest source, which is the smallholder. However, the high transaction costs of doing so would often lead the big intermediary to rely on local traders who charge higher prices than smallholders but shield it from the market failures further down the value chain. In Dalaguete, Cebu, for example, even local traders turn to what is known as 'vegetable commissioners' who perform the tedious tasks of dealing directly with numerous smallholders, passing on the credit from the traders and buying their produce from the nearest market or consolidation point.

In the context of institutional voids, the value earned from the final consumers is distributed based on the power structures within the chain, which in turn, are derived from the ability to deliver efficiency and scale. For the same product and level of quality, value chains in poor countries will therefore be longer compared to those of more developed economies, because of the institutional void that attracts alternative (but relatively less efficient) transaction mechanisms and types of players.

Traders, of course, prefer to skip the big consolidators, just as smallholders would want to bypass the 'commissioners,' but they cannot because of their inability to match the cost efficiency generated by the scale economies of the bigger players in the value chain. The relative cost of 'selling' efficiency, or the relative transaction costs of intermediaries increases as one goes upstream towards the smallholders. This is due to the higher risks of direct engagement with poor smallholders and operation in rural areas. Another reason is that as the scale of the transaction falls, the cost of transaction per unit of the product traded increases. In contrast, agricultural value chains in richer economies have relatively lesser layers of intermediation because of the power of farmers to produce in greater scale and their

**FIGURE 2** Efficiency premium (EP) in non-inclusive value chains



lower transaction costs thanks to the better functioning of markets and institutions.

The highest transaction costs are experienced by smallholders at the end of the value chain, where the extent of market failures is typically most severe. This is the so-called 'poverty penalty,' which refers to the relatively higher costs shouldered by the poor compared to the other players in their participation in the value chain (Mendoza 2011, 2). Their reliance on informal credit sources means that the interest rates they face are significantly higher. In addition, the opportunity costs of spending their time in search-related activities (i.e., for better markets, more advantageous credit conditions) are higher because a great part of their effort is spent on satisfying their more basic needs (Mendoza 2011, 13).

In the absence of markets for the goods and services needed by the poor (e.g., roads, credit, knowhow, insurance from risks), the costs of participation in value chains can be prohibitive. This leads to the situation wherein smallholders are lodged in the margins of value chains where market mechanisms do not function and transactions are largely relational: contracts are informal and smallholder incomes are dictated not by market prices, but by the nature of their relationships vis-à-vis the buyers/traders.

Middlemen are often demonized and seen as pure exploiters of the smallholders' state of poverty. In reality, they fill in a gap in that institutional void, precisely where the support of government and all the rest of the actors in the value chain are lacking. The greater is the extent of the institutional void, hence, the distance between smallholders and markets, the more important the role of middlemen becomes. Since the transaction costs closest to smallholders are highest, relatively speaking, intermediaries are left with little option but to also demand higher returns (i.e., by pushing down the price given to smallholders) and charge high interest rates, or not to be active at all when the markets are too thin.

The extent of non-inclusion is worsened when the determination and distribution of value is tainted by opportunistic behavior. The absence of the usual mechanisms that curb opportunism is one of the key properties characterizing institutional voids. Weak political governance, for example, allow local officials to deliberately curb the provision of public goods in order to perpetuate corruption. It is not uncommon to find government officials who are themselves engaged in trading or provision of credit. Inability to capacitate smallholder cooperatives to negotiate with big commercial interests also has led to exploitative contracts that marred the implementation of agrarian reform, especially in the plantation regions of Mindanao. Institutional voids characterized by the absence and weakness of market institutions therefore reinforce existing social inequalities as market access and opportunity are governed by local institutional arrangements (Crow 2001; Rodrik 2007).

