

**ADDIS ABABA UNIVERSITY
SCHOOL OF ECONOMICS**

**Weak Asymmetric Power and Looser
Coordination among Actors: Hurdles for
the Ethiopia's Leather Industry Competitiveness**

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**Weak Asymmetric Power and looser Coordination among
Actors: Hurdles for the Ethiopia's Leather Industry Competitiveness**

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This is to certify that the project prepared by Taye Tibebu entitled: Weak Asymmetric Power and looser Coordination among Actors: Hurdles for the Ethiopia's Leather Industry Competitiveness and submitted in partial fulfillment of the requirements for the degree of the Degree of Master of Arts (Applied Trade Policy Analysis under Economics) complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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ABSTRACT

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Addis Ababa University, 2012

Though it is not equivalent to its potential, the leather industry in Ethiopia has been one of the key industries which support the special economic need of the nation called foreign currency generation, besides other economic benefits. Evidently, irrespective of the potential availability of relatively competitive resource base, cheap labor, policies and strategies, incentives as well as support institutions, the value captured by the core actors or individual firms and the export performance of the industry shows wider gap from the expectation mainly due to weak asymmetric power relation and looser coordination among different level of actors.

But competitors, especially many emerging economies, have shifted their development strategies or business environment from simple export-oriented firm level thinking to an emphasis on gaining access to higher value adding strategies in global value chains. True, this necessitates systemic efficiency and competency of all actors along the value chain. Actually global value chain approach (VCA), as a method and development strategy, gives possibilities to appropriately analyze the efficiencies, competencies, opportunities and perhaps also the risks of the whole value chain and help forward the development or upgrading strategies so as to be globally competitive.

In this respect, Ethiopia's leather value chain is characterized by very low supply of raw materials with poor quality, complex routes of input recovery, sluggish material flow with wider gap between end users expectations and producers' performance, very low value added, dysfunctional information flow, weakly exercising of governance functions and less coordination among macro-, meso- and micro-level actors along with some rivalry directions or policies.

Thus, the immediate measures to be taken so as to make the sector competitive are to fill the gaps of those suboptimal value chain attributes and to reconcile and align those antagonistic directions and policies accordingly.

Key Words: value chain, value added, governance, coordination, transaction cost, product flow, information flow, critical success factors, leverage points, benchmark, upgrading

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If I wish to praise His glorious acts or to confess my evil thoughts, I think, the better place would be the church than putting them in this kind of piece of paper. Besides, I don't want to deliver any lip service for any one or institution.

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List of Acronyms

AALF	All Africa Leather Fair
AAU	Addis Ababa University
ADLI	Agricultural Development Led Industrialization
AGOA	Africa's Growth Opportunity Act
ARI	Agricultural Research Institutes
BEE	Business Enabling Environment
CSF's	Critical Success Factors
COMESA	Common Markets for Eastern and Southern Africa
CSA	Central Statistics Agency (Ethiopia)
EBA	Everything But Arms
ECAE	Ethiopian Conformity Assessment Enterprise
ECBP	Engineering Capacity Building Program
ECF/WB	Ethiopian competitiveness Facility/World Bank
EIDS	Ethiopian Industry Development Strategy
ELIA	Ethiopian Leather Industry Association
EPA	Environmental Protection Agency
ERP	Effective rate of protection
ESA	Ethiopian Standards Agency
FDI	Foreign Direct Investment
FDRE	Federal Democratic Republic of Ethiopia
FIAS	Foreign Investment Advisory Service (World Bank Group)
FTA	Free Trade Area
GDP	Growth Domestic Product
GTP	Growth and Transformation Plan
GVC	Global Value Chain
LIDI	Leather Industry Development Institute
LLPTI	Leather and Leather Products Technology Institute
MFN	Most Favored Nations
MOA	Ministry of Agriculture
MOFA	Ministry of Foreign Affairs
MOFED	Ministry of Finance and Economic Development
MoI	Ministry of Industry
MOTI	Ministry of Trade and Industry
TBT	Technical Barrier to Trade
VAT	Value Added Tax
VCA	Value Chain Approach (Analysis)
WIP	Work in Progress

Chapter 1: Introduction

1.1 Background of the Study

From the Stone Age to the beginning of the Egyptian civilization through the Romans' domination till today, man has regarded skins and leather as dependable materials for meeting his basic needs such as making footwear, tents, shields, harness, containers for liquids, boats and even armor (Kwabena A., 2009). According to him, ever since leatherwork has characteristically been regarded as one of the major contributing factors in the economic development and industrial transformation, it is known that several countries including the UK, Italy, Germany, USA and France have progressed through this industry. Currently, China, India, Italy, Pakistan, Turkey, South Africa, Brazil, Vietnam, Indonesia and Argentina are counted among the global industrial giants in the field of leather production which are heating up their economic development and stability with enormous revenues generated from exportation of various forms of cured raw hides, skins, finished leather and leather products (World Leather, November /2008; Krishnamurthy V. 2009).

Globally, leather industry, but tanning subsector, is considered as one of the labor intensive and buyer or consumer oriented venture. By its nature and structure, the industry is transnational in operation and scope, pursuing geographical shift of production zones mainly based on lower labor cost advantage on one side and the location of know-how in design, innovation and marketing on the other side. That means, the industry is highly export oriented and global in scope mainly due to the difference in geographic production zones (developing regions) and design and marketing zones (developed regions). Currently, the primary reasons for the geographic delocalization of the industry are competitive labour cost, trade liberalization and organizational flexibility or division of labor that give comparative advantage for the new production zone (Kumar S. 1997; Roukova P. 2008; Krishnamurthy V. 2009).

Leather industry in Ethiopia is the long existing and relatively established manufacturing venture in the modern as well as traditional mode of production. It is an indigenous¹ industry not only because it has been practiced to produce traditional artifacts since long ago but also the country is well endowed with the basic raw materials, manpower and local ownership and to some extent machinery and technological know-how. Especially the resource endowment competitiveness is indicated by the huge populations of cattle, sheep and goat which are 53.4, 25.5 and 22.8 million respectively (CSA 2010/2011). Though it is not equivalent to its potential, the industry has also been one of the key industries which support the special economic need of the nation called generating foreign currency. It constitutes an important component of the export sector of the national economy. It has also a tremendous contribution at least potentially for formal and informal employment opportunities.

The industry has large potential to grow in the country not only because of the resource base competitiveness but also the opportunities of global trend to shift geographically following labor cost and open market and the national export strategy and interest on it. As Mats Graner (2007) argues, the statistical correlation between an industry's technical efficiency and growth and its export participation is positively related due to the so-called learning effects; which works for the leather industry, too. Kaplinsky/Moris (2001) discusses also that integration into the global economy provides the opportunity for sustainable economic and income growth of an industry.

Currently, however, irrespective of the potential availability of relatively competitive resource base, cheap labor, policies and strategies , incentives as well as support institutions, the export performance of the industry and the value captured by the domestic actors or individual firms shows wider gap from the expectation. According to LIDI/MoI's 2010/2011 fiscal year report, the export plan expected from the industry was \$180 million while the performance was only 57% which is actually the best achievements in real terms in the industry's history. This aggregated weak performance is the reflection of each firm's inefficiency and ineffectiveness of value adding activities in particular and the business enabling environment and the support system in general.

¹ But currently about five foreign owned tanneries and three more footwear manufacturing companies are in the pipeline or start operation.

Recently many emerging economies have shifted their development strategies or business environment from simple export-oriented industrialization to an emphasis on gaining access to higher value adding strategies in global value chains (Gereffi G. et al 2001). In this respect, the current direction of Ethiopian Government towards value addition (towards finished product the so called functional upgrading) export in the leather industry is one of the sound policies. My frustration is that based on the current development pace, competencies and set up of firms and support systems, it may be only illusion to achieve the GTP (2014/15) target of \$496.50 million export contribution from the industry.

Evidently, while the level of contribution of a firm (in the industry) to the national economic system is measured by the value of its output or the value added, the contribution made by the factors of production employed in the sector is very scanty and the returns to the local producers is less lucrative. For instance, Ethiopian herders and family sheep owners are receiving around \$2 for the skins that will be used to produce one golf glove that is both strong and thin, and better than skins from other sheep breeds. The exporting sector is obtaining \$5 for the leather that will be manufactured into the finished glove. Outside of Ethiopia, the retailers with higher market governance share, design capability and brand name retail the glove for \$25 (Light Year IP, 2008).

Still in this economically and structurally interwoven world, focusing only on firm level efficiency, if any, is not enough to be competent in global market. In this era of modernity in which technological explosion and industrial coordination is the order of the day, the current awful state of our leather industry is intolerable as it is disincentive to mobilization and consolidation of the actors towards harnessing the industry to the national development and improvement of livelihood holistically. Explicitly, it necessitates systemic efficiency and competency of all actors along the value chain. To the extreme, in the type of value chains that produce and sell labor-intensive global consumer goods such as footwear, where the leading actors are large retailers, (ex-) manufacturers of established brand names and import-wholesalers, i.e. buyer-driven markets, global cooperation and coordination is a must so as to remain competitive (Schmitz H. et al 2001).

Besides, the focus on the asymmetry of bargaining position between leading global buyers and manufacturers from developing countries, which would lead one into the

domain of the principal-agent theory, can help discipline the behavior of the manufacturing firms in the developing countries like Ethiopia; even up to self product branding stage. Such an environment may well offer more opportunities for organizational learning or upgrading (Schmitz H. et al 2001). Gereffi (1999; 2005) states that no access for producers to the lead firms (global buyers) means, it is being excluded from the world's main export markets.

Actually value chain approach (VCA) presents possibilities to appropriately analyze the conditions for the whole value chain development and competitiveness by assessing the opportunities and perhaps also the risks so as to access the global market (Stamm E., 2004). It has also the mission to optimize the benefits or polarized income distributions arising from globalization; that is its indispensable dark side occurring not only in firms or countries not participating in globalization but also in those actively participating in the process of global integration due to fierce competition. According to Stamm, VCA was developed and conceptualized in the context of globalization trend. It bears the mission to optimize the benefits which can be obtained from globalization, as well as to offer answers to the discouraging challenges posed by globalization.

For instance, availability of livestock (raw materials) has only a moderate impact on the competitiveness of leather industry. Rather this bottom-up development approach is becoming increasingly unrealistic and old-fashioned due to the restructuring of international value chains and the dominant role of individual lead firms. In China, nearly 80% of the raw material used for manufacturing is imported from various countries such as Argentina and USA (ICT, FAO 2005 cited in Krishnamurthy, 2009: Xian V. 2008). But the 31% of the world leather export is from China as she has already structurally streamlined and globally functioning governance patterns in export value chain in general and leather sector in particular since 1980's. In other words, this is the result of firms upgrading, insertion of firms into local and global value chains, in such a way as to maximize value creation and learning. How and what does Ethiopia learn from this tremendous performance? This can be achieved through the VCA as shall be disclosed in this research on the Ethiopia's leather industry.

The core competencies of buyer-driven value chains, like in leather and footwear industry, are increasingly found in knowledge-intensive activities such as market forecasting, design, market development and market support, and in the exploitation of

global locational advantages for sourcing labor and specific resources. The access of firms from developing countries to large, differentiated global markets (i.e. one form of value chain upgrading) can be much more readily achieved through integration into value chains organized to facilitate the division of labor than through independent export. That is, the sourcing and outsourcing strategies of large industrial and commercial corporations are becoming key determinants for the integration of developing countries into the world economy.

1.2 Statement of the Problem

The Ethiopia's leather industry produces leather and leather products from livestock animal hides and skins slaughtered in the country for export and domestic consumption as well as for conventional or traditional artifacts which in addition provide job opportunities for several people in the country.

From the brief review of literatures addressed in chapter two, it has learnt that a number of studies have been published by different scholars and institutions on the industry. Unfortunately, there is no a single comprehensive and in-depth study touching upon various aspects of leather industry as yet. Most of the recent studies are partial and confined to improving quality and supply of the raw material, awfully with less action based responsibility and feedback from stakeholders. On the other hand, almost all studies in our disposal are intuitive or qualitative and none show empirically vigorous results along the value chain.

Not to undermining these findings, there is an old saying from Sharphouse (1995:26): *One cannot make a silk purse out of a sow's ear", and it is very true of the leather industry; unless the raw material is brought at the appropriate price, quality and quantity, the profitable success of the venture is in jeopardy.*

However, as the incompetetiveness of the industry is wider than these factors, it seems impossible to address the problems in piecemeal. Rather a systemic and systematic approach should be applied to reap benefits from the industry. In other words, the VCA methodology has the task to identify the reasons why the previous development programs or researches were not able to tackle the persisting problems.

Although Ethiopia is endowed not only with huge natural resource base in this industry but also the types what the world market demand, its economic contribution at national level, has been a mirage. Three types of skins coming from Ethiopian breeds, Bati Genuine, Bati Type and Selalie Hair Sheep, which have clear potential to be world market brand, are used to produce some of the finest leather in the world; all fetching high retail prices for the developed manufacturers and retailers abroad, (Light Year IP, 2008). Related to this, though new breeding may not be priority for Ethiopian species as breeding can give unpredictable result in some attributes; say in hide's fiber texture, it should be acknowledged that other breeds of animals generate larger sizes of skin or hide as size is appreciated in determining the economic cutting value of leather. Ethiopia is among countries which experience the longest lead time in import-export practices; up to four months for importing of leather chemicals and up to four weeks for custom clearance which is a single day duty for China (ECBP, 2011; Arvis J. et al 20110).

