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Leveraging Economic Opportunities

## A FRAMEWORK FOR INCLUSIVE MARKET SYSTEM DEVELOPMENT

### INTRODUCTION

Achieving sustainable impact at scale is the objective of most USAID projects. Inclusive market system development is increasingly recognized as a potential means for achieving this objective. Reflecting many of the Agency's priorities, an inclusive market system development approach focuses on building the capacity and resilience of local systems, leveraging the incentives and resources of the private sector, ensuring the beneficial inclusion of the very poor, and stimulating change and innovation that continues to grow beyond the life of the project.

Specifically, the objective of inclusive market system development is to catalyze a process that results in a market system that is

- *competitive*—system actors are able to effectively innovate, upgrade and add value to their products and services to match market demand and maintain or grow market share;
- *inclusive*—delivering a sustainable flow of benefits to a range of actors, including the poor and otherwise marginalized, as well as to society as a whole; and
- *resilient*—system actors are able to address, absorb and overcome shocks in the market, policy environment, resource base or other aspect of the system.

Inclusive market systems development is the continuation of USAID's evolution of thinking around private sector development. It builds on the Donor Committee for Enterprise Development's identification of good practice in the delivery of goods and services through market actors<sup>1</sup>; and on the subsequent value chain approach (see text box 1).

The Leveraging Economic Opportunities (LEO) project aims to improve USAID programming by enabling the development of inclusive market systems. To support this process, LEO has developed a framework that defines market systems and provides general guidelines for interventions. The purpose of this brief paper is to describe this framework to USAID and implementers, promoting a common understanding of market systems, as well as some of the implications for project interventions.

#### TEXT BOX 1: RELATION TO VALUE CHAIN FRAMEWORK

Since 2006, USAID has promoted use of the value chain (VC) framework<sup>i</sup> to encourage a market system approach to economic growth with poverty reduction. The VC framework is an effective tool for communicating the roles and relationships of VC actors in bringing a product or service from inception to end market consumers. Learning over time has revealed the need for an expanded model that expresses the wider context in which VCs operate. This wider context is essential because the goal of inclusive market development goes far beyond moving a product or service from inception through to end market consumers. Rather, it aims to catalyze a process that results in a market system that is able to adapt as needed over time to deliver a sustained flow of benefits to system actors, including the poor and otherwise disadvantaged or excluded. The market systems framework therefore builds on—and is intended to complement rather than replace—the VC framework.

<sup>i</sup> See Kula, O., J. Downing & M. Field. (2006). *Globalization and the Small Firm: A Value Chain Approach to Economic Growth and Poverty Reduction* (USAID).

<sup>1</sup> Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention. The Committee of Donor Agencies for Small Enterprise Development (2001).

## DEFINING INCLUSIVE MARKET SYSTEMS

A *market system* is a dynamic space—incorporating resources, roles, relationships, rules and results<sup>2</sup>—in which private and public actors<sup>3</sup> collaborate, coordinate and compete for the production, distribution and consumption of goods and services. The behavior and performance of these actors are influenced by other actors’ decisions, and by rules, incentives and the physical environment. Market systems are composed of vertically and horizontally linked firms and the relationships embedded in these linkages; end markets, input and support service markets; and the environment in which they operate, which may include socio-cultural, geographic and political factors, infrastructure and institutions.

*Inclusive* market systems are those that engage and benefit a range of actors including the poor, women, youth, ethnic minorities and/or other marginalized groups who are often excluded—or even exploited—by traditional market systems. In inclusive market systems, such actors are able to acquire access to the opportunities, skills and resources to upgrade, and the capabilities to engage with and influence these systems to reap the benefits that arise from the upgrading process.

## UNDERSTANDING MARKET SYSTEMS

Promoting inclusive market systems requires donors and implementers to understand the local context and peculiarities of the system in which they are working, in addition to the general considerations enumerated below.

### 1. Market systems include value chains

Figure 1, the market system, illustrates how households interact with multiple, possibly interconnected value chains. Value chains catalyze and are impacted by broader economic change through multiplier effects.