But what perpetuate, and in fact, reinforce this non-inclusive status quo? The answer lies in the degree of efficiency generated in the value chain, creating powerful incentives to preserve the current state of affairs. As long as the value chain is perceived to be competitive, there will hardly be any private motive to rock the efficient boat of profits. When competitive pressures emerge, however, the multiple prisoner's dilemma so characteristic of collective action problems becomes even more apparent. It is in the interest of every player in the value chain to collaborate in order to increase overall productivity, but in the absence of credible coordination mechanisms, all players choose to maximize their individual gains with the result that everybody loses. Moreover, the status quo of non-inclusion is so resistant to change because in the context of institutional voids, the government, which is normally tasked to coordinate and facilitate collective action in order to solve the societal prisoner's dilemma, also fails.

## What are inclusive business models and what are the driving motives behind them?

An inclusive business model (IBM) is generally defined as one that seeks to achieve both profit and societal goals. In the context of agricultural value chains in developing countries, particular attention is given to the increased and more meaningful participation of smallholders, as well as the positive impact on the environment.

However, the efficiency and profitability of the status quo, especially for the lead firms and all the big players in the value chain (at least in the short- and medium-run), makes it difficult to envisage a path towards inclusion where lead firms themselves would be the protagonists. Pronouncements of companies' intent to embrace inclusive business models are often met with the same scepticism given to corporate social responsibility (CSR) efforts, especially when the core business of these companies are linked to bad labor and industrial practices or environmental harm. IBMs, in fact, are more difficult to implement and could therefore be subjected to more suspicion, since this would entail not only avoiding harm, but doing good, that is, building new institutions and arrangements that create the right incentives to make inclusion all throughout the chain sustainable.[6]

However, it is precisely this capacity to influence the governance and the outcome of value chains for smallholders that potentially makes lead firms a powerful force for inclusion. The vicious cycle of low levels of productivity of smallholders and low agricultural incomes is broken when lead firms (or other players big enough to create significant and sustainable impact) take on the task of addressing the market and institutional failures of the value chain head-on, even at the expense of higher transaction costs, at least in the short- and medium-run.

There are various motives behind the decision to transition to an inclusive business model. As Figure 3 (on page 11) illustrates, the path towards inclusion and sustainability can be triggered by intrinsic, extrinsic, or mixed motives (van Tulder 2010). A lead firm might be driven to act by fear of legal liability due to a visible adverse societal impact, such as environmental damages (intrinsic motive, inactive attitude). Potential reputational damage

[6] By this definition, therefore, an inclusive business model is not: (1) merely linking smallholders to value chains without the intention or the strategy to lift them out of poverty; (2) increasing smallholder incomes but the products offered to end consumers are harmful or their production entails environmental damage; (3) helping communities through CSR but value chain is not inclusive; and (4) providing quality and affordable products to consumers but the production process is not inclusive.

**FIGURE 3** Transitions towards inclusive business models

| | | Basic Attitude | | | |
|---|---|---|---|---|---|
| | | Liability | | Responsibility | |
| Societal Responsiveness | Intrinsic | 1 Inactive | | 3 Active | 4 Proactive |
| | Mixed | | | | |
| | Extrinsic | | 2 Reactive | | |
| Business case: | | Classic | Defensive | Strategic | Societal |

*Source:* van Tulder 2010

due to growing consumer awareness of bad corporate practices could, for instance, lead firms to react and correct their policies (extrinsic motive, reactive attitude). More sustainable efforts towards inclusion are reached when firms begin to accept their social responsibilities and understand the long-run strategic importance of all their partners in the value chain, particularly smallholders in achieving sustained growth and competitiveness (intrinsic motive, active attitude). Finally, being aware of the critical role of business in the process of societal change, the societal need to address systemic and collective problems through collaborative efforts becomes a powerful impetus to seek partnerships with other societal actors.

In the Philippine context, a number of initiatives are motivated by pro-social, moral and/or religious convictions, as evidenced by the explicit reference to faith or nationalist ideals in the vision and mission statements of profit and non-profit organizations alike. Some companies that have expanded throughout the years and carry a characteristic Filipino brand, speaking of a desire to pay forward and contribute to nation-building.