It has therefore become imperative to examine the end-to-end chain of the industry (from animal husbandry stage up to the distribution of the products) in order to pinpoint opportunities and constraints of the industry and make the industry competitive worldwide so that the actors can reap the deserved margins.

1.3 Objectives of the study

To put the research problem into operational terms, the following objectives are set.

1.3.1 General Objective

The main objective of this research is to investigate the economic efficiency and the business environment of the leather industry with the help of VCA and ultimately identify and imply alternative strategies to improve its efficiency and effectiveness. It is to trace qualitatively and empirically the structural and dynamic factors of the industry which help to improve the supply side constraints.

1.3.2 Specific Objectives

- ♣ To describe essential value chain concepts, particularly related to leather industry
- ♣ To analyze the end markets towards pinpointing the deficiencies (critical success factors or CSF's) influencing the economic performance of the leather industry

- ♣ To evaluate the economic performance and income distribution of the industry in the vertical linkages in terms of income distribution and the value added
- ♣ To assess information flow and the governance pattern, its trends and inter-firm relationships and their implication for domestic and export markets
- ♣ To appraise the business enabling environment and support markets in relation to growth and performance of the industry in various stages of the value chain
- ♣ To suggest broad guidelines and measures in order to improve the level of productivity, employment opportunities, export performance and returns by overcoming various bottlenecks and constraints confronting the industry

1.4 Research Questions of the Study

In so doing the above activities or objectives, we seek to answers the following questions:

- o Who are the actors that participate in the leather value chains?
- o How much value do actors add to the product in the different steps in the chain?
- o Are there actors (lead firms) that coordinate activities in the domestic value chain?
- o What are the contractual arrangements under which actors buy and sell products?
- o What are the power relations in the chain and to what extent do they determine how economic gains and risks are distributed among chain actors?
- o How do actors exchange information and learn to improve products and performance?
- o What technical and financial services are available to support actors in the chain?
- o What is the level of competitiveness of firms in the value chain in terms of CSF's?
- o What opportunities /bottlenecks exist for development/upgrading of the value chain?
- o Which policies and institutions support/constrain chain actors for development?

1.5 Hypotheses of the Study

This thesis posits that:

- ✓ The underlying problem of the leather industry is mainly the looser coordination of structural value links in the supply side of the chain and its weaker asymmetric power in the governance patterns and information flow

- ✓ VCA is highly applicable to value chain upgrading in structural integrations and paving the ways to functioning governance patterns as well as information networking

1.6 Significance of the Study

The anticipated result of this research is expected to be an input for policy makers, support institutions and core actors in the value chain to act on the leverage points identified in coordinative and cooperative manners. VCA is clearly a very powerful instrument to analyze the potential growth of the sector and the distribution of the benefits in the chain. It is a useful analytical tool that helps understand the policy environment that provides for the efficient allocation of resources within the sector and, thus, important for policy makers to integrate the local industry to the global value chain and globalization so that it gains sustainable learning effects in all respects. Besides, the leather industry enterprises in particular and the government and public at large can benefit from the economic efficiency and effectiveness from the orchestrated action as per the recommendation forwarded. Local or international development partners and institutions can also consult this research findings and recommendations so as to fill the financial, technological or business matchmaking constraints the core firms face.

1.7 Limitations and Scopes

The credibility of these findings may be influenced by two main limitations. The first is related to the data type itself-cross sectional data-in which all possible limitations that can be encountered due to the use of such data may also appear in this research. The second limitation is ascribed to the selected model itself-value chain methodology. True, VCA with its multi-sectoral, systemic and systematic approaches, it depicts a number of important weaknesses of traditional firm level analysis. But the strength of VCA-comprehensive and in-depth analysis-is at the same time its weakness because it requires a lot of efforts and time to draw a complete picture of a value chain. Collecting such several data types and resolving the issue of confidentiality to financial information is then cumbersome. Thus, the task to simplify the value chain e.g. by excluding activities or firms considered as less essential or seemed to impossible to access can lead to the

risks of overlooking important parts of the chain and thus creating distorted results. Moreover, its biased orientation to export market and lead firms for the context of development model and less attention to environmental and social issues are also among other weakness of VCA to be raised.

Given that Ethiopia has tariff-free access to the world's largest markets, the European Union and the United States, and generally faces lower tariffs in other its major markets than it applies itself, the major factors that account for the low trade share of GDP and the deep trade deficit must be considered to lie in its domestic economic framework (Ciuriak, D. et al, 2010). In global value chain setting, being competitive internationally mostly requires efficient domestic value chain integration (Porter M. 1998; Hubert Schmitz, 2005). Because a country is only able to influence prices within its own borders, the analysis is particularly interested in analyzing the composition of domestic factors. Thus, this study is mainly concentrated on the analysis of the domestic value chain or supply side constraints, the holistic productivity, performance of chain supporters and business enabling environment and related governance patterns and linkages of firms in leather industry particularly by tracking the trajectory starting from input up to leather footwear production line.

1.8 Methodology and Data Source

To attain the aforementioned objectives: the activities of data collection, mapping of the value chain, analysis of income flow, the value-added and rent repository nodes, CSF's, governance patterns and information flow as well as structure and conditions of macro and meso level actors are accomplished.

My value chain analyses are conducted through a combination of qualitative and quantitative methods, featuring a further combination of primary survey, focus group discussion, participatory rapid appraisals (PRAs), informal interviews and secondary data sourcing for identifying the key constraints and policy issues that require further exposition. For this, a well designed questionnaires, observations and interviews are applied accordingly. Then the methodology of the VCA is applied for the analysis of the leather industry concentrating on the variables addressing the research objectives (in general: gross output sales, inputs costs, transaction costs, flow of product, services, information). Specifically the activities done are:

- I. Theoretical Literature survey**-Previous but recent literatures are examined on value chain analysis concepts and approaches in general and the setting of world leather and the Ethiopia's leather industry in particular. The literature is mainly based on the analysis of case studies and project experiences gathered in recent development literature, including:
- ▶ International and local literature published on the topics related to business linkages and value chains concepts in general and leather sector in particular from academic journals, textbooks and online accesses
 - ▶ Official policy and strategy papers from the government and all major bilateral and multilateral donor agencies (in general and with a specific focus on Ethiopia's leather industry),
 - ▶ manuals, guidebooks, toolkits on the “value chain approach” published by donor agencies, NGOs and consulting companies
- II. Field Study**-This study combines qualitative and quantitative approaches:
- ✓ A questionnaire-based survey among firms and support systems and
 - ✓ interviews of Expert or informant key actors and end users
- III. Data Source:** Firms' financial and commercial performance reports, government reports such as export figures and any relevant data to the research
- IV. Sampling Technique**- Purposeful sampling strategies are pursued for this study in addressing limited samples but more informant ones. The samples or study units include core actors such as tanneries, leather footwear manufacturers, international buyers and local end users.
- V. Data types:** As per the study questions, objectives, cost and time, the required data are collected from on-site visit of the selected firms and institutions , sourcing from:
- ✗ secondary data from previous works and
 - ✗ Primary data by interviewing and observation

1.9 Organization of the paper

The rest of the paper proceeds as follows: chapter two is dedicated mainly to global value chain concept itself; how it has been developed, what the specific elements and related characteristics of global value chain are what the global leather industry trend and the

setting of Ethiopia's leather industry looks like. Then the basic attributes to the value chain methodology is addressed in the third chapter. The fourth chapter describes the undertaking of VCA methodology in the leather industry and presents the results and discussions of the empirical and descriptive research. Afterwards, the results are concluded and recommended not only with the upgrading alternatives but also by addressing the strengths and weaknesses of VCA and other limitations.

Chapter 2: Literature survey

2.1 Global Value Chain Approach

2.1.1 Historical and Theoretical Overview

The theoretical framework of global value chain (sectors producing for global markets) incorporates three streams of literature – transaction costs economics, global production networks and technological capability and firm-level learning – to identify three variables: the complexity of transactions, the ability to codify transactions and the capabilities in the supply-base: that play a large role in determining how global value chains are governed and changed (Gereffi G. 2005).

The Global value chain (GVC) concept is not new² if earlier terms to describe the same phenomenon are remembered: supply chains, international production networks, commodity chains and filieres. However, “The novel aspect of the contemporary GVC approach is that it anticipates competition and integration in the new globalized economy,” (van Dijk P 2008).

This contemporary and more encompassing GVC concept came up when the discussion of the effects of globalization started. In this globalized world, it is not just a matter of whether producers participate in the global economy which determines their level of returns or values to production but how and on what terms they do so (Kaplinsky, 2001;Pietrobelli C. 2007).

The concept of a global value chain comes up to the production of goods and services to the global market. A shirt, for example, may be designed in New York, cut in India, assembled in Kenya, and sold to a consumer in Los Angeles. Even the re-emergence of multinational corporations in the 1950s and 1960s did not change this very much, unlike these days global value chain; as such large firms had their design, production and marketing functions under one roof, or at least within easy reach of one another (McCormick, 2001). He claims also that by the 1970s, however, the picture started to change as multinational enterprises began to locate labor-intensive activities in

² Girvan (1987) narrated that in 1960's and 1970's similar concept was used in analyzing the development of mineral exporting, as cited in Kaplinsky (2000).

developing countries as part of a global restructuring and rationalization of their operations. The process intensified in the 1980s and 1990s, when greatly improved transportation and communication technologies made it feasible to subdivide the production zones so that even a single product could be made in multiple locations.

Thus, since the 1960s, the global economy has been rapidly integrating through spectacular increase in international trade in goods and service as Francophone Filieres studied contract farming and vertical integration in agriculture at the same decade (Raïke 2000 cited in Kaplinsky 2001).

But the formal and the original value chain idea by Michael Porter (1985) narrates that a firm could identify, improve and maintain its competitive advantage by identifying its core functions such as acquisition of inputs as well as production and delivery of outputs which it can perform more cheaply and better than its competitors. This is done by disaggregating and quantifying the value of each core function of the firm (Stamm, E. 2004). Later Porter (1990's) reshapes his idea in such a way that firms in the value chain are embedded in a large stream of activities called the value system.

When Porter (1998) recognizes the ease of transportation and cross-border economies of competition, he posits that in value chain performance what matters most for competitiveness are not physical inputs endowed or scale but productivity. Here, in his broader view than his original work, he argues also that the lasting competitive advantages in global economy lie increasingly in local things- knowledge, relationships and motivations that distant rivals cannot match. However, this idea sounds more to the scope of clustering (geographic integration) than the GVC approach. But what is more relevant to GVC approach as he explains is that when a product passes from one part of a product chain or life cycle stage to the next, across border, it gains value.

According to Kaplinsky / Morris (2001), the value chain concept has been evolving from economic methodologies which were first developed to analyze and enhance the competitive advantage of firms participating in globally disperse economic activities. Andrew Feller and his colleagues, in their 2006 article, state that the value chain concept is first and foremost a strategic concept arising from a strategic theory of firm competition. Whereas Stamm (2004) advocates the implementation of VCA in development context in order to address challenges for trade policy and the promotion of economic development. His idea is that information asymmetries between large and

small or between powerful and less powerful actors must be reduced, thus allowing the most equitable appropriation possible of value-added generated by the division of labor. Stamm claims that given the small domestic markets in most developing countries, rapid economic growth, such as that can help to achieve the MDG1 (halving global poverty by the year 2015), is only through a greater global division of labor and increasing international exchange of goods and services. He also presupposes that for growth to have a widespread impact, it is also crucial for producers in developing countries to be able to assume an important position within value chains on the basis of specific competitive advantages.

In this perspective, the major issues in the GVA literature are the role of lead firms-the issues of power in the chain and the resulting distributional and development options; and the division of labor-the low road GVC competition³ (just based on cheap resources like labor) or the high road competition (based on innovation) (Guilano et al., 2005;Pietrobelli C. 2007). Thus, theory formation in GVC has more concentrated on the value chain governance situation (Humphrey and Schmitz, 2000) and not so much on how to promote competition or anti-trust policy so as to assure a fairer distribution of the margins and development.

The chain governance patterns can be characterized as a network-styled way of governance, arm's length market relations or as a situation of oligopoly. That is, sometimes one firm plays a very important role in the chain. Thus market power is sometimes analyzed to learn the governance pattern; but it is rarely the subject of a competition regulator.

Scholars in different disciplinary traditions vary considerably with regard to their views about globalization and its implications for governance. The major paradigm perspectives on globalization and governance issues include: *international institutional*, which focuses on changing patterns of international cooperation, inter-dependence and authority between nations; *comparative institutional*, which focuses on national responses to increasing globalization like deregulation and country level institutional arrangement or complementarity; *international economic*, which highlights the distinctive features of the global economy, issues related to unequal distribution of returns from international trade,

³ This development option is termed as 'immiserising growth' by Raphael Kaplinsky (2000)

resulting from the growing importance of the newly industrializing economies (NIE's) in international production and trade; *international industrial organization*, which emphasizes the creation of new forms of international production networks in the global economy by the so called the “integration of trade by disintegration of production cites”⁴; and *the global civil society*, which explores the rise of non-governmental organizations (NGO's) and the growth of a global civil associations and the impact they have on international relations (Gereffi G. 2004). These theories/ views are complementary, rather than substitutable, to each other.

Although all the above views and perspectives have their own contribution to the current globalization and governance set up, for development theorists (proponents of global value chain approach), the international industrial organization is most important to the emergence of contemporary value chain approach (Humphrey et al 2001; Gereffi 1994 cited in Gereffi 2004).