*Example:* Development of the maize sector may contribute to an increase in the number of agricultural equipment leasing companies; the growth of the poultry sector, which uses maize for feed; and/or the emergence of small restaurants, bicycle repair shops, and other small businesses in rural areas where farmers’ incomes are increasing.

Figure 1: Market system

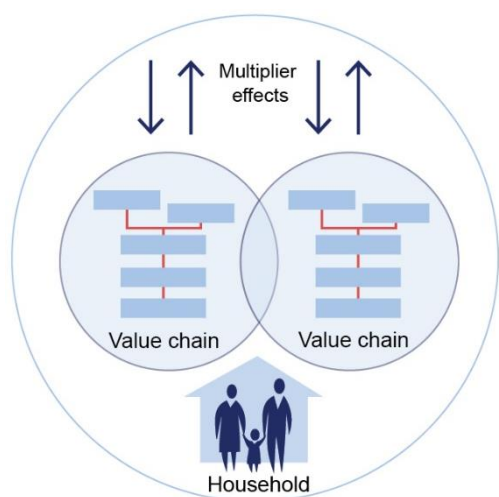
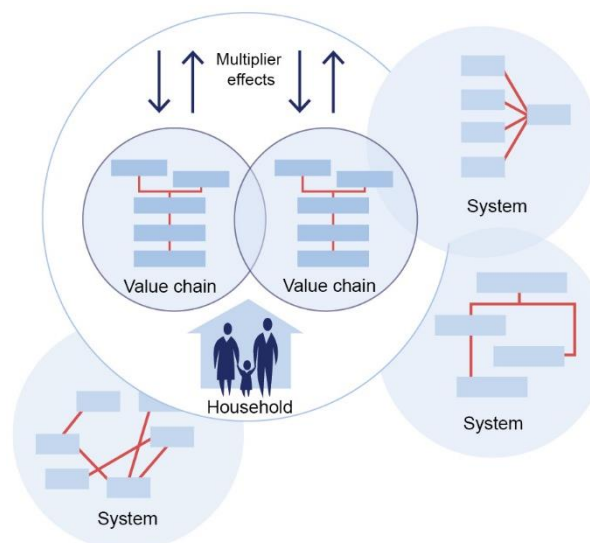


Figure 2: Interconnected systems



<sup>2</sup> USAID. (2013). *Local Systems: A Framework for Supporting Sustained Development*.

<sup>3</sup> Generally, the ideal is for private sector actors to deliver goods and services, and public sector actors to set and enforce the rules. However, in actuality, these roles are not so clearly differentiated in many markets around the world.

## 2. Market systems interconnect with other systems

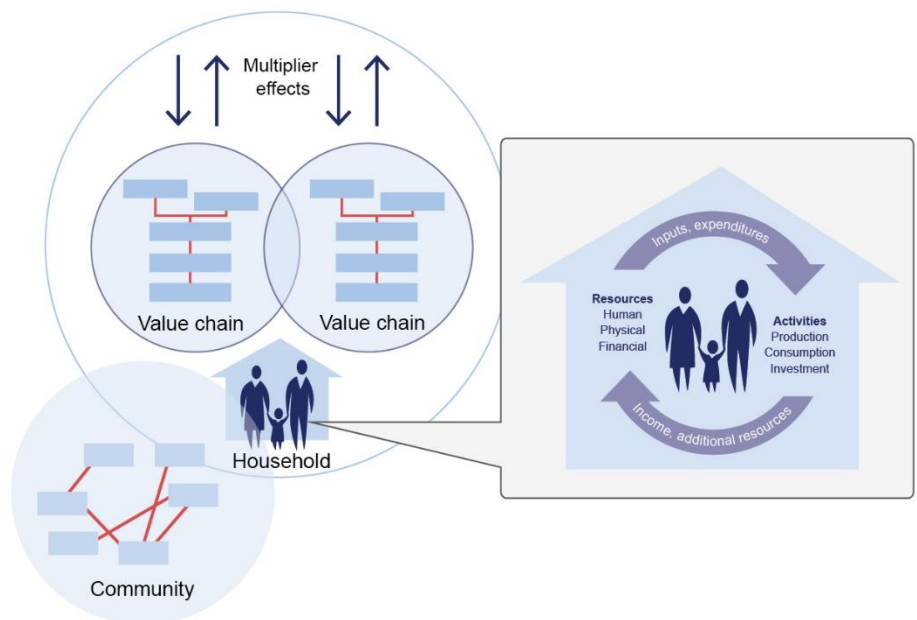
Market systems interact with other systems (figure 2), such as health systems, education systems, socio-cultural systems, and ecosystems. Changes in one system can affect the functioning of other systems. While no single project can be expected to simultaneously transform multiple systems, such interconnectivity sometimes allows practitioners to trigger broad-scale change in the market system by targeting linkages with other systems. By understanding the connections between systems, practitioners can decide whether to address a given constraint in a linked system, or find ways to mitigate its impact.