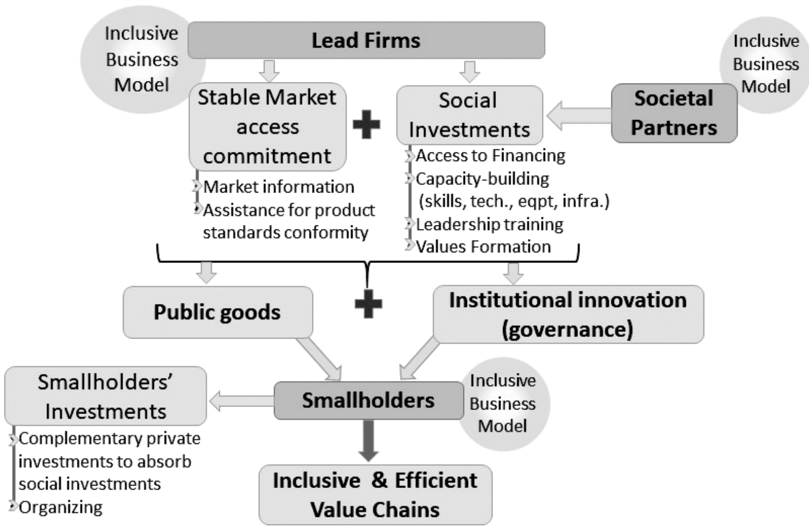
Wicked problems, when not addressed, eventually lead to crisis scenarios wherein players are pushed to the wall and are left with no choice but to change their current systems and practices. The outbreak of conflict and violence or extreme form of scarcities, for instance, are often due to structural inequities. The continuous decline of agricultural incomes has been gradually eroding the incentives of smallholders to remain in agriculture, thereby threatening the sustainability of value chains dependent on the steady supply of commodity inputs. Some lead firms might therefore not be intrinsically motivated to be inclusive but are forced to be so due to the adverse impact of non-inclusion on the competitiveness of all the enterprises linked in the chain. For outcomes to be sustainable, however, the value of inclusion as a source of resilience for the entire value chain must be recognized. As Kolk and van Tulder (2014, 89–90) argued, it is this mix of intrinsic and extrinsic motives that could propel lead agents out of their comfort and efficiency zones to embark on the more difficult but necessary task of creating inclusive value chains.

## How do value chains transition towards inclusion?

Once powerful players reach the decision to directly address the market and institutional failures instead of merely 'purchasing' efficiency, the whole dynamics of a value chain changes. The typical trickle-down growth mindset, where efficiency is given priority over equity, is reversed, thereby initiating the build-up of social investments for smallholders. Lead firms are potentially effective agents of change because of their capacity to commit stable market access and their ability to invest in sizeable resources. This, in turn, encourages other societal partners to contribute their own investments, leading to a joint pool of capital that can be invested on the needed social and physical infrastructure for the poor. NGOs, development organizations, and government agencies are often natural partners for lead firms given their public service orientated mandates. This complementarity of private, public, non-profit investments through sectoral partnerships is thus one of the basic pillars of inclusive value chains.

As depicted in Figure 4 (on page 13), the transition towards inclusion gradually progresses the more that value chain stakeholders are able to address institutional voids through the provision of

**FIGURE 4** Transitions towards inclusive and efficient value chains




public goods and new governance mechanisms. It is this process that eventually bridges the distance between markets and smallholders, enabling the latter to address the high costs and risks of production. An important milestone is reached when incentives arise for smallholders themselves to invest on their own capacities, both as individuals and as a collective. Attendance in trainings and workshops and the usage of appropriate inputs and application of modern production practices are relatively expensive undertakings for smallholders. But with the promise of stable market access and the assurance of help from the rest in the value chain and beyond, smallholders will be likely to take on these investments despite costs and risks.

Inclusive business models ensure sustainability because of the new institutions and market arrangements that set off the virtuous cycle of inclusion and competitiveness. The multiple prisoner's dilemma is solved through coordination and repetitive cooperative behaviour that instills trust and cements long-run relationships between suppliers and buyers. As Dixit (2009, 6) argued, "good governance underpins the whole Smithian process whereby individuals specialize in different tasks and then transact with one another to achieve the full economic potential of the society." Efficiency and equity in this light is not so much a trade-off, but rather as twin goals that must simultaneously be aimed at, with equity motives being an effective trigger of public and private investments, and hence, long-term efficiency and broad-based growth.