The VCA analyses the activities (designing, production, bank and custom clearance services, transportation, marketing and distribution etc.) required to bring a product from its conception to the final consumer across- borders; while regions, countries, individual localities or firms try to improve their relative position in the global economy (Sturgeon T. 2008). In these activities, he witnessed that the orchestration of international agreements, sound macroeconomic policy, sector specific industrial development policies, technological acquisition and firm-level responses to the demands of overseas buyers have all been put forward as explanations and prescriptions for rapid industrial upgrading and economic development in East Asia and elsewhere.

Still Gereffi (2001) frustrates that the lack of a well-defined theoretical framework limits both the generalizations that can be derived from diverse case studies and comparisons of different value chains. But he argues also that in order to make the approach more effective, it is necessary to develop common parameters for defining different types of taxonomy, coordination and governance of value chains that can be made operational through a robust set of indicators.

According to Kaplinsky, the three key analytical features of value chain that need to be analyzed and which can transform the heuristic framework into an analytical tool are:

⁴ Feenstra R. (1998, 2008)

- Effectively functioning value chains involve some degree of ‘governance’
- Effective and sustainable value chains arise from systemic, as opposed to point-efficiency
- Effective value chains are means for ‘rent accruing’, and these rents are dynamic

In nutshell, the recent global value chain concept stresses not only the linear and static theory of competitive advantage (based on low cost structure and pricing strategy) which is only a necessary condition of networked corporate management issues, unlike Porter’s (1998) idea, but most importantly also the dynamic efficiency (proactive innovation and governance relationship) (ERA,2009).

But what is the contemporary definition of global value chain?

2.1.2 Conceptual Definitions

Kaplinsky / Morris (2001) gives an overview of value chain related terminologies and methodologies—some conflicting—used therein from the angle of economic competitiveness; while Stamm (2004) highlights or views VCA in the development context to address challenges for trade policy and the promotion of economic development. Anyway, the following give brief descriptions of three relevant predecessors that have brought us to the contemporary definition of VCA incorporating those views.

♣ **Global Commodity⁵ Chain (GCC)⁶**: This phrase was introduced by Gereffi and his collaborators (Gereffi 1994 cited in Gereffi 2001); to analyze industrial commodity chains attached to global manufacturing system which is centrally coordinated but has internationally dispersed productive activities. GCC attracted significant attention on account of its crucial distinction between buyer-driven and producer-driven global

⁵ Value chain proponents chose to replace the term “commodity” with “value” because of popular connotations of the word “commodity” with undifferentiated primary products such as crude oil and bulk agricultural goods, and because the term “value” captured both the concept of “value added,” which fit well with the chain metaphor they were using, and focused attention on the main source of economic development (Sturgeon J. 2008)

⁶ The phrase “Global commodity chain” coined by Gereffi to refer to any chain of value-adding activities linking enterprises dispersed across the global economy has limitation in scope as it should also encompass chains producing and trading high-value items such as cars, computers and aircraft. That is, the use of the term “commodity” for this high products is very different from its use to refer to widely traded, basic products such as cocoa and coffee. Therefore, to avoid this confusion the term “value chain” shall be used here (UNCTAD, 2000).

chains. These distinctions are forms of governance—a central concept in GCC that illustrates the interaction of actors along the chain and its determining factors (e.g. market power). The same concept plays a key role in VCA. Gereffi and his co-workers (2005) expand the concept of governance further by taking into account three key determinants: transaction costs, codifiability of information and capability of suppliers; thereby deriving five basic types of governance patterns in GVC: markets, modular, relational, captive and hierarchy governance levels in value chain.

- ♣ ***Filière*:** This term has a literal meaning in French “thread” and conceptually originated from studies of contract manufacturing and vertical integration in French agriculture in the 1960s (Kaplinsky R. 2000). This approach was later applied to analyze agricultural production of cacao, coffee, cotton, etc. in developing countries formerly under French colonization. The early *filière* analysis had the main objective to increase efficiency through identifying flows of physical inputs and services required in the production of a final product (a good or a service) as well as the actors involved within. It has a strong empirical quantitative research tradition which attempts to measure inputs and outputs, prices, value added along the commodity chain, transportation and transaction costs, and scale of economies (Raikes 2000, cited in Bair J. 2005). The later version of *filière* adds political economy dimension as it takes into account the role of public institutions. Therefore, *filière* essentially bears a close resemblance to the contemporary VCA except its static character reflecting relations at a certain point in time and its weak emphasis on the dynamic of actors’ interactions along the chain (governance patterns).
- ♣ **Value Chains in the Work of Michael Porter** was popularized through his 1985 best-seller ‘Competitive Advantage: Creating and Sustaining Superior Performance’. He refers to ‘value chain’ as various value-adding activities in an individual link in the chain—which VCA terminology refers to as ‘intra-link activities’. These value-adding activities encompass ‘primary activities’ like inbound logistics, production, outbound logistics, marketing and sales, and service (maintenance); and ‘support activities’ such as management of firm’s infrastructure, human resource management, research and development and procurement. The differentiation of these activities has the ultimate goal ‘to maximize value creation while minimizing costs’. Hence,

Porter's original value chain concept focuses predominantly on firm level and corporate network analysis and does not consider cross-border production and trade which is taken into consideration by VCA. The second term he used is 'value system' which describes the interconnection of various firms in different links reflecting inter-link linkages—which VCA terms as the 'value chain' itself. In the English language, these conflicting uses of terms lead sometimes to confusion.

Currently (as of 2001) development researchers in the area have reached in consensus to use common terminologies, in Bellagio Italy, for the concept of value chain with specific definitions. Value chain is defined as: The full range of activities which are required to bring a product or service from conception, through the different phases of production (involving a combination of physical transformation and the input of various producer services), delivery to final consumers, and final disposal after use (Kaplinsky 2000: 8). [...] As can be seen from the definition, production per se is only one of a number of value-added links or structural factors. Moreover, there are ranges of activities within each link of the chain. Value or value-added, as Porter (1985) defined it, is the amount buyers are willing to pay for what a firm provides. Value is a central concept in value chain study for a sector. It is captured as the sum of value added such as wages, profits and natural resource rents in profit seeking business. In this sense, a value chain approach describes how producers, processors, buyers, sellers, and consumers—separated by time and space—gradually add value to products as they pass from one link in the chain to the next (UNIDO, Expert Meeting, 2009). Value added is, therefore, created within industrial linkages as a unit of the system, while a firm's product in the downstream is the input for the very next upstream one. These value chain participants or actors sometimes cooperate, by the help of lead-firms, to improve the overall competitiveness of the final product; but may also be completely unaware of the linkages between their operation and other upstream or downstream participants, which results in weaker structural integration. Lead firms are those that focus on the more value-adding activities⁷ such as product strategy, product definition, product design, and end - user sales and marketing. They are predominantly located in developed countries and include not only multinational

⁷ Value adding activities are activities, in *the eyes of the final consumer* that make a product/service more valuable (Fearne A. et al 2009).

manufacturers, but also large retailers and brand-name firms. They play a significant role or governance in specifying what is to be produced, how, and by whom (Gereffi G. et al 2001)⁸. Where powerful lead firms do exist, their power stems from two attributes: their market power (measured in part by concentration or market share) and their positioning in chain segments in which they can create and/or appropriate high returns. Both sources of power (governance) are derived from a multiplicity of barriers to entry that results in higher economic rent.

2.2 Elements of Value Chain framework

Value chain thinking requires firms or actors to embrace collaborative efforts in integration and cooperation, which in turn demand aligned objectives, open communication, sharing of resources, risks and rewards (Fearne A. et al 2009). That is, in applying this economic approach as a development model, value chain integrity and trust are basic ethics to be in place.

On the other hand, global value chain approach addresses the questions: Who adds value where along the chain; who controls the chain coordination at what extent; and who are the winners and who are the losers from the globalization of product markets and how can be spread these gains from globalization along the chain?(McCormick D. 2001).

To address these issues, VCA necessitates understanding a market system in its totality: firms that operate within an industry—from input suppliers to end market buyers; support services that provide technical, business and financial services to the industry; the business enabling environment in which the industry operates and the power that dictates the relationships—all referred to as value chain elements or actors.

The value chain framework that ensures the incentives for and the capabilities to compete in and benefit from market participation globally by cooperation, coordination and orchestration towards reaping the opportunities and alleviating business hurdles in

⁸ *This article was first published in the IDS Bulletin Volume 32 No 3 'The Value of Value Chains: Spreading the Gains from Globalization' edited by Gary Gereffi and Raphael Kaplinsky. Later re-titled: "Globalization, Value Chains and Development"*

enterprises' activities generally include structural and dynamic factors characterized by several elements⁹.

Thus the process of value chain analysis in turn necessitates understanding of the value chain framework constituting:

- ♣ The **structural factors** of the value chain framework are embedded with all firms and institutions that conduct business by adding value and helping move the product/service towards the end markets and
- ♣ The **dynamic factors** of the value chain framework are referred to as the determinants of firms and organizational behavior and their effect on the functioning of the structural elements of the chain in terms of product/service and information/knowledge flow.

2.2.1 Conceptual Distinction

From the outset, as the structural factors of the value chain influence the dynamic factors of firm's behavior and these dynamics also influence how well the value chain performs, there is no clear boundary between these elements. But it is useful to conceptually distinguish between the governance of a value chain and its coordination. While governance (characteristic of dynamic elements), at least in the context of the VCA, describes the power relationships between actors within the system and the possibility of appropriating profits; coordination (characteristic of structural elements) is closely related to management of the delivery of tangible goods and products to the interfaces between the segments of a value chain (Stamm E.2004). In other words, while governance is basically understood as setting rules; coordination can be viewed separately as implementing these rules and monitoring their adherence to the rules.

2.2.2 Structural Elements

One of the governance rules called logistics parameters that determine the competitiveness of value chains is increasingly being expressed by the organization of

⁹ The key 5 structural and 2 dynamic factors in value chain framework comprise respectively End Markets, Business Enabling Environment, Vertical Linkages, Horizontal Linkages, Supporting Markets, Value Chain Finance, Information and Communications Technology; and Value Chain Governance and Inter-firm Relationships (USAID, ACDI/VOCA; 2008); accessed through www.globalvaluechains.org/

complex production processes without unnecessary loss of time and with low transaction costs (e.g. through optimum inventory maintenance) and the ability of the actors in the value chain to electronically manage inter-organization communication and the flow of data plays a growing role.

The new institutional economics states that the cost of transacting—determined by institutions and institutional arrangements—is the key to economic performance. It is therefore argued that the institutions of a country – such as its legal, political, and social systems – determine its economic performance, and it is this, according to Coase¹⁰ (2007), that gives the new institutional economics its importance for economists. Transaction cost economics, as developed primarily by Coase and Williamson, suggests that economic organizations emerge from cost minimizing behavior (including transaction costs) in a world of limited information and opportunism. Coase's seminal work on firm theory states that without transaction cost consideration, institutional choices are not an issue.

Neo-classical economics, on one hand, have ignored the role of institutions; economic agents were assumed to operate almost in a vacuum with zero transaction cost.

But the New Institutional Economists recognize that transactions are not costless. They therefore concern themselves not only with how these institutions affect economics but also how these institutions are formed with the embedded positive transaction costs. That is, the implicit assumption of zero transaction costs by neoclassical school is not practical in real life. That is because if transaction costs are zero then the parties to tort transactions will bargain without cost to an efficient result or process whichever way property rights are assigned at the outset. The decision to use one mode of production or marketing rather than the other should not be taken as given (as is the prevailing practice) but should be derived (Williamson E. 2009).

“Transaction cost economics is the means by which to give breathe operational content into governance and organization,” (Williamson E. 2009). According to him, breathing operational content into the concept of governance would involve examining economic organization through the lens of contract rather than the neoclassical lens of choice that only focusing on prices and output; and supply and demand. The lens of contract include

¹⁰ His paper titled 'The Nature of the Firm' was published by JSTOR in 1937 and released to internet in 2007

both theories that emphasize ex ante incentive alignment (agency theory¹¹/ team theory, property rights theory) and those for which the ex post governance of contractual relations is where the main analytical action resides. Coase (1937) asks that what efficiency factors determine when a firm produces a good or service to its own needs rather than outsource.

Thus, as VCA addresses, the joining of key attributes or parts of transaction costs by appealing to the efficient alignment hypothesis are imperative and one of the major competitive edges. This is similar to **Convention theory approach**, a French Institutionalism Approach, to studying economic coordination- more concerned about decision making in the presence of imperfect and often asymmetric market. But what are those (fragmented) elements to be coordinated with the help of transaction cost?

The rising integration of global markets through trade has brought with it a disintegration of multinational firms, since companies are finding it advantageous to 'outsource' an increasing share of their non-core manufacturing and service activities both domestically and abroad (Feenstra R. 2008). But if production is increasingly fragmented across geographic space and between firms, then how these fragmented activities are coordinated?

It is explained by transaction costs economics in terms of the complexity of inter-firm relationships and the extent to which they involve investments specific to a particular transaction. Different motivations for constructing complex firm-to-firm relationships result in three modes of industrial organization: market, hierarchy, and network; though the current typology identifies five basic types of value chain governance patterns (Gereffi G. et al 2005; 2009). Mostly, Coordination by transaction costs increases when supply is time-sensitive; as separate processes have to be better coordinated in order to synchronize the flow of inputs and structural elements through the chain. Level of transaction costs depends to a large extent on a lack of information, weak market transparency, inappropriate legal regulations and trust (GTZ, 2008).