*Example:* Increased schooling for children may lead to rural-to-urban migration, which may cause the costs of agricultural production to rise as the rural labor pool shrinks. Meanwhile the development of mobile money platforms to enable the transfer of remittances back to rural areas, may create the opportunity for increasing smallholder farmer access to credit, enabling investment in more profitable production technologies.

## 3. Market systems include households and communities

Households and communities are also systems (figure 3). Decisions about resource allocation are negotiated among household and community members, influenced by individuals' incentives and expectations, status and decision-making power, a range of socio-cultural norms and traditions, and physical factors that constrain available options. Understanding household and community systems and how they interact with each other and other systems can be important for achieving development objectives.

Figure 3: Household system



*Example:* Household finances and risks, along with community level socio-cultural norms, should be understood if small-scale producers are being encouraged to participate in certain value chains—particularly if this participation is likely to result in reduced resources for other economic activities, threaten an individual's household or community status, or create additional demands on women's or children's time. Additional activities may need to be included in a project to compensate for potential negative impact—such as activities that reduce women's labor demands, or that strengthen the voice of youth within the community.

## 4. Market systems have “soft” boundaries

Since market systems contain sub-systems (household systems, value chain systems, etc.), and are connected to health systems, political systems, ecosystems, and the like, project implementers and managers are faced with the challenge of how to define the intervention space. How wide or focused should the parameters be for the purposes of analysis, the design of interventions, the monitoring of systems change, and the evaluation of impact?

The process of setting the system boundaries should begin with understanding the objective of inclusive market system development: to catalyze a process that results in a market system that is competitive, inclusive, and resilient.

The intervention space for inclusive market system development must include the actors and institutions that need to be directly or indirectly engaged in order to achieve this objective. These actors and institutions will be determined through market system analysis, and identified in the project's theory of change (see text box 2). This theory of change will be adapted and updated periodically throughout the life of the project in response to changing system dynamics and project learning, and the actors and institutions considered key to development of the market system will similarly need to be adjusted.

*Example:* To catalyze change in the horticultural value chain in Liberia, project implementers found it necessary to address issues related to transportation infrastructure, seed importation policies, and customary land tenure.

Farmers proved unwilling to invest resources in horticulture until their rice yields increased to meet the consumption needs of the household. Buyers were unable to expand into rural areas because of a lack of literate, business minded youth available to work as buying agents. Over time, the project's view of the market system grew beyond the horticulture value chain to incorporate the rice value chain, input supply systems and educational institutions, among others.

## 5. Market systems are complex

Market systems contain many actors, institutions, structures and influences that are both interconnected and independent. These system elements interact in ways that are often unpredictable at the transaction level—although at the aggregate level may be observed to follow patterns over time. Consequently, the results of many interventions in market system development projects cannot be predicted in advance.

*Example:* When market prices for a product increase, production at the aggregate level can generally be expected to increase in response. At the local level, however, there may be many reasons why this does not occur. A project in Mozambique found that farmers did not grow more chilies in response to rising demand because the peppers were planted primarily as land markers, and were not viewed as a “serious” crop worthy of investment.