The determination of the amount and nature of social investments is highly context-dependent. While inclusive business models may illustrate the driving forces or elements needed to make projects work, they do not provide a one-size-fits-all template that can be easily applied or replicated. For this reason, deliberate and collaborative learning among stakeholders is key in making sure that inclusion is eventually achieved. The design of IBMs, for instance, must consider: (1) the different types of smallholders and their initial levels of assets and productivity; (2) the different types of products (e.g., exports, high value crops, commodity crops, fisheries); and (3) the different types of geographic regions and the corresponding quality of public infrastructure and other public goods. Where more social investments are needed, the lower is the initial level of assets and skills of farmers, the higher the quality of product demanded, and the more inferior are the existing public goods and services for the poor.

## Some emerging lessons from inclusive agricultural value chains

This section briefly analyzes three agricultural value chains in order to highlight some of the insights gathered. These cases consist of Jollibee Foods Corporation's value chain for vegetables, the SKK Farmers' Corporation's value chain for rice, and Unifrutti Tropical Philippines Incorporated's cavendish banana value chain.[7]

**LESSON 1:** Some inclusive business models need to be incubated in a company policy space that allows experimentation (and hence, also failures) as well as long-term visioning. However, it is

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[7] *See* Box 1 (on page 16) for further description of the three cases.

important that clear and strong support should be given by the top leadership of the company.

The development of inclusive business models is often hampered by the prevailing mindsets within the organization itself. As Halme et. al. (2012, 744) pointed out, a so-called 'intrapreneurial bricolage' is needed, wherein an individual or a group of individuals act like an entrepreneur in a large organization, introducing out-of-ordinary activities in order to pilot alternative practices stemming from a different set of paradigms. The empirical evidence presented by Halme et. al. (2012) show that intrapreneurial bricolage may be a fundamental element of inclusive innovation. In the case of JGF, they are provided resources (i.e., 1.5% of JFC's net profits), and independence to develop programs but backed by the company's owners themselves. This prevents a situation wherein the innovations by JGF are locked in the fringes of the company and do not impact on mainstream business practices. How that intrapreneurial bricolage is enhanced and nurtured, and the ways in which inclusive innovation are introduced into core business are interesting areas of further study.

The vision of inclusion was primarily espoused by Unifrutti's first chief executive officer (CEO), but was diffused throughout the organization by way of weekly values formation and a monthly Values Reconciliation Board.[8] The latter is a forum wherein rank-and-file employees can air their grievances directly to the highest leadership (or his representative) of the company. This measure was adopted in order to ensure alignment ('reconciliation') of practices with the vision and mission of Unifrutti. Since the core business model is geared towards inclusion, intrapreneurial bricolage in this context is focused more on ensuring coherence of intent and practice, as well as fostering the alignment of the vision throughout the different segments of the company. The current challenge is the alignment beyond the walls of the company and throughout the value chain, particularly with the external grower cooperatives, and with the lead firm of the global value chain with whom Unifrutti is linked.

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[8] It is now called Values Reconciliation Movement.

**BOX 1: EMIT C4C's case studies on agricultural value chains**

Jollibee Foods Corporation (JFC), being the Philippines' largest fast food chain and one of the biggest in Asia, sources most of its agricultural inputs from large-scale suppliers. Since 2007, its social responsibility arm, the Jollibee Group Foundation (JGF), launched the Farmers Entrepreneurship Program (FEP) in order to convert JFC's massive daily requirement for agricultural produce into an opportunity to raise smallholders' incomes. They realized that two important interventions are needed: build the entrepreneurial capabilities of farmers and coordinate the activities of key players in the supply chain in order to address the market failures that directly contribute to the marginalization of the farmers who are the weakest participants of the chain. This effort was spurred by JFC's 'paying-it-forward' motive, explicitly voicing out its aim to contribute to nation-building. The focus on direct sourcing was driven by the decision to use the company's core business and competencies in order to be more efficient and effective in helping the poor.