The structural elements of a value chain that include all the firms and support systems to be coordinated, possibly by transaction costs, are characterized in terms of five factors as described below (USAID, ACDI/VOCA; 2008) :

¹¹ "The relationship of agency or contractual agreement is one of the oldest and commonest codified modes of economic and social interaction," Stephen. Ross 1973.

1. **End markets** are the demand side, people or buyers, with powerful voices for learning and change; not a location or place. They are important sources of demand information. The demand of end-market informs supply side actors who in turn build capacity to meet demand and compete in the marketplace. They determine trends of market opportunities and characteristics—including price, quality, quantity and timing—of a successful product or service. End markets are the starting point of the value chain analysis. It is through the analysis of end markets that we are able to identify the investment needs that will drive value chain upgrading.
2. **Business enabling environment (BEE)** also called macro level condition is all at once global, national and local regulatory premise in which the value chain operates with domestic and international business determinants including social norms and customs, laws, regulations, policies, international trade agreements, public infrastructure and utilities such as roads, electricity, water etc. Significant BEE constraints are appraised or discovered during a value chain analysis. To know whether the BEE is competent and conducive, national and local policies, duties, business licensing and administrative procedures, sector specific incentives and programs, enacted regulations and the state of public infrastructure are analyzed. The international business enabling environment requires the investigation of conventions, treaties, agreements and market and product standards.
3. **Vertical linkages** are linkages or co-ordinations between firms at different levels of the value chain that reflects the quality of relationships among firms or micro level actors. Buying and selling relationships link firms vertically. In these co-ordinations, firms are vertically linked to a varied range of market actors including wholesalers, retailers, exporters, traders, middlemen, input dealers, suppliers, service providers and others. These linkages are critical for determining the speed of moving a product, service or the transfer of skills and information between firms up and down the chain to the end market. More efficient transactions among firms that are vertically related in a value chain increase the competitiveness of the entire industry. Thus, an important part of value chain analysis is the identification of weak or missing vertical linkages.

4. **Horizontal linkages** are formal as well as informal cooperation/collaboration between firms at parallel levels in a value chain that can reduce transaction costs, create economies of scale; and contribute to the increased efficiency, shared skills and resources, risk sharing, enhanced product quality through common production standards and competitiveness of an industry, in general. Irrespective of negative effects, parallel firms' competition in product types and quality and price can improve innovation. Thus, the other objectives of value chain analysis is to identify areas where collaborative bargaining power could reduce the costs or increase the benefits to firms operating in the chain.
5. **Supporting markets** or also called meso level chain supporters include financial services; cross-cutting services such as business consulting, legal advice and telecommunications; and sector-specific services, for example, leather laboratory test and shoe design services. Many of the services provided by supporting markets correspond to non-financial services referred to by researchers as *business development services* (BDS). These include training, consulting and accounting services which may be provided by for-profit firms and publicly funded institutions and agencies. VCA should therefore seek to identify opportunities for improved access to services for target value chain actors in such a way that the support markets will be simultaneously strengthened, rather than undermined.

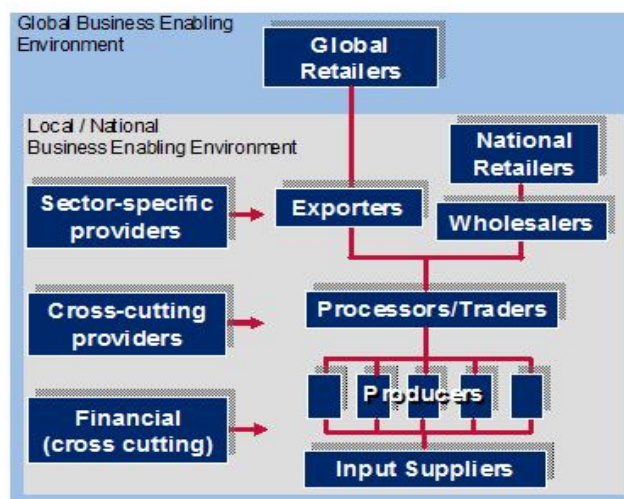


Figure 1: structural organization of a value chain (USAID, ACDI/VOCA; 2008)

2.2.3 Dynamic Elements; Governance and Relationship

In thinking of business relationships, one can broadly distinguish between three phases (Schmitz, 2005):

- o Traditionally, the relationships between producers and customers are thought to be market-based; demand and supply and price and output relations. This assumption continues to prevail (though not always explicitly) in many textbooks concerned with international trade.*
- o In the 1970s and 1980s, the importance of intra-firm trade was highlighted in research on multinational corporations and their subsidiaries.*
- o In the 1990s, a new form of coordinated trade was shown to be of increasing importance: lead firms from developed countries coordinate (or govern) the trade with developing country firms that remain nominally independent.*

The third form of relationship is value chain relationship. Thus, value chains are not just strings of market relations where buyers and sellers act freely. Often there are powerful actors in the chain who pull the strings and control the flow of goods, income and information. Value chain analysis, thus, can help identify leverage¹² points and improve the situations in weaker links, where returns are low.

Governance is a core dynamic feature of value chain framework that characterizes the relationships or linkages among stake-holders in the chain. Value chain governance is imperative as it relates to the ability of a stakeholder to determine, control and/or coordinate the activities of other actors in the value added chain. Governance aspects stand at the center of the global value-chain discussion (Stamm E. 2004).

Value chain governance is considered as organization through non-market relationships (Humphrey J. et al 2000). Gereffi (2001) defines it also as non-market coordination of economic activity. Anyway, governance in which particularly power is more concentrated in intangible core competencies (i.e. designing, branding and marketing) is important determining factor in value chain framework; as Kaplinsky (2000) proposes that effectively functioning value chains involve some degree of 'governance'.

¹² *Leverage point is a point where a small change say in physical or policy input can result in competitive change in output or income*

Lead firms in modern value chains set the governance rules or the parameters to which other firms of the chain conform. Value chain governance rules encompass products, processes and logistics parameters (Stamm E. 2004).

- Product parameters determine the design of the products to be produced.
- Process parameters determine how the product is to be produced.
- Logistics parameters determine how much of a good is to be produced when and how the physical flow of goods is to be executed.

Value chain governance differs significantly with respect to how strongly governance is exercised, how much governance is concentrated in the hands of a single firm, and how many lead firms exercise governance over chain members that causes power asymmetry. For Kaplinsky (2001), power asymmetry is thus central to value chain governance in coordinating or deciding and managing business duties such as:

- positioning (who is allocated what role in the value chain)
- integration of components into the design of the final products, and the quality standards with which this integration is achieved
- logistics (when and where inputs and outputs are shipped along the chain)
- monitoring of the outcomes, linking the discrete activities between different actors and establishing and managing relationships between the various actors comprising the links

It is this role of coordination, the complementary role of identifying dynamic rent opportunities and apportioning roles to key players which reflects an important part of the act of governance. Humphrey and Schmitz (2000) observe that the key driver to governance is the risk of supply failure.

Based on the classical separation of powers (terms borrowed from civil governance including rule making, rule executing and rule enforcing), it is possible to distinguish three forms of value chain governances: legislative, executive and judiciary governances (Kaplinsky 2000; McCormick 2001).

First, the basic rules which define the conditions for participation in the value chain need to be set. In the past, these rules were largely concerned with meeting basic cost parameters and guaranteeing supply; but increasingly as Japanese management practices

spread during the 1990s the critical success factors(CSF's) came to include what is known as "QPD" (that is quality, price and delivery reliability). More recently, the "rules" of global participation have increasingly come to include conformance to international standards such as ISO9001 (on quality), ISO14001 (on environment), SA8000 (social accountability standards) and other industry-specific standards such as phyto-sanitary and HACCP (hazard analysis and critical control point) in the food processing industry. The definitions of these various sets of rules as defining the basis of participation in value chains can be termed 'legislative governance', i.e. setting the parameters that govern the value chain.

In order to meet these rules of participation, there needs to be some form of proactive governance (which might be termed '*executive governance*'¹³) which provides assistance to value chain participants in meeting these operating rules, i.e. managing the various subordinate links in the value chain. This executive governance may be direct (helping a supplier achieve quality standards for example) or indirect (influencing a first-tier supplier to assist a second-tier supplier, or introducing a supplier to a service sector firm which can assist it in meeting the standards which are required).

It is also necessary to audit performance and to check compliance with these rules– this can be seen as '*judicial governance*', i.e. coordinating the conformance to the set parameters.

In some cases the same party or actor exercises all three sets of powers without distinction.

These governance roles may be exercised by lead firm(s) in the chain or by parties external to the chain.

The exercising of *sanctions* is also a key to the function of governance in value chains. The ultimate negative sanction is whether a particular party is included or excluded in the production network, and has access to final markets. But there may be intermediate forms of negative sanctions as well, such as limiting the role which particular producers play in the chain, or imposing cost penalties for non-conformance.

¹³ *power asymmetry is only partially equivalent to governance as it only entails the function of setting requirements (legislative) and enforcing them (judicial), while the function of building the supplier's capability (executive) is not considered as an integral part of governance (Humphrey / Schmitz (2005)*

Not all sanctions are negative, of course, and there may be various forms of reward which governors may grant. For example, the ability to meet specified quality standards on a regular and sustained basis may mean that a supplier will not be subject to the same level of auditing as previously or price mark up etc.

In value chain governance patterns, the degree of trust between different parties lies in the range between arms-length relationships and obligatory relationships (Sako, 1992; Humphrey et al, 1998 Cited in Kaplinsky 2001). In the former low-trust chain, suppliers are frequently changed to pursue short-term price advantages and failure to conform to the wishes of the governor leads to the rapid sanction of exclusion from the chain. These low trust relationships characterized the era of mass production. By contrast in modern flexible production systems (sometimes referred to as the era of “mass customization”), trust becomes increasingly important, and failure to reach the required level of standards does not automatically result in the sanction of exclusion; instead executive governance is exercised to assist the transgressing party to achieve the required levels of performance. High-trust relationships, in which the governor has legitimacy from other links in the chain, tend to be associated with long-lived relationships, goes up to vertical integration. In other words, governance as the power for the value chain coordination is neither a point of dominance nor necessarily is found only in a single firm. Rather governance is seen as a form of value-chain coordination within a continuum between pure market relationships and hierarchy (Gereffi / Humphrey / Sturgeon, 2003). Related to hierarchy, the overlapping idea is business partnerships or contractual relationships which are collaborative mechanisms among public or private value chain partners who agree to share resources, knowledge and risk in order to achieve more efficiency in the production and delivery of products and services (UNIDO, 2009). Between the two polars, the market and hierarchy trusts, three different forms of value chain relationships are highlighted as relevant types.

- ♣ **Modular value chains-** for products which are produced largely independently of each other and are assembled on the basis of standardized interfaces. The suppliers manufacture products according to the detailed instructions of the buyer, but maintain full responsibility, e.g. for the process technologies employed.

- ♣ **Relational value chains**- in which a dominance of complex interactions between buyers and sellers exist that often lead to a high degree of mutual dependence.
- ♣ **Captive value chains** in which smaller suppliers are largely dependent on the big customers. These chains are often characterized by a high degree of monitoring and control by lead firms or big customers.

Usually the simplicity of the value chain governance patterns is confusing very often by the complexity of real-world relations as many value chains are characterized by a multiplicity of “governors”, often setting conflicting rules to the poor producers who serve their needs (Kaplinsky et al 2001).

Based on the concept of governance, two types of value chains can be identified; chains of buyer-driven and producer-driven (Gereffi G. 2001)¹⁴. The first describes those chains where the critical governing role is played by a buyer at the apex of the chains; which are characteristic of labour intensive industries (and therefore highly relevant to developing countries) such as footwear, clothing, furniture and toys. Besides, buyer-driven chains are more important to the export-oriented strategy and networked production systems of the 21st century. In these chains, large retailers, marketers and branded manufacturers play the pivotal governance role in setting up decentralized production networks in a variety of exporting countries, typically located in the third world. One of the distinctive features about contemporary production systems is that they tend to be “market-pulled”, as opposed to the “supplier-push” nature of protected and low-competition value chains in previous decades.

The second describes a world where key capital intensive producers in the chain, generally commanding vital technologies, play the role of coordinating the various links and take responsibility for assisting the efficiency of both their suppliers and their customers. Later, with the effect of the internet in value chains, Gereffi (2001)¹⁵ himself recognizes the possibility of a third kind of chain called infomediary-driven or information-intensive “commodity” chain.

¹⁴ This concept was first addressed by Gary Gereffi (1994, 1999b) as cited by the same author in Gereffi (2001):value of value chain

¹⁵ Gereffi, G. (2001) ‘Shifting governance structures in global commodity chains, with special reference to the Internet’, *American Behavioral Scientist*, 44, 1616–37.

2.3 Flows of Product/ Service, Income Distribution and Information

After addressing structural and dynamic factors of a value chain, it is possible to map the flow of products /services, income and information along a chain. Products/services usually flow starting from the first supplier until the end user; value added income from a respective user to the respective supplier and information mainly from lead firm(s) to the suppliers, as seen in figure 3 (Feller A. et al 2006). Thus, value chain development focuses downstream on creating value in the eyes of the customer. That is, supplies go one way and money goes the other. While supply chains focus primarily on reducing costs and attaining operational excellence, value chains focus more on innovation in product development and marketing. That is, while the former is purely a business management tool, the latter reflects more of a development concept. As defined elsewhere, a value chain is composed of links which add value to a product/service. These links are structured vertically from the conception to the consumption/recycling. Within each link, there are also various activities /actors involved. That is, a single link in a value chain can also “branch” horizontally, since it sometimes needs supporting functions delivered by other firms (raw and supporting materials for production, financial sources, etc.). In this interwoven link the products/services flow vertically.