However, not everything in a market system is complex, as defined by Snowden and others (see text box 3, below).<sup>4</sup> Some project interventions target *complicated* parts of the system, where inputs are transformed into outputs through cause and effect relationships that are not self-evident but can be explained. Expertise is needed to understand the change process, which may be captured through a similarly complicated theory of change or causal model. Many interventions in market systems development projects simultaneously have aspects that are *simple* (where processes or causality can be predicted with a relatively high degree of certainty), *complicated* and *complex*, depending on the type of knowledge needed. Understanding whether a change process is simple, complicated or complex will affect the way practitioners plan, implement and measure the performance of activities.

### TEXT BOX 2: THEORY OF CHANGE

The theory of change identifies the main constraints in the market system that must be addressed for that system to become competitive, inclusive, and resilient. The theory of change describes the underlying assumptions behind the change process and the expected changes leading from interventions to outcomes to impact. It is important that the theory of change reflects market actors' view of how change occurs and will occur. Articulating a theory of change is helpful in creating a shared vision of the project objectives, how these will be achieved, and what will be used to measure progress.

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<sup>4</sup> There are a number of excellent summaries of current thinking on complexity and possible implications for market systems. These include Britt, H. (2013). *Complexity Aware Monitoring* (Discussion Note). USAID.; and Jenal, M. and S. Cunningham. (2013). *Gaining systemic insight to strengthen economic development initiatives* (Working paper 16). Mesopartner.

*Example:* If appropriate procedures are followed, barring disastrous weather conditions, crops planted will grow in a more or less predictable fashion. Such **simple** interventions typically rely heavily on explicit knowledge and are relatively simple to codify in standard operating procedures and through best practices.

Knowing which varieties are most appropriate for a given type of soil, agro-climatic conditions, consumer preferences, micro-nutrient needs, and market trends, requires expertise in variety of areas from agronomy to nutrition to market analysis. Such **complicated**, multi-dimensional interventions require both explicit and tacit knowledge. They resist easy codification, but can be managed by experts and lead to the identification of good practices.

The process by which farmers decide to change their production practices is influenced by a wide range of factors, including access to resources, cultural attitudes toward innovation, individuals' risk tolerance, economic alternatives and risks to household wellbeing. Many of these influences are beyond the control of the project implementer. In this **complex** situation, multiple "best guess" interventions need to be piloted and observed to see which are most effective in promoting the adoption of new production practices.

### **TEXT BOX 3: SIMPLE, COMPLICATED AND COMPLEX SYSTEMS**

The Cynefin framework provides a typology of systems and processes, including simple, complicated and complex.

A **simple** system is characterized by order; linear cause and effect relationships; and perceivable, predictable and replicable results. A typical example of a simple process is baking a cake.

A **complicated** system is also characterized by order, and cause and effect relationships. However, these relationships are not self-evident. Results can be replicated with a high degree of certainty of outcome. Such systems are best understood by breaking them down into their constituent parts, which can then be analyzed by experts. A typical example of a complicated process is sending an astronaut to the moon.

A **complex** system is characterized by disorder and non-linear relationships between cause and effect. Complex systems have many interconnected and interdependent elements and dimensions, and the results of interactions among these elements are unpredictable and nonreplicable. Such systems lend themselves to experimentation, and a focus on relationships and retrospective pattern identification. A typical example is raising a child.

Based on Snowden, D. (2000). Cynefin: a sense of time and space, the social ecology of knowledge management. In C. Despres & D. Chauvel (Eds.), *Knowledge Horizons: The Present and the Promise of Knowledge Management*. Butterworth-Heinemann.

## **6. Market systems are self-organizing**

Market systems evolve in response to many external and internal factors and forces. It is extremely important for donors and project implementers attempting to strengthen inclusive market systems to understand the drivers that have resulted in a system's current way of operating. The vested interests of market actors generally need to be addressed for widespread change to occur. Vested interests may not be apparent at the outset of an intervention, but often emerge as market system changes begin to take hold. Ongoing analysis and learning are therefore essential.

*Example:* A project seeking to strengthen input supply networks in a country where the government uses fertilizer subsidies to gain rural votes, may need to assist the government in finding new ways of demonstrating commitment to the agricultural sector; or may need to work with industry groups and media channels to communicate the inequitable benefit distribution and long-term adverse effects of such subsidies.