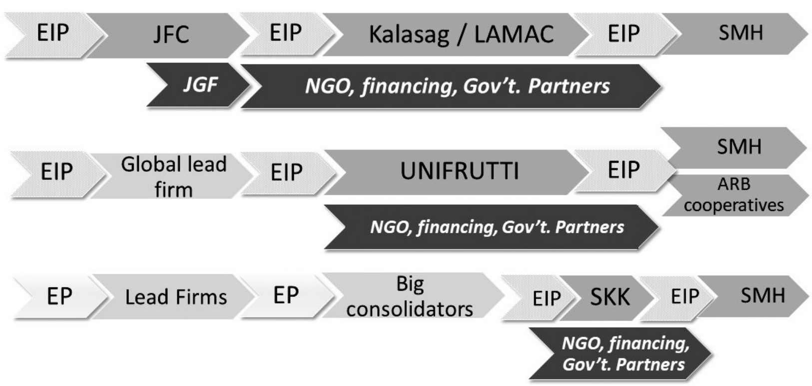
Unifrutti Tropical Philippines is a Cavendish banana exporter active in Mindanao since 1992. While the plantation sector is generally typified as being exploitative of workers and harmful for the environment, Unifrutti is known instead for its high labor standards and care for the environment. Its inclusive business model is driven by faith-centered vision, explicitly stating its commitment to improve the quality of life of "our brother Muslims, Cultural Communities, and Christians (…)," and "preserve and restore the environment by implementing reforestation and other enhancement measures to maintain the ideal micro-climates conducive for sustainable agricultural production" (Leonard et al. 2015, 55). The case of Unifrutti is unique in the sector also because of the decision to invest in conflict-ridden areas in Mindanao. Their 25 years of experience demonstrate the inseparable link between peace and inclusion, and how business could be a powerful means to realize both.

The Saradit ng Kristiyanong Komunidad (SKK) Farmers Corporation originated from the Basic Ecclesial Communities (BECs) of the Diocese of Libmanan, Bicol. In 2013, the regional Department of Agriculture provided them with a Php 16-million rice processing center, which allowed them to provide rice farmers with an alternative market for their palay. The SKK Farmers Corporation also has been providing access to production financing, values formation, and simple farm implements. The core intent of SKK is to give smallholders more economic and social leverage in the rice value chain (Capacio et al., forthcoming). The SKK story provides a glimpse of the circumstances of standalone players in the value chain, who, with the assistance of social financing organizations, persevere to lift smallholders out of poverty despite of their marginal power in the supply chain of rice. The mix of these cases provide us with the opportunity to study the drivers of successes and failures of interventions to help smallholders from a position of power and/or weakness in the value chain.

**LESSON 2:** Partnerships are key in completing the minimum level of social investments needed to capacitate and incentivize smallholders to be proactive. Inability to meet this threshold could expose smallholders to even further risks and threaten the viability of inclusion efforts.

Figure 5 below illustrates the value chains of the cases discussed in this section. All three cases relied on the collaboration of various societal partners in order to enable smallholders to be linked to the value chain and benefit from that engagement. In earlier phases, smallholders have experienced the adverse outcome of missing interventions. For instance, in Cebu, Lamac Multipurpose Cooperative initially extended agricultural loans to smallholders but without the guaranteed access to markets. External shocks, such as prolonged droughts led to harvest failures, which quickly resulted in the debt trap of the most vulnerable smallholders. In the case of SKK, the same climactic shocks (i.e., three floodings in one planting season) caused smallholders to return to the fold of informal lenders and traders as the lending facility of SKK was insufficient to cover the needs of smallholders for production loans. Some Agrarian Reform Beneficiaries (ARB) cooperatives linked to Unifrutti had market access guarantees as well as sufficient financing, especially to address the destruction brought about by Typhoon Pablo in 2012 and the resulting outbreak of plant disease. However, the lack of organizational