To see this, as Kaplinsky (2001) states, first, mapping of the range of activities in the chain provides the capacity to decompose total value chain earnings into the rewards which are achieved by different parties in the chain that gives synoptic overview of earnings (both international and intra-national) in globally linked activities. Mapping is more important than; say trade statistics on aggregate or branch-specific analyses (agriculture, industry, services etc.) that only capture part of the story. Then, the income distributions is calculated on the basis of the *value added* (that is output value minus input costs) rather than the gross value of sales/exports in each link of the value chain. The reasons for this are obvious—for example, a buyer near the apex of the value chain may account for only a small portion of total chain value added, but will have a very large share of the value of turnover. It is natural to think of profits in mapping the distribution of income; the greater the barriers to entry, the higher the level of profitability. But profitability is misleading indicator to determine patterns of returns; particularly if competitive pressures are high throughout the chain or if none of the

entrepreneurial functions are earning monopoly rents and producer profit is scanty as the major surplus goes to consumers.

The concept of global value chains was developed, inter alia, to explain the unequal distribution of welfare gained through international trade (Stamm E. 2004). Analysis of income distribution in a value chain is used to address the issue of growing inequalities.

At least for important captive value chains in light industry, it can be shown that the lead firms in industrialized countries concentrate on those activities that promise the highest profit margins. These are knowledge-intensive activities with high barriers to entry, for example, in the area of design and marketing. On the other hand, increasing competition due to low barriers to entry leads to continual pressure on income (wages, profits) at the lower end of the value chain. Actors in segments with low barriers to entry are subject to intense competition and often can only survive in the market through a low-price policy. In contrast, actors in segments with high barriers to entry can limit the competitive pressure and thus safeguard their margins. Basically, it is true that the higher the barriers to entry, the higher are also the profit margins. On the contrary where levels of competition are high, income shares are under threat.

Secondly, a value chain approach analyses the way in which particular firms, regions and countries are linked to the global economy. This helps determine the distributional outcomes of global production systems and the capacity which individual producers have to (functionally) upgrade their operations and thus to launch themselves onto a path of sustainable income growth and help understand the dynamics of income distribution over time. However, opposite upgrading trend is also gaining popularity in recent years, namely by specialization on core competence and outsourcing of non-core activities (Kaplinsky/Moris 2001).

Thirdly, by focusing on the institutions which drive international specialization, value chain analysis identifies the normative forces which can be used to alter these distributional patterns.

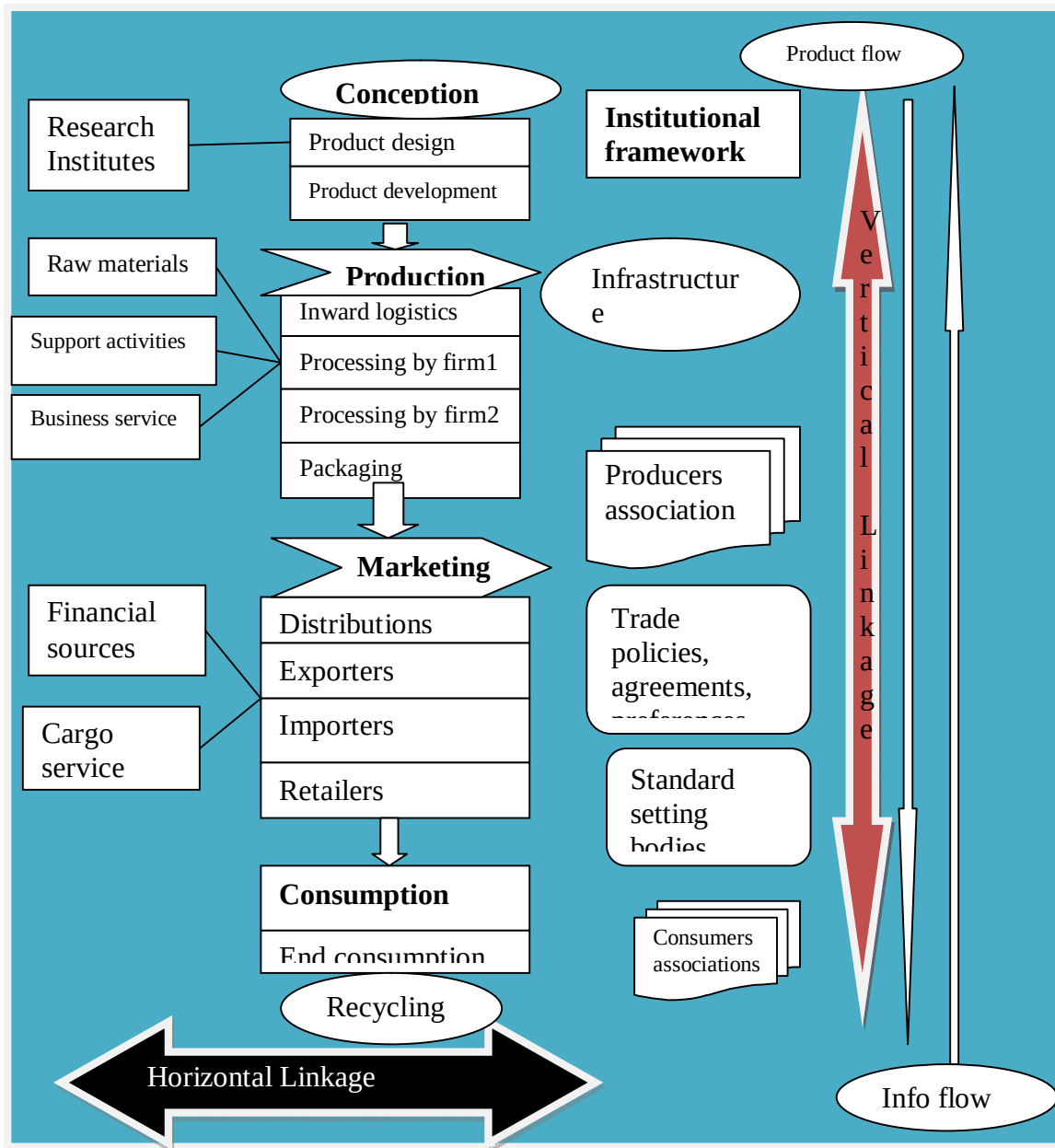
Besides product/service and income flow, there are several forms of **information** flowing along the chain from end consumer to first supplier: buyer requirements, technical assistance and signal of conformity. Buyer's requirements that force the backward suppliers to comply with can be transferred throughout the chain in non-codified or codified forms. Non-codified information means that the buyer communicates the

requirements—and also enforces these—directly with his suppliers and thus reflecting high coordination/transaction cost. Codified information implies formal procedures that regulate standard-setting, evaluation, monitoring, and compliance of requirements as in the case of certification scheme. The basic idea, here, is to reduce complexity (coordination cost) of information transmitted between firms and to allow clean hands-off between trading partners, though, thereby transferring the direct costs of monitoring and control from the buyer to the suppliers.

In this case, suppliers in developing countries—that are not yet ready to meet these requirements- refrain to access the export market since the requirements frequently do not yet apply to their domestic market and thus creating a gap of capabilities required for the domestic and export market (Feller A. et al 2006).

The second form of information, namely technical assistance, should ideally flow along the chain together with the buyer requirements. Basically it covers all measures (transfer of technology, capacity building, financial investment, advisory services, etc.) undertaken to enable backward suppliers to meet the defined requirements. This is a basic necessity to create a functioning governance structure in the value chain.

Figure 2: GVC structure and flow of product/service, income and information (adapted from Kaplinsky et al 2001)



However, the existing case studies show that this is generally not always the case (Gereffi G. 2005). For example, in international agribusiness value chain it is less likely that buyer imposes their requirements and at the same time provides technical assistance to enhance the capability of their suppliers. Instead, they rely on specialist producers and suppliers. Therefore, they provide “problems” (specifications about the types of

products they want) rather than “solutions” (instructions and information on what needs to be done and how to do it).

Thus, in place of lead-firms, another of source of assistance in the latest trend is the development programs tailored by multiple stakeholders such as international development agencies, NGOs, and government agents. These agencies act as executive governance.

The last form of information, according to Kaplinsky (2001), is the signal to conformity. This comprises a system in which suppliers can measure their performance against the requirements set by the buyer. It can be accommodated in various forms, such as a system of ‘reward and punishment’ (price bonus and price penalty), quality-price signal (price differentiation according to the process or product quality), or – in a stricter form – inclusion or exclusion from the chain based on the ability or inability to fulfill the basic requirements. The non-conformity signal or over-emphasis on punishment while providing no or little reward can impede the advance of the supplier’s capability since no or little incentive is given to achievements obtained by the supplier.

2.4 Significances of Value Chain Approach: Learning and Upgrading

In this market liberalized world, firms within an industry in a country or region must increasingly compete—even in local markets—with firms and industries across the globe. The hypothesis of VCA is that firms that produce global commodity can capture/ create economic rent/value and promote economic growth by sustainably aligning themselves into international, regional and/or national value chains. Value creation is an additional value added as a result of value chain upgrading (GTZ, 2008). The methodology of VCA highlights the importance of linkages between public policies, institutions and the performance of core firms; and therefore it is an appropriate tool for a broad audience in both the public and private sectors.

VCA helps to understand how producers’ capabilities are upgraded, how access to export markets can be facilitated, how the returns to different activities are determined or to learn the risks of exclusion and the dynamics of relationships within value chains.

Particularly, value chain development/upgrading issues are very relevant to developing countries, as traditional production systems are usually isolated and building relationship

with local, regional or global markets is important. To achieve this goal, the approach helps to systemically as well as systematically analyzing and understanding of a business environment or the economic growth opportunities and constraints (USAID, ACIDI/VOCA; 2008). This means, such a broad scope of industry analysis is needed as the possible principal opportunities and/or constraints to competitiveness may lie within any part of this market system or the environment in which it operates; and can help know the incentives for and the capabilities to compete in and benefit from market participation by cooperation and coordination of the opportunities to enterprises' activities; hence called value chain upgrading. Formally in the value-chain literature, "upgrading" is understood as the process that enables a firm to take on more value-intensive functions in the chain, make it harder to replace, and thus appropriate a larger share of the generated profits (Stamm E. 2004). It is also considered as 'learning by doing' or by participation in a given lucrative business activity.

Firms can upgrade their processes ('doing things better'); products ('making better things'); move into higher value-added stages in the chain like from simple production activity to design and marketing ('functional or intra-firm upgrading'); or they may serve a new sector or new value chain (Inter-chain upgrading or chain creating) by learning processes [Humphrey et al 2000]. In other words, opportunities offered by GVA to firms for developing countries are learning (planned or unplanned i.e. spillovers) and innovation for value chain upgrading.

For instance, East Asian firms have made the upgrading transition from original equipment assembling (OEA), that is, thin value added activity under contract to a global buyer; to original equipment manufacturing(OEM), that is manufacturing a product which will bear the buyer's badge; to own design manufacturing (ODM) and now to own brand manufacturing (OBM).

Precisely, in this largely liberalized world that forces producers to operate on a global market (globalization), the key policy issue is not whether to participate in global markets, but how to do so in a way which provides for sustainable growth, while the means is VCA (Pietrobelli, 2007).

As liberalization and globalization have made developing countries' industries more vulnerable to intense competition from global players as well as other competitors within the same boundary and they lack capacities to comply with new business rules and

quality standards, which constitute barriers to their integration in national, regional or global value chains, value chain development issues are very relevant to these firms to learn; as their traditional production systems are usually isolated and struggle to build relationships with local, regional or global markets (USAID, ACDI/VOCA; 2008).

Learning is a key to industrial upgrading, with so many mechanisms such as starting from arms-length technological “borrowing” through a range of practices that encompass technology licensing, reverse engineering, the injection of equipment and know-how through FDI and firm-level adaptation to demands made by both foreign affiliates and overseas buyers (Gereffi, 1994; Feenstra R. et al 2008). The lead firms that set the “rules of the game”, mostly due to their ability to create powerful brand names and enforce standards, are usually based in developed countries. As lead firms seek to ensure consistent quantity and quality of supply, small firm stand to gain knowledge and technology transfers from these larger firms through, for example, increased access to firm inputs, standardization and certification bodies.

Broadly, effective and thus poverty-alleviating growth in developing countries that is also environmentally sustainable is not conceivable without access to the large and differentiated markets of industrialized countries. The value chain approach presents possibilities to appropriately analyze the conditions for this and to assess the opportunities and perhaps also the risks. Especially important for development-policy practice is the question of under which conditions labor intensive firms, like in leather industry, from developing countries can gain access to the global value chains, how they can appropriate a relevant share of the value added, and how they can draw non-tangible benefits (technological and organizational learning) from integration into value chains. Finally, important observations also arise with respect to the appropriation of value created by actors in the chain through the division of labor (Stamm E. 2004).

2.5 Global Value Chain of Leather Industry and Its Trends

The production of leather and leather products is “globalised” as activities along the value chain occur in different countries. In other words, leather and leather products as international commodities are among the most widely traded and universally used products in the world (de Buckle S. 2001). An interesting fact is that the value chain of leather and leather products knows no national or continental boundaries thus making it easier to source parts or all of the chain in third countries (CIBCO, 2007). The most important aspects that an importer of leather must consider is the price and quality competitiveness, reliability of the supplier, speed of delivery and the technological advancement with respect to major competitors so that vertical integration of the supply chain will prove more profitable and ensure greater assurance for the company.