Systems contain two types of feedback loops. Reinforcing loops (commonly called vicious or virtual cycles) consist of an action that produces a result which influences more of the same action. Stimulating reinforcing loops that increase the competitive, inclusive, and resilient properties of markets can enable change to gather momentum, reach scale, and be sustainable.

*Example:* Successful savings and loan groups allow members access to the necessary capital to invest in productive assets. As these productive assets generate a cash flow, members are able to “grow the pot,” leading to increased savings and increased access to loans.

Balancing loops, on the other hand, dampen change processes. An initial action causes a response which creates less of an incentive for the same action. Market systems development projects may need to find ways to break or circumvent such systems.

*Example:* In some cultures, individual smallholder farmers are reticent to embrace new technologies or practices because of fears of how community members will react. Successful farmers may be viewed with suspicion by their neighbors, or thought to be “getting ahead of themselves.” This obstacle to change may be lessened by working with groups of farmers, or by obtaining the support of community leaders.

## IMPLICATIONS FOR FACILITATING CHANGE IN MARKET SYSTEMS

Applying an inclusive market system framework to the design, implementation, and monitoring of projects has many implications, some of which are highlighted below.

- **Analyzing the market system**

Market systems can be analyzed at three levels—macro, meso and micro. The macro-level focuses on the high-level theory of change, and includes dimensions such as demographic trends, the multiplier effects of agricultural development, and the impact of safety nets.

At the meso level, the aim is to understand how the market system operates, and why. This level of analysis includes end market and value chain analyses, studies of key interconnected systems, network mapping to understand the boundaries of a system, and assessments of rules and knowledge flows. The analysis should also take into account how the market system influences and mediates access to, use, and effectiveness of the asset endowments of actors in general, and the target group in particular. Meso-level analysis informs the overall vision and goal of the project, which may not change over time.

However, project strategy, which starts with an initial theory of change and set of interventions, will change over time through a continuous learning process that is informed by the third level of analysis. At the micro level, the focus is on intervening, learning, and adapting through the use of learning (or feedback) loops.

- **Defining the intervention space**

Defining the intervention space entails using the market system analysis and ongoing discussions with systems actors to get a good understanding of the target group and their context; and the key internal and external drivers of change,

### TEXT BOX 4: CONDUCTING SYSTEMS ANALYSIS

Define the inter-connections in the system using a framework of relationships, roles, rules, resources and results. Identify the key inter-connections in the system, such as: Who, in what function, is connected to whom? Which connections are most intense in terms of volume of interaction, product flows, information exchanges, benefit streams, and learning? Who and where are the drivers of change? What are the power dynamics in various inter-connections (e.g., price setters vs. price takers)? Who has the most resources to invest, and who has the least? Which nodes in the system offer the greatest leverage for catalyzing change? Where is there risk in the system (environmental, financial, political or social)?

particularly in markets the target group engage in, and the institutions that affect them. The boundaries should be set wide enough to i) see beyond individual transactions to the patterns of behavior that emerge; ii) find points of leverage to address constraints in a scalable, cost-efficient or effective way; and iii) include actors key to sustainable impact, including decision-makers, influencers and those with the potential to lose out as a result of changes in the market system. Project implementers will need to reassess the appropriateness of the system boundaries periodically in response to system dynamics and ongoing learning. Making the intervention space too broad at the outset of a project can lead to confusion and paralysis.

- **Designing interventions in a complex system**

The market system analysis can be used to identify changes that appear to be key to increasing the competitiveness, inclusiveness and/or resilience of the system. While these are unlikely to be all the changes needed, they provide a starting point for designing interventions. As project interventions stimulate change in the system, ongoing analysis and learning will identify new entry or leverage points (and obstacles) that will require adjustments to plans and the introduction of new interventions.

A preliminary determination can be made as to whether the needed change processes are simple, complicated or complex, recognizing that additional analysis and learning throughout implementation may challenge this categorization. This determination can be made by assessing the level of uncertainty in how to achieve the change; the level of agreement or divergence among market actors about the need for the change or how to achieve it; and the existence or lack of knowledge and capacity among key actors for achieving the change.<sup>5</sup>

In *simple* situations, where there is agreement about the needed change and how to achieve it, best practices can be applied. Interventions can be clearly laid out, timelines defined, and budgets allocated accordingly.