**FIGURE 5** Efficiency and inclusion premium (EIP) of inclusive value chains



expertise and weak leadership of the ARB cooperative, coupled with the regulatory failure on the part of government and peculiar market conditions, led to pole vaulting and mismanagement of loaned funds. This kind of instances show how piece-meal approaches to inclusion may do more harm than good. Linking smallholders to the value chain does not automatically lead to inclusion if their incomes do not rise to levels that allow them to escape structural poverty. And for this to happen, partnerships among key stakeholders must be created in order to ensure that the threshold level of social investments needed for smallholders to meaningfully participate in the value chain are simultaneously met.

**LESSON 3:** The impact of inclusive value chains on smallholders increase the more direct actors in the value chain embrace inclusive business models.

The Farmer Entrepreneurship Program has resulted in a significant rise in the incomes of smallholders covered by the program because the biggest and most powerful actor in that particular value chain was the one that opened up a channel of inclusion. Expanding that window of opportunity deeper within the core business of Jollibee Foods Corporation, and externally, to more products and farmer communities remains to be a formidable challenge, but the significant rise in smallholders' incomes currently reached by the FEP demonstrates the large potential impact of a lead firm's shift towards an inclusive business model. The same is true for the workers of Unifrutti-managed plantations and external growers (mostly from cooperatives) linked to the company. This is because Unifrutti, while being relatively small in the global value chain, is large enough to provide resources and redistribute value towards smallholders. However, if the foreign lead firm governing the global value chain is not inclusive, at least not explicitly, it could limit the capacity of Unifrutti to fully implement its inclusive business model. The case of SKK illustrates instead the many dilemmas faced by a small actor in a predominantly non-inclusive value chain. The resources bundled by SKK and partners were insufficient to meet all the financing needs of smallholders, which in turn, made it difficult to ween rice farmers away from their traditional relationships with informal traders and lenders. Moreover, the lack of long-term links with big off-takers hampers the viability of SKK's business model. These problems are currently being addressed by scaling up (e.g., investing on a bigger rice mill) in order to reach the level of quality and price competitiveness needed to be a credible supplier to institutional buyers. The experience of SKK is typical of many social enterprises or NGO-driven projects where insufficient resources, small scale of operations, and weak capacity to extract value in the entire chain limit the growth of smallholder incomes.

**LESSON 4:** A sustainable inclusive value chain requires all key actors, including smallholders, to embrace an inclusive business model.

Lack of reciprocity or free-riding by partners deflate the resolve to persevere with inclusion. Collective action therefore requires mutual trust, which is facilitated when everyone takes on an inclusive business model for its underlying long-term vision. The convergence of interests and vision of Jollibee Group Foundation and Catholic Relief Services was one of the principal triggers that led to the establishment of the Farmers Entrepreneurship Program. The partnership of Unifrutti and FarmCoop has also been based on the shared objective of empowering ARBs in the banana sector in Mindanao. The same is also true with SKK's collaboration with microfinance and social financing institutions such as PinoyME Foundation, Peace & Equity Fund, and church-based Pondo ng Pinoy. What seemed to be important, especially with business-NGO partnerships, is the balance between efficiency and equity objectives and the acceptance that both aims should be met. However, this balance does not always come in naturally. One microfinance partner, for instance, locked-in a farmers' group, hindering their graduation towards formal financing at lower interest rates. In some cases, the greater weight given to equity dampened the smallholders' entrepreneurial spirit and resilience. When asked why one farmers' group succeeded and another failed, a local government official said that it was because they have 'spoiled' the latter, providing them with subsidies and help that only instilled dependence. The more successful farmers' group, in contrast, had to rely more on their own organizational skills and resourcefulness. There were also ‘spot partners’ who come in at their convenience to meet their organizational or funding agenda, but do not follow through or stay long enough to ensure that their task is fully completed or that smallholders are sufficiently capacitated. The result is disillusionment and a waste of resources, as smallholders end up resorting back to their old practices.