During the first half of the twentieth century, the obvious center of the global leather and footwear industry was Europe (Italy, Spain, Portugal and others) and USA but since the 1960s and 1970s it was shifted to relatively low cost areas like Japan, Taiwan, Korea and Hong Kong, among others. Later, in the 1980s and early 1990s, the center was transferred again to mainland China coastal areas followed by towards Vietnam, Brazil and India; and even to Africa, after the new Millennium. The center has been moved many times because there’s always been, omnipresent, a cost reducing strategy of world’s leading producers (the leather industry, particularly footwear subsector is a labor-intensive industry; its growth is decided mainly by factors like labor costs, raw materials supply, environmental protection cost and of course, by the market). So far, the Asian countries are producing nearly 85% of the world’s total footwear products (de la Matta M., 2008; Krishnamurthy V. 2009).

The usual explanation for the globalization of the leather industry is the ceaseless search for cheap and amenable labour. But the performance of this industry in a range of exporting countries suggests that labour costs alone are insufficient; inter alia, intermediaries are often crucial in articulating the global value chain (Stella L. 2002).

Anyway, this dynamic geographical relocation of manufacturing activities has positive impact on the global leather value chain at the world level, i.e. hides from South America may be processed efficiently in India and intermediate and end products can be sold in Europe or the United States (de Buckle S. 2001). This process has advantages of

increasing capacity and flexibility, specialization, lower production costs, shorter delivery times, etc. The fundamental determinants of competitiveness within this industry which are labor costs, trade barriers, making leather products better, more quickly and more productively than competitors seem to be important factors within the relocation process. On the other hand, Schmitz (2006) also argues in the way that non-price factors (quality, brand, speed) play an increasing role for competing in global markets though price competition continues to lead to downward pressure on prices, reinforcing the importance of low-cost/low prices in order to enter the chain.

The leather global value chain involves a series of activities that begin with product design and the selection and purchase of raw materials and intermediate inputs and go through processing, marketing and distribution. The chain continues with the operation of sales of intermediate and end products. The last component of the chain is the consumption of final goods in form of shoes, garments and others regulated by internal and external demands.

In this case, the leather production-consumption value chain has three main processing stages, each requiring different combinations of material inputs, labour and capital. The first stage is the recovery of raw materials that has direct links with animal production activities; hides and skins are recovered from dairy, draught animals or animals from slaughter houses and are transformed into various types of leather and manufactured end products. The production of raw hides and skins depends on animal population and slaughter rate and is related mainly to meat consumption. As this depends on the demand for meat, the supply of hide and skin is price inelastic (Lopez A. et al, 2008). Thus, while world production of bovine meat has grown at a rate of 1.5% per year in the last three decades, as has fresh hide production¹⁶, too. Leather tanning and finishing is the second stage that involves relatively capital-intensive operations while the third stage, which is the production of leather products, is a more labour intensive activity. These three processing stages are linked to key commercial components of the chain, the marketing of intermediate inputs, components and end products, and trade and consumption; it is considered as the fourth stage or the product placement activities (de Buckle 2001; SADC/TIB 2006). Inputs to the chain without which the chain cannot operate under

¹⁶ www.faostat.fao.org

competitive basis are: qualified labour, design and art centers, component production, access to chemicals, technical and administrative support institutions, research and development, training as well as a set of adequate policies.

In this new global scheme there is a tendency for developed countries producing cattle to concentrate on the export of raw hides and skins and on importing footwear and leather products. On the other hand, developing countries (e.g. China, Vietnam, India etc.) import raw materials, semi-finished and finished leather to produce footwear and leather products locally, based mainly on low labour costs and re-export them (Lopez et al 2008). Thus, these days, the manufacturing of leather products takes place in the East with the major market being in the West. The main consuming markets in the world for leather products are Europe (EU27), the biggest; and North America. These areas (the West) are the target markets for many leather products manufacturers who aspire to be exporters. The footwear manufacturing industry (which is a barometer of the rest of the leather products manufacturing industry as it covers about 65% leather product consumption) in these areas has declined year after year for the past two decades, as they lose the battle with imports (Qattous M. et al 2009; Buckle, 2001). Virtually all footwear (96%) sold in the United States is produced overseas by contract manufacturers, 87% from China (Packaged Facts, 2009). Only the Italian leather manufacturing industry survives¹⁷ because of innovation in terms of being the world fashion leader; as product development, design, and styling, where higher rents reside; still has its heart in there except sports footwear that occurring in USA (Kaplinsky 2000). He addresses also that, especially footwear subsector, being highly labor intensive, there has been a significant decline in the share of production accounted for by high income countries in recent years; in some key economies such as Germany, the UK and the US what was once a large and vibrant sector has shrunk dramatically and continues to lose manufacturers and employment. While the cost share of labor is about 30% in the developed nations, it is only about 10-15% for this industry in the developing countries¹⁸.

China's high production of leather (about 31% of the world sales share) is not reflected in the quality of domestic hides and skins due to poor slaughtering practices and inferior

¹⁷ *Clustering and business merging could also contribute for Italy's leather industry to survive (Porter M. 1998).*

¹⁸ *Cost breakdown of labor, materials and overhead in developed countries respectively are 30, 40 and 30% while 10-15, 70 and 15-20% in developing nations (R.Beeby/Automation).*

quality of cattle, as nearly 80% of the raw hides and skins used for manufacturing is imported from countries such as USA and Argentina (Krishnamurthy V. 2009; Xian V. 2008). Rather, the tremendous success of China in this industry is not only a low cost production, but more importantly, she is a full service provider of end use products. That is, China can provide all the services required to produce the product from design to shipment. The turn time required for the footwear producers in China to produce a prototype and a projected cost is measured in hours and days; while the turn time required for a prototype to be developed and complete bill of materials and costs in the Dominican Region e.g. is measured in weeks (USAID, 2005).

Stressing on marketing issue, it is the core of the modern leather product business. The principal marketing agents have the necessary trade information and have established a wide network of sales channels that allow them to contract production, provide finance and serve the customer on time managing the complex mechanism of buyer-driven value chains, both in the local and the export market; the latter is usually managed within the rules of a buyer-driven value chain and triangular manufacturing (Schmel1998; Magretta 2000)¹⁹. These authors also claim that marketing and trading whereby established trade contacts, brands, promotion and financial power are prevailing are far more valuable assets than manufacturing technology and related knowledge. Nike's marketing budget (which is about \$2 billion a year, is probably only a billion dollars or so behind what it spends to manufacture 225 million pairs of shoes)" (Forbes Magazine 2008)²⁰. Nike is the world leader in sports shoes with a 47% market share. In fact, it is at this stage that the bulk of profit margin/rent is found nowadays. For instance, in manufacturing a pair of shoes for men in Argentina, if the whole process is divided into four stages, around 4.5% of value is added at the first stage of obtaining the fresh hide. During the second stage, which ends with finished leather, a 9.5% increase in the value is possible. The making of the shoes adds up to 32% of the value; but in the marketing phase, almost 55% of the total of the value can be added (Lopez A. et al. 2008).

On the other hand, as global manufacturing skills have diffused increasingly widely and become highly competitive, rents have come to be concentrated mainly in design, brands (especially in sports shoes) and buying skills. Buying agents- many of whom were

¹⁹ These references are cited or tracked in www.trendsforshoes.com

²⁰ Cited in Jegge F. (2010)

formerly manufacturers but were forced out by growing competitions- are largely located in the final product markets and have played a key governance role in creating this competition in production which erodes rents in this link in the chain. That is, Western actors in this industry shift to the service industry stage of designing, innovation and branding while manufacturing activities are concentrated in developing countries. Organizations in the developed economies source leather products from developing economies directly or through intermediaries while focusing on building brands. Hence, an increasing number of footwear and leather manufacturers are engaged in contract manufacturing for global buyers (*sourcing companies*).

In this respect, there is practical evidence from Brazil leather industry. During the 1970s and 1980s, when Brazil became the major producer of women's leather shoes (covered about 12% of the world sales share), her entry to global market was directly mediated by the key governing role (executive governance by directly supporting at firm-level and inter-firm upgrading and linkages) played by these buyers (captive governance); particularly a US base single buyer who had been taking the 25% of Brazil's shoes. As this watchful buyer firm learnt that Brazil was becoming the dominant supplier with a growing bargaining power, it systematically cultivated production capabilities in China in the 1990s, when China has emerged as the hub of leather manufacturing zone. For Brazil's leather industry, the consequence was painful at least temporarily in terms of income erosion; real wage of shoe workers fell by 40%, corporate profitability was squeezed, product quality requirements by the buyer have increased, batch size order fell, yet there is no final product price improvement during 1990s. This trend continues and Chinese leather and footwear producers will suffer from the same erosion of returns as these global buyers are now cultivating new production in Vietnam and other low wage economies including Africa (Krishnamurthy, 2009; Kaplinsky, 2000).

Similar analysis by Schmitz (2006) shows us how competitive capabilities can be upgraded and diffused by the chain governor and how rent is dynamically shifted between countries and activities among chain actors. Concerning Brazil's leather sector, it could remain alive whatever high the pressure from cheaper Chinese-made shoes in the US market, by diversifying exports, in particular to penetrate into higher quality markets in Western Europe as she had already learnt the business trick from those governors and competency developed from Sinos-Valley clustering success (Nadvi K. 1995).

Coming back to triangular manufacturing, it describes a world in which shifting competitive advantages leads to a situation in which producers who are forced out of the market due to competition, become governors for production destined for third market in buyer driven value chain. Practically, in footwear subsector, Taiwanese producers who initially could displace manufacturers in US and Europe have themselves been displaced by even lower cost producers from China. But their response was to winding down of their own manufacturing operations and become the intermediaries or agents who govern Chinese production capabilities and consign the products to the final markets (mainly to US and EU markets) [Schmitz H. 2006].

To summarize, concentrating on activities of labor-intensive stages of the value chain might not lead to sustainable income growth in developing countries and hence a better strategy would be to shift to more value-added stages, based on design or marketing skills (de Buckle 2001). Besides, the governance and coordination role of buyers with global vision are increasingly significant. That is, given the above “buyers’ requirements” the most effective way for producers to gain entry into developed markets would be to familiarize themselves with developed countries’ regulations by forming trade and business contacts.

2.6 Overview of Value Chain Setting in Ethiopia’s Leather Industry

The population²¹ size of heads of cattle, sheep and goat, from which hides and skins are produced in Ethiopia, reaches respectively 53.4, 25.5 and 22.78 million (CSA, 2010/2011) covering as high as 2.4% of the world share (FAO, 2001). The production of hides and skins is principally in the farms of the mountain and high plain areas and this environment causes hides and skins attain a considerable fiber thickness (an important intrinsic characteristic). Ethiopia is endowed not only with this huge natural resource base in the industry but also the kinds what the world market demand. Evidently, the three types of skins coming from Ethiopian breeds: Selalie Hair Sheep, Bati Genuine and Bati Type, which have clear potential to be world market brand, are used to produce some of the finest leather in the world; all fetching high retail prices for the developed manufacturers and retailers abroad, (Light Year IP, 2008).

²¹ *It includes only livestock population from sedentary areas*

Given that labor is currently Ethiopia's most abundant²² factor and that a lot of activities in the leather sector are relatively labor-intensive, such a significant livestock resource potential provides additional opportunity for substantially expanding the leather and leather products output for local and the export market (M. Amin M. et al, 2006; Nega B. et al 2002). While the Ethiopian Government Industrial Development Strategy- EIDS (2003) justifies this sector as a priority sector, it presupposes this opportunity.

However, the production/supply of hides and skins is constrained by the production of animals for their meat and milk, which is relatively a high-income consumption item. This is worsened by: low local demand of meat (i.e. low off-take rate²³) due to low level income of the majority of the population; unavailability of policy that discourage livestock export; the country's insignificant export share in meat production, hence unable to exploit the external market; using of cattle as a means of production in traditional Ethiopian agriculture; and low hide and skin recovery rate²⁴ for a variety of reasons and low hide quality caused by a variety of traditional animal husbandry practices, skin diseases as well as poor and traditional slaughtering technique. The utilized capacity in 2005 was only 15.4 million pieces, which was 48%²⁵ of the installed capacity of tanneries. This low capacity utilization is worsened by tanneries themselves as they tend to export only semi-processed products while they have installed upstream or finishing facilities. Nega (2002) argues also that the performance of the footwear industry reflects the stage of development of the leather sector as a whole since, for a fully integrated leather sector, its cumulative outcome is reflected in the end product of the leather products sub-sector. According to the study, the Ethiopia's footwear subsector is less coordinated and inefficient with its little competitiveness to export or even to satisfy the domestic demand.

In addition to short supply, the quality of sheepskin in Ethiopia is deteriorating mainly due to ecto-parasites disease, known locally as 'ekek'. Almost 80% of the total

²² Under Lall's (2000) technological classification, leather manufacturing demands only low-tech/ low knowhow.

²³ The average off-take rates of Ethiopia's cattle, sheep and goat respectively are 8, 38 and 45% (FAO 2001); while sheep's off-take rates in Iran, China and Egypt are respectively 87, 71 and 56% (WBG, 2006).

²⁴ Traders collect /supply about 70% of the hides, and 90% of the sheep and goatskins to the industry (FAO 2001).