In *complicated* situations, there is either agreement about the needed change but low certainty about how to achieve it (technically complicated situations), or disagreement on the need for the change but certainty on how to achieve it (socially complicated situations). In technically complicated situations, projects may need to bring in additional expertise, and conduct more thorough analysis. Results chains can be helpful in showing the pathway and markers of change between the intervention and expected outcomes. In socially complicated situation, practitioners may need to engage in more intense stakeholder engagement to achieve a greater degree of consensus.

In *complex* situations, where there is neither agreement on the needed change nor certainty about how to achieve it, implementation flexibility and ongoing learning are essential. Projects may need to pilot multiple “best guess” interventions to observe emerging patterns, and then scale up interventions that appear to be contributing to the desired change. Effective interventions are generally grounded on the capacity and interests of market actors, and different sets of coherent interventions are often needed to create a convergence of interest that can lay the groundwork for the change process.

Change processes initially thought to be simple or complicated may in fact be complex. Projects therefore need to create a learning environment, and mechanisms to track changes in the market system to verify anticipated change or identify unexpected change. Similarly, apparently complex change processes may actually be complicated processes about which insufficient information is known. Ensuring that analysis in ongoing throughout implementation allows practitioners to reduce this knowledge gap.

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<sup>5</sup> Hummelbrunner, R. and H. Jones. (2013). *A Guide for Planning and Strategy Development in the Face of Complexity*. Overseas Development Institute.

- **Increasing the competitiveness of markets**

Even in environments not typically exposed to systemwide shocks, market systems are dynamic, and market actors need to be able to innovate in response to new opportunities and challenges to remain competitive. Inclusive market system development therefore necessitates a facilitation approach<sup>6</sup> to project implementation that focuses on catalyzing local ownership of the change process. A facilitation approach creates the conditions under which market actors can innovate and adapt to changes in market trends or in the enabling environment without project support, through a focus on building capacities, strengthening relationships, and aligning incentives in pursuit of shared objectives. Projects may therefore focus more on stimulating pressure points within market systems (or their interconnected systems) that encourage change that supports increased competitiveness, rather than taking a strategy of more directly encouraging individuals to adopt change. Project interventions will take a variety of forms, but may include working with the media, influential businesses, and/or community leaders to incentivize and direct the momentum of the change process.

- **Increasing the inclusiveness of the market system**

To inform the design of interventions that will catalyze change processes resulting in a more inclusive market system, analysis needs to include a specific focus on i) who is traditionally excluded, and why; ii) which excluded actors—if included—would have the most catalytic impact on poverty reduction, women’s empowerment, or other inclusion goal; and iii) where there are opportunities to align competitiveness and inclusion objectives.

Interventions need to take into account the fact that the poor and marginalized have unique characteristics—such as greater vulnerability to risk, limited resources to invest in upgrading, and fewer relationships with people who are upwardly mobile—that often preclude them from being able to take advantage of opportunities that are traditionally created through market system development efforts. This may necessitate the addition of activities that build the capacity of the poor and marginalized to more profitably engage in markets. Recognizing the multiple, interconnected systems that impact poor or marginalized individuals, households and communities, inclusive market system development depends on a strongly articulated vision and operationalized plan for transitions between activities; integrates the sequencing and layering of activities; and is supported by a robust causal logic and knowledge management mechanisms.

- **Strengthening the resilience of the market system**

There is little documented evidence to date of what factors make market systems resilient, but key characteristics seem to include the ability to learn, mechanisms for stakeholder coordination, and the promotion of diversity. It is important to note that there is often a tradeoff between resilience and efficiency (which affects competitiveness) as shock preparedness requires addressing a wide variety of shocks that may or may not occur, but which incur a cost.

To increase the resilience of market systems, practitioners may need to focus on strengthening communication and trust among market actors; support the development of early warning and other analytical mechanisms; or help market actors recognize the benefits of diversified products and markets.

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<sup>6</sup> See USAID. (2012). *Understanding Facilitation Briefing Paper*.