The incidence of pole-vaulting, or smallholders reneging on contracts by selling to spot buyers, is particularly problematic for building trust and confidence among value chain partners. Opportunistic behavior is fostered by a host of factors and a good understanding of these factors is needed to ensure that relationships are not broken at the first incidence of a misstep. A particularly extreme case of pole-vaulting was experienced by Unifrutti with one of its external grower ARB cooperatives and at least four lessons can be derived from it.

First, smallholders need to develop their own business model, but this must be given enough time as norms shaped by years of living in poverty can only be changed gradually. Numerous studies point to the psychological consequences of destitution, which breed economic behavior that severely hinders the escape from poverty. Short-sighted and highly risk-averse decision-making among the poor have been shown to prevent them from goal-targeted behavior: for instance, making them stick to habitual behaviors, including outdated ways of production. Smallholders are therefore highly responsive to short-term gains. It will take education and confidence on the durability of market access for them to switch to long-term planning and resist short-sighted opportunism.

Second, developing the leadership skills of the smallholders’ leaders is of paramount importance. As the experience of JGF and Unifrutti has proven, different farmers’ cooperatives facing the same circumstances will often be differentiated by the quality of their leaders.

Third, effective governance entails monitoring and credible sanctions. As Dixit (2009, 10) rightfully pointed out, “the most effective defence against opportunistic behavior is counterparties’ surveillance." In the case of the pole-vaulting partner of Unifrutti, however, it was clear that even the physical setup of the plantation made monitoring close to impossible. The set of sanctions available were also not credible, as it proved to be extremely difficult to delist erring members from the cooperative.

Lastly, there is a gap between spot and agreed prices that will test (and break) even the strongest of partnerships. That price gap is easily remedied when the lead firm has full discretion to set prices so that they do not deviate too far away from market levels. However, a local intermediary or lead supplier in a global value chain do not have such full discretion. In such cases, the financial viability of both the smallholders' and companies' business model would call for adjustment measures that can be mutually agreed upon.

**LESSON 5:** The process of building inclusive business value chains is replete with tipping points. To overcome these, effective leadership or expansion of partnerships, long-term financing, and diversification strategies are needed.

Inclusive business models go against the grain of many standard practices. The essence of leadership is to prod, convince, and sometimes force others to take the narrow path avoided by most. For Jollibee, it meant opting for a more laborious way of purchasing directly from farmers when more efficient alternatives are just an email away. For Unifrutti, it meant aiming for a 75-25 percent permanent to contractual hiring ratio when the industry standard is exactly the opposite. It also meant investing in conflict-ridden areas of Mindanao when safer alternatives could be found elsewhere. For SKK, it meant persevering in building up resources when practically all financing channels for smallholders have closed. In all these instances, leadership meant accepting the short-run costs and pains because of the vision of long-run benefits for all.

Resilience of the whole value chain requires that participating groups and organizations are themselves guided by able leaders. There are numerous 'tipping points' when success or failure depended on the strength of leaders to persevere in the search for innovative solutions, take initiative in finding own resources, organize more able members to help those who are weaker or assailed by calamities (e.g., pests and diseases in their fields), and nip short-sighted opportunistic behavior in the bud when market conditions shift power towards farmers (e.g., sharp rise of spot prices due to scarcity). Leadership among smallholders is particularly important as they are the ones who must escape the position of dependency in the value chain. But at all stages of the value chain, different types of leadership can be observed. Most vital is a particular combination of two leadership: (1) transformational leadership, which is aimed at addressing the root causes of the non-inclusive nature of value chains, and (2) connected leadership, which realizes that change can only be achieved in collaborative ventures, both inside the own organisation and externally, with other stakeholders.