²⁵ Currently there are also at least five foreign owned new tanneries in the pipeline or to start operation.

sheepskins from highland Ethiopia are affected by ‘ekek’. Almost 100% of the sheepskins rejected due to defects of all kinds have also ‘ekek’ defects (Akalu D. et al 2011). This infectious skin disease is ubiquitous not only on sheep but also on cattle and goat species. With this widespread problem, it is unthinkable to be price competitive or to fetch premium price. As calculated, the market price differential between grade I/III and V/R pickle or wet-blue products reaches about 40% (M. Amin M. et al, 2006).

The domestic leather industry value chain is characteristic of a non-integrated chain in which all actors operate independently with weak backward and forward linkages; all transactions are arms-length and cash based; prices fail to reflect premiums for superior quality inputs; and productivity and capacity utilization is minimal and declining mainly due to the absence of joint investment (M. Amin M. et al, 2006). Needless to say that these problems are persistent and even noticed in the Government white paper-EIDS (2003); while the actions taken are less integrated and fruitless as reflected in the GTP base year(2009/2010) export figure i.e. only \$75.73 million annually. The most common constraint is the lack of synergy among the Ethiopian Leather and Leather Products Industry (ELLPI) stakeholders, which is probably related to the fact that the ELLPI is not seen as a system, where components are interactively linked (UNIDO, 2005).

With this setting, GTP (2014/2015) claims that by achieving 90% production capacity of the tanneries and by reducing the current 50% lower grade distribution of input of hides and skins to 15%, it is possible to produce 60.2 million square feet finished leather annually that can be converted into leather products and partly be exported for \$496.5 million. This national plan assumes largely that the performance of the meat production subsector can grow about eleven times of the base year figure (\$10.18 million) so as to relieve the hunger of the tanneries in raw inputs.

Actually, before the GTP execution, a strategy with a model of *policy mix* for the industry called “Top-down (Pull)” Approach, which was experimented by China and Italy for the footwear industry, has proposed and implemented since 2005. According to this approach the leather products: mainly, footwear, leather goods and leather garments should be developed in a way that they would “pull” the tanning sector to produce better quality and increased quantity of finished leather; subsequently the quantity and quality of raw material (UNIDO 2005).

Even though the strategy states that the respective business plan has designed using value chain approach, it hasn't well addressed or incorporated at least the role of the value chain governance.

True, for the whole chain to function effectively, each of these stages requires specific inputs, policies and support systems. Inputs include (in addition to raw materials) technology and knowhow (i.e. equipment, chemicals and components, design, research and development and, information) as well as human resources development, technical and administrative support institutions and financing.

But the prerequisites for taking a value chain approach to function include a minimum level of competitive governance and stability in the enabling environment, the existence of at least some market activity (even with low-value products or exclusively local markets), a governance pattern that coordinates this market and a project goal of economic recovery or growth.

Thus, in order to see the options of inputs, policies and support systems it is imperative to assess the governance patterns and its coordination role of the industry with the help of value chain approach.

Chapter 3: Specification of GVC Attributes to Undertake VCA

Value chain approaches (VCA) have been utilized by development practitioners and researchers equally to capture the interactions of increasingly dynamic (and complex) markets in developing countries and to examine the inter-relationships between diverse actors involved in all stages of the marketing channel (Kaplinsky, 2000; 2004; Dolan and Humphrey, 2000; McCormick, 2001; Bair and Peters, 2006; FIAS-WBG, 2007; Pietrobelli et al 2008; USAID, ACIDI/VOCA, 2008; UNIDO Expert Meeting, 2009). It provides an assessment of material flows, information flows, and stakeholder relationships (Fearne A. et al 2009). Usually, in VCA, the methodology applied is based on random quality check principle – i.e. based on selected import or/and export shipments in key commodity groups. Basically VCA is more concerned with political economy aspects such as power; indeed this is where its roots lie.

Though there is no mechanistic way of applying value chain methodology, as Kaplinsky (2001) stated, the activities outlined below, as extracted from the above literatures, will commonly encompass the generic VCA methodology undertaking.

- Selection of entry point for VCA
- Analysis of CSF's in end- markets
- Mapping value chains and analyzing values and their distributional issues
- Governance of value chains
- Benchmarking of efficiency indicators and
- Upgrading in value chains

Entry point is the starting point for executing VCA methodology. The entry point can be a particular issue/goal (income distribution, poverty alleviation, firm competitiveness, local value added, export earnings etc.) to a particular actor or product in a sector.

Concerning **CSF's**, they are well dealt for market segmentation issues. Markets are *segmented* (say for leather articles into high class leather-high income market, economic leather-low income bracket, seasonal, fashion, classic etc.) each having its own distinctive market characteristics together with market size and growth. One of the distinctive features about contemporary production systems is that they tend to be “market-pulled”, as opposed to the “supplier-push” nature of protected and low-competition value chains in previous decades. This puts a primacy on the characteristics of end markets in every chain, and generally represents a high-order priority in all value chain studies. It will almost always be important to decompose the final market in the

value chain into different market segments. This is important as market heterogeneity has increasing in the current world.

Contemporary global end-markets comprise a number of critical characteristics which need to be analyzed to understand value chain dynamics. These include:

- Market characteristics, based on market segments, referred to as CSF's. E.g. in low income final markets, price will be a relatively important CSF. In higher income end markets, non-price CSF's like quality and branding will generally be relatively more important, with innovation, customization and quality dominating. For classic products, customers prefer larger volumes of relatively standardized components. For fashion products meeting delivery time is the most important CSF.
- Not only are markets increasingly segmented, with each having distinctive combinations of CSFs, but they are also *increasingly volatile*. For example, even in mass markets in the global clothing industry, the number of seasons has grown from two (winter, summer) to four (winter, spring, summer, autumn) and now to eight (early and late summer, and so on).
- The CSF's in each market can be readily grouped into those factors which are "*order qualifying*" (that is, producers need to achieve these in order to participate in these markets), and those which are "*order winning*" (that is, these are the critical factors which lead particular firms to succeed, perhaps by selling at a price premium).

For primary research purpose, a useful tool for conducting analysis of CSFs and order qualifying and order-winning characteristics is through the use of scored responses on a 1-10 or 1-5 scale. The first step is to undertake a limited number of pilot interviews to get a feeling for the CSF's in a particular market or market segment. These will vary by sector. For example, perishability may be an issue in food products, but not in electronics or banking services. Thereafter, key respondents should be asked how important each of these CSFs is in each of the key market segments, using a scale of 1 (not important) to 5 or 10 (extremely important). Experience suggests that each of these scaling points needs to be described briefly; otherwise respondents seldom utilize the bottom of the range. The same CSFs should be utilized in each segment of a sector market to facilitate comparison between segments, but respondents should also be offered an "other category" to write-in CSFs not provided to them. It is then possible to plot these responses on to a radar chart, by the help of Microsoft Excel, which provides a picture of the preferences, and is

particularly useful in that it makes it clear that modern markets are characterized by multiple CSFs. For example, in many markets it may not be a matter of price or quality, but both price *and* quality.

Besides, knowledge of the ways in which disparate producers are connected into different final markets is of particular importance to value chain analysis to characterize value chains as being either “**buyer-driven**” or “**producer driven**”.

From the perspective of value chain analyses, among the key issues to research are:

- The *identification of the key buyers* (Retail chains, Wholesale firms, Independent buyers or large firms of chain governors)
- The *dynamics of the* buyer concentration levels and relative power
- *charting the CSF’s* which these buyers exercise or prefer based on the identified buyers and their dynamic buying function

After constructing a “tree” of input-output relationships, which is **mapping**, the next task is to put numbers or values to the variables under investigation using the accounting principle. Thus the activities include:

- Mapping of the physical flow of products along the chain
- the flow of services, consultants and skills along the chain
- Quantifying the gross output values
- net output values (that is, gross output, minus input costs)
- employment, where relevant distinguishing between permanent (on payroll) and temporary (off payroll) staff, gender
- destination of sales - for example to wholesalers and retailers; concentration of sales amongst major buyers; number of buyers
- imports and exports, and to which region

From this, the **value added** that takes place in various stages are assessed within a:

- discrete parts of a plant or firm or farm’s productive activities
- particular plant, firm or farm
- link in the value chain (in design, marketing or production, which will not always be synonymous with the activities of individual firms in each of these links) or
- In the sub-national locality and at the national level.

In assessing value added share, the central principle is to take gross output costs—including material costs, depreciation costs of equipment, labour costs, utilities and profit – and then to subtract total input costs (bought-in materials, components and services, not factor costs!!). This procedure should be applied at all stages of the analysis.

Value Added=FOB Price–Value of raw and Intermediate Inputs purchased (EXW)²⁶

The next activity is to analyze the productive efficiency of different parties in the value chain. This is referred to as “**benchmarking**”. The parameters of benchmarking are the challenges defined by the ability of the firm to meet the CSF’s; which it or its chain confronts in its final markets.

Both practices and performance outcomes of CSF’s can be benchmarked against internal operations over time (historic performance), and against competitors (best achievers).

VGC governance analysis is also one of the most important attributes to know how:

- The powerful actors force other parties to take particular actions, e.g. to limit themselves to assembly rather than to involve themselves in design.
- The powerful actors make deaf to the demands of others

In general, the larger the firm (in terms of attributes to follow), the more influential its role is.

- Share of chain sales
- share of chain value added
- share of chain profits
- share of chain buying power
- Control over a key technology and distinctive competence holder of chain, e.g. a brand name

²⁶ *Excluding primary input costs such as utilities, equipment maintenance and administrative overhead costs (in addition to labor, capital and land) as well as, in some cases, logistic costs (FIAS 2007).*

In many cases chains may have more than one rule-setting lead-firm. So the issue is one of whose rules-agenda is heard most loudly/pervasively. A useful way to research this issue is to utilize the methodology employed in the analysis of CSF's.

Besides, to research the **upgrading trend** of a value chain, usually the characteristics of the different upgrading types, mentioned elsewhere, are dealt. Finally, Kaplinsky (2001) and his colleagues recommend that in studying value chain, considering the following principles as part of the value chain methodology is imperative.

- be driven by the question(s) you seek to answer and not the method;
- Mapping helps to show up bottlenecks, inequities and leverage points for action;
- using a combination of methods and resources answers a research question effectively; and,
- Chain analysis is mainly about relationships; know both sides of the story by mirror question, and thus feed your analysis back to the stakeholders.

Chapter 4: Research Findings and Discussions

Hereby, not only the findings from the tanneries and shoe factories survey and the expert and end-users interviews conducted are presented but also the secondary data from CSA on the sector are supplemented and analyzed.

Representative four sample tanneries and four shoe factories with the annual aggregate capacity to produce 75,068,000ft² of leather and 2,800,000 pair of shoes within a benchmark plan of 280 working days respectively are taken that cover 29.2% and 70% of the total capacities of the respective sub-sectors in the fiscal year of 2010/2011.

The analysis begins hereunder with the description value chain actors and their mapping; then it proceeds with the analysis of the level of value added, product and information flow. The governance pattern of the industry is also assessed followed by the observation of the critical success factors of the value chain. Finally, it is closed with the presentation of the situation and performance of macro and meso level structure of the sector.

4.1 Actors' Situations; Product, Income and Information Flows

4.1.1 Key Actors and their Situations in the Leather Industry Value Chain

In Ethiopia context, there exist three levels of 'active' actors for leather value chain.

In the first level, there are core **micro level actors**; those actors which include the fundamental business chain operators such as livestock producers, raw hides and skins traders, tanneries, leather product manufacturers, distributors or retailers and operational service providers such as transporters (road transport enterprises, shippers, air lines), banks, custom offices etc. to the core micro level actors.

In the second level are **meso level actors** which are termed as **Chain supporters** which facilitate the performance of the micro level actors. They include the industry association (ELIA), sector-specific agencies for technology transfer and training institutions (LIDI, ARI/MOA), specialized departments in the public administration (Export Promotion Departments), foundations or development programs (ECBP, UNIDO, ECF). These institutional actors are objectively established to play the role of:

- promoting markets and price data publication, sector-specific general information, organization of fairs and forums etc. as expected from ELIA
- Giving services of shared technical facilities etc as expected from LIDI Lab.

- o Training and capacity building, product marketing, public relation and advocacy for common interests of the value chain etc. as expected from LIDI and ECBP
- o Financing for technology transfer as ECBP, UNIDO, ECF/WB etc. do
- o Export promotion (e.g. as MoFA business delegations and attachés do)
- o Technical inspections in the interest of consumer or public protection and indirectly for the industry as well. e.g. quality inspection by ECAE, environmental and safety inspection by EPA

In the third level are macro-level actors or conditions which include national and international government and other public organizations responsible for shaping the business enabling environment (BEE) of the value chain. They constitute two tiers:

1. The general conditions for doing business environment, which include:

- o Macro-economic policies and conditions (monetary policy like interest and exchange rates, fiscal policies like customs duties on imports of intermediate goods, taxation (direct and indirect) etc.))
- o International (bilateral or multilateral) trade policy treaties like COMESA, AGOA
- o Laws and regulations for business registration and licensing etc.
- o Contract security and legal enforcement framework
- o Extension and quality of road and port infrastructure

2. And competency of sector-specific conditions for doing business in the industry level, which include:

- o Competency of standards regulating body (ESA and ECAE) in the markets
- o Suitability of the sector-specific trade policy or product-specific taxes levied
- o Competency of the sector specific support services funded by government, such as specialized research, technology and training institutions (like LIDI)
- o availability and cost of utilities such as energy and water

However, having those actors is not enough for competitiveness. Thus, the possible prevalence of problems of market/institutional failure within the value chain, lack of input resources and technical capability, lack of coordination, information asymmetry, opportunistic behavior and mistrust are to be analyzed.