One of the hindrances of upscaling the scale and reach of inclusive value chains is the lack of adequate financing partners willing and able to provide a complete set of loans (for production inputs and buying funds) and prepared to enter into long-term relationships, not only with smallholders, but with all the participants of the value chain. This requires that financing organizations open up to new venues of so-called 'blended finance' provisions and the development of new financing instruments that support conglomerates or value chains, rather than individual actors like smallholders. This requires that financial institutions should have a much better understanding of how an 'inclusive business model'—at all levels of the value chain—looks like both in terms of ambition and realization. Banks do not seem to have the right metrics/protocols to make a proper risk assessment of value chains that are aiming at longer term inclusion and competitiveness.

Initially, only social enterprise/microfinance partners took the risk in exploring the uncertain (and largely unknown) terrain of value chain financing of smallholders. Early financing partners have themselves invested by exposing themselves to the many risks accompanying the initial stages of building an inclusive value chain. Their participation broke the chicken-and- egg problem of the smallholders' bankability, where banks do not lend because of high risk, which, in turn, is caused or exacerbated by smallholders' lack of credit access. The path to bankability is paved by inclusive value chains, providing the conditions that allow smallholders to prove their financial resilience, which, in turn, attracts the profit interest of commercial banks. Some smallholder cooperatives, in fact, eventually shifted out of microfinance and towards the lower-interest regimes of commercial banks.

Reducing the various dependencies inherent in captive value chains is one principal aim of partners working for inclusion. Eventually, this can be achieved when smallholders have free access to a diversity of end markets as well as service and input providers.

## Conclusion

When market failures are rampant, letting the markets work freely only marginalizes smallholders even further. When weak governance or regulatory institutions combine with market failures, an institutional void arises, thereby breeding opportunistic behaviour. The 'tragedy of the commons' is that while everyone understands that a society based on opportunism ultimately harms all, no one takes the initiative to act because individual effort is felt as being futile when what is needed is collective action.

In the context of value chains, however, lead firms have the power and resources to address the institutional void in their own value chains. The key trigger is understanding that everyone ultimately suffers from non-inclusion, while everyone ultimately benefits from collective action in the form of higher productivity and competitiveness. This long-run vision of shared creation of value and shared prosperity for all is the critical spark towards inclusive value chains.

When lead firms do not act, other actors may try to do the best they could and possibly achieve some success. However, limitations in terms of resources and uncertainties of market access could greatly limit the impact of these interventions. Unifrutti, for instance, is a big company but a relatively a small player in the international market and is in a captive relationship with the lead firm of the global value chain of Cavendish bananas. There is therefore a limit with which Unifrutti can adapt its strategies or use its resources in order to make its value chain fully inclusive. Social enterprises, such as the SKK Farmers Corporation in Libmanan, Camarines Sur, are fully committed for inclusion, but its impact on smallholders is hindered by their lack of power in the local value chains for rice. One of the reasons why the status quo of non-inclusion is so persistent is due to inability of most (global and local) lead firms to project themselves towards the long-run, especially when their enterprises are highly efficient and profitable in the short- and medium-run.

Clearly, the lack of appropriate government services and enabling environment for farmers to thrive are other key elements of the wicked problem of Philippine agriculture. The Jollibee, Unifrutti, and SKK cases demonstrate what can be done and what impact inclusive business models have on smallholders, but upscaling through replication and expansion of ongoing initiatives needs even greater collaboration (e.g., industry-wide) and the engagement of government for policy reforms. In the Escaping the Middle-Income Trap (EMIT) project, from which this research on agricultural value chains originated, we found that while reaching the middle-income level for countries like the Philippines may not be difficult, transitioning to the higher income category would require better institutions. The same is true in stepping up the impact of inclusion. The power of inclusive business models to effect lasting change and lift smallholders out of poverty is bounded by the institutional void more prevalent in the overall socio-economic system.

There is likewise the danger of inclusive value chains producing islands of prosperity in a sea of misery, thereby accentuating inequalities within communities. This is the reason why an inclusive value chain cannot build inclusion alone. Levelling the playing field for the rural poor needs more inclusive lead firms, intermediaries, financing institutions, and government agencies. The understanding of what inclusive business models are and what they entail must be further deepened and diffused.

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