Up next, the existing situation of core micro level actors of the leather value chain is presented followed by the discussion in the product and income flow through the chain.

- **Livestock Producers and Situation of Raw Inputs:** Livestock producers are significant actors in the leather value chain as it begins with animal husbandry and breeding system. Needless to say that the producers of small holder farmers and pastoralists are practically the only sources of hides and skins raw input to the country's leather industry. As the most recent CSA (2010/2011) survey indicates, the country has such a huge livestock resource base actually with frustrating issues as indicated in the data **table 1** below. Huge part of off-take (73% on aggregate) was taken place due to death than planned commercial transactions in all the three livestock breed types; livestock exporting is considered as one of the strategic fair businesses without any value addition as the figures indicate and GTP claims so high; the country is highly porous in all four directions for smuggling²⁷ of this resource; rate of annual local slaughtering was very small relative to the resource base; number of annual births or fertility rate was very small that in turn affects off-take rates or revival of the breed, if we think of the other side.

All these are among major problems that affect the production of hides and skins or the efficiency of leather industry and hence need strategic trade policies and operational coordination. As explained, the practical hides and skins production and supply (the practical off-take rates) estimated is very minimal compared to the population size. Actually the potential of increasing commercial off take rates of livestock can be promoted by improving the current husbandry or caring system to reduce mortality and by increasing the fertility rate. True, if one commits to upgrade this value chain, the basic assignments and actions should be in improving this husbandry practices, the fertility and off-take rates as these inefficiencies are the major weak link in the chain. The most relevant actors for integrating this break are those small holder farmers and pastoralists together with the government organ that directly mandated to upgrade and monitor the practices (MOA and its subordinate).

²⁷ Example: Price of live animal in Kenya is above 29% than that of in Ethiopia...Cattle from Southern Ethiopia are trekked through Moyale to Northern Kenya illegally...Out of all cattle marketed in Kenya, 22% are from neighboring countries, largely from Ethiopia. (ERA/2009)

Hides and skins production is practiced by households²⁸, slabs (small slaughter houses at Wereda or rural level) or abattoirs (large slaughter houses in terminal markets or large cities) and ends with the sale of a raw commodity at their respective gate. That is, in Ethiopia, hides and skins production occurs without any specialization, capacity, or accountability²⁹ and transaction is practiced literally at the livestock production gate or at any other points where the cattle are trekked and slaughtered, to the next value chain actors. Thus hides and skins production process is another problem area of the sector seeking policy issues.

- **Situation of Hides and Skins Traders, Input Supply and Recovery System:** The marketing of raw hides and skins, the basic raw material for leather industry value chain, is stretched in space and time starting from the point of slaughter to the premise of leather processors, if not considered the livestock trekking and trading routes. Meanwhile, the commodity passes through different hands without changing its basic form or value, if not deteriorated in quality due to poor handling. Value adding is only ambiguously considered at this stage as 15% indirect tax has to be imposed, at least on paper as it is exempted, while the raw material passes over from traders to tanners.

These hands or actors include household slaughters, slabs, butcheries or abattoirs, hide and skin collectors, big suppliers or traders, transport enterprises, traditional tanners or formal tanning industries in order or to different routes accordingly (see **figure 3**). The raw inputs assembling activities, the collection of raw hides and skins from household slaughters, butchers, hotels and slabs, preserving, packing and delivering of the raw material to a factory for industrial processing are necessary though not considered as value adding in the eyes of end-users, except grading. Clearly, they argue some activities of assembling, like storing, as ‘waste’ or unreasonable transaction cost incurring activity.

Usually, large abattoirs in Addis Ababa sell the fresh input at final market price directly to tanneries without the involvement of the middle actors or traders. This is

²⁸ About 90 and 30 percent of the supply of skins and hides, respectively, originate from the traditional homestead slaughters (Tadesse, 2005).

²⁹ There are over 1,800 licensed hides and skins traders and an estimated 3,000 illegal (unregistered) collectors across the country (TACT Training/ELIA, 2011)

the type of benchmark activity even Kenya is practicing and what end users recommend for the sake of cutting transaction cost, better recovery and quality issues.

Table 1: Total annual livestock population, number of births, heads of locally slaughtered, number of deaths and other indicators

Type of livestock	Total population	No of annual Births	No of locally slaughtered	Number of deaths ³⁰	No of sales for		Goss ³¹ off-take rates, %
					exported	smuggled	
Cattle	53,382,192	10,335,933	417,327	4,092,986	302,760	?	8
Sheep	25,509,004	11,187,626	3,273,016	5,727,118	261,390	?	38
Goat	22,786,946	9,454,904	1,916,553	5,125,629	30,590	?	45

Source: Own compilation based on CSA Survey 2010/2011, MOT trade database and FAO/2001

It is worth mentioning that in some raw input regional markets such as Debre Markos, Selale, Gondar, Jimma, Bati and Wellega purchasers offer the same price for raw skins as they offer in Addis Ababa and its surrounding, before transportation and other costs accrued, as these markets are well known for better source of quality.

Anyway the final value of an input at its place of use (tanneries in and around Addis Ababa) includes all value of the basic input costs, profit margin of traders, transportation costs, duty and VAT, brokerage and unofficial payments incurred up to that point. Therefore, the performance of these value chain actors determines the efficiency of the sector's input supply system. Considering these complex routes and constraints, the annual justified hides and skins supply potential to tanneries and the estimated supply gap are presented in **table 2**.

The routes to supply of chemical inputs for tanneries, and accessories and components for footwear manufacturers are even longer and more complex which results in higher inventory costs as it largely dependent on the imported ones from Europe, America and Asia. About 92% by cost of chemicals consumed, amongst the major cost drivers of tanneries, constituting about 26% of their total cost as summarized in **table 4**, are imported. This is really a major incompetency or

³⁰ It includes animals that died from diseases and other causes. Note! No of deaths > No of slaughters.

³¹ Gross Off-take (incorporating all possible outflows and inflows) based on FAO/2001 data

economic inefficiency of the subsector in comparison to the benchmark³² ratio (10%) as indicated by **chart 3**. Similarly, for shoe factories' accessories and components which constitute about 44% of their total costs, not less than 83% by costs are imported, too.

Evidently, the headache to manufacturers arises when they understand, as can be seen from **annex IIA**, that the average raw materials stock holding period in the sector reaches about 156 days, with a little worse in shoe factories (195 days) than tanneries (128 days). More awfully, the average inventory turn-over in times per annum³³ is only about 1.78 for the whole sector, 1.69 for tanneries and 1.90 for shoe factories. Unfortunately, this is not only one of the causes for chronic working capital shortage to producers due to large inventory handling by them so as to escape from possible sales loss but also discourages the end users as they know that such a business strategy is among major waste areas in their eyes, and ultimately make the chain price uncompetitive globally.

³² All the benchmark indices or activities mentioned in this paper are findings of other researchers or institutions and are not my own research findings.

³³ Annual inventory turn-over in times= $\frac{\text{total cost of goods sold in a given year}}{\text{average inventory values in the year}}$

Table 2: The annual hides and skins supply possibility using justifiable off-take rates of livestock types projected from the sedentary population surveyed by CSA in 2010/2011, estimated supply gap and leather production level

Type of livestock	Annually produced livestock	annual off-take ³⁴ rates for hides and skins, %	hides and skins to be produced, in unit piece	Supplies of hides and skins to tanneries based on the recovery rates (70% & ³⁵	Tanneries' daily ³⁶ capacity as of 2010/201	Annual full capacity ³⁷ (85% of installed capacity) of tanneries (based on 280 working days)	Excess or shortage per input type to fill the capacity, %	Aggregate gap in capacity, if there is a possibility of shift form skin to hide (with some adjustments of facilities)	Annual possible production of finished leather, in m ²
Cattle	53,382,192	8.45 ⁺	4,510,795	3,157,557	8,400	2,352,000	+25.5	-40%	7,429,027
Sheep	25,509,004	35.30 ⁺	8,999,577	14,436,689	143,370	40,143,600	-64.0		3,386,046
Goat	22,786,946	30.90 ⁺	7,041,166						2,354,848

Source: Own Compilation based on CSA 2010/2011 Livestock survey

³⁴ The general commercial gross definition of off-take rates of livestock (net sales as a function of total herd stock, Sutter 1987) may not be reasonable indicator for potential hides and skins production and supply as animals can be sold for other purposes than for slaughtering. Rather, the justifiable off-take rates for hides and skins production and supply are the percentage of the sum of slaughters and deaths as a function of total herd size, if we ignore the size of smuggled hides and skins across borders. Thus, the plus signs on the off-take rates are to indicate that the gross off-take rates are always larger than the ones discussed here. The ultimate off-take rate in this case should be thought of as slaughter rate if we were to work hard to diminish death rate to zero. The de facto, however, in our case is that the contribution of death to off-take rates for hides and skins supply is very large as indicated in **table 1** and this in turn shows that our husbandry practice is very poor. Even to the leather sector, according to ES-11201:2008, hides/skins from fallen animals (insufficiently bled carcass due to death) which covers 73% of the total are considered as 'reject' in grade.

³⁵ UNIDO/MOTI 2004/2005 Business Plan

³⁶ LIDI 2010/2011 Report, as presented in **annex III**

³⁷ Benchmark indices based on UNIDO/MOTI 2004/2005 Business Plan

Coming back to the issue of hides and skins supply, the tabular presentation above shows that paradoxically there is huge daily over-capacity (64%) of tanneries, comparing to the constrained supply of skins though there is still more than 25% hides supply potential beyond the formal daily capacities. The paradox is that even if the country is endowed with such a huge resource base, due to traditional husbandry practices or poor disease controlling system, sluggish fertility and off-take rates, the benefit is still minimal. If the tanneries work towards facility adjustment, actually with some cost, so that they shall use more hides input instead of skins; the aggregate input gap can be narrowed to 43% which is still huge unsatisfied demand.

As mentioned above, whatever the gap is, the small holder farmers and pastoralists with their traditional husbandry practice, breeding system and commercial views are practically the only initial sources of hides and skins raw input to the country's leather industry. One of the strategies of the government to fill this gap that causes major inefficiency in this sector, as stated in GTP document, is to import raw hides and skins, though not practical yet as the resources are highly demanded or controlled by national trade policies globally³⁸.

Thus, the feasible strategy seems only the inward looking to use the national resource efficiently. As an illustration, if we target strategically that the potential optimum off-take rates of the country to be achieved in the near future are 12, 50 and 50 for cattle, sheep and goat respectively, without affecting the breeds' revival as FAO recommends, the country's leather production from hides and skins can spring from the current estimate of 13,170,000 to 25,270,000m² (92% production increment) as put in **table 3** below; given that the growth rate or fertility of the livestock population is improved not to affect at least the current population size significantly. To stretch there, it is also assumed feasibly that the recovery rate for hides and skins to reach to 80% and 95% respectively. This can totally mitigate the annual gross input constraint or gap which is currently estimated to be about 10.3mln m² from **table 2**.

³⁸ Raw hides and skins export is practically impossible by Kenyans, Tanzanians or Sudanese due to the 40% export tax and even rises to 80% in Uganda; which is only possible to those who know the magic like China. (Sauer Report 2011). China has higher technical capability, facilities and efficient doing-business environment, trade policies and infrastructures that other can't compete.

But to achieve such targets, the stakeholders should work cooperatively and in orchestrated manner so that the current input constraint can be completely tackled and the production efficiency and competitiveness of tanneries will increase.

Table 3: Potential optimum or achievable off-take rates and the country's leather production level in the near future

Type of livestock	Base year population	Potential achievable off-take rate, %	Hides and skins to be produced, in unit piece	Supplies of hides and skins to tanneries based on the recovery rates 80% & 95% resp.	Possible leather production level, in m ²
Cattle	53,382,192	12	6,405,863	5,124,690	16,186,850
sheep	25,509,004	50	12,754,502	12,116,780	5,065,420
Goat	22,786,946	50	11,393,473	10,823,800	4,022,120

Source: Own compilation based on FAO recommendation

Here it is worth mentioning from the table that although Ethiopian breed sheep and goat skins are highly demanded in the world market, the huge potential to expand production resides on hide resource base.

- **Situations in Tanneries:** These are actors in the processing stage which act to the transformation of raw hides and skins into one or more finished internationally traded commodity. Raw commodities, of course, are also traded globally, although not currently practical for Ethiopian's raw hides and skins due to special trade policy as explained later on. As of 2010/2011 there are about 28 privately owned tanneries in Ethiopia; out of which, 5 of them are foreign owned ones. In the same year, fully operating tanneries are not more than 22. The total daily soaking capacity of these tanneries reaches 143, 370 and 8,400 pieces of skins and hides respectively. As shown in **table 2**, with the current situation, there is about 43%³⁹ aggregate input gap for tanneries assuming the annual working days to be 280 and the full working capacity to be 85% for all. This means, if tanneries work in full capacity continuously, *citrus paribus*, they can work only 159 days per annum with this constrained input while they are idle in the rest of the year.

As mentioned elsewhere, the inputs of imported chemicals are one of the major issues that need serious attention in improving the competitiveness of the tanneries. The

³⁹ Hide split production is also considered in the overall estimation

outputs of these tanneries are available to export markets, as indicated by arrow 3 in **figure 3**, or to the local footwear, garment and leather goods manufacturers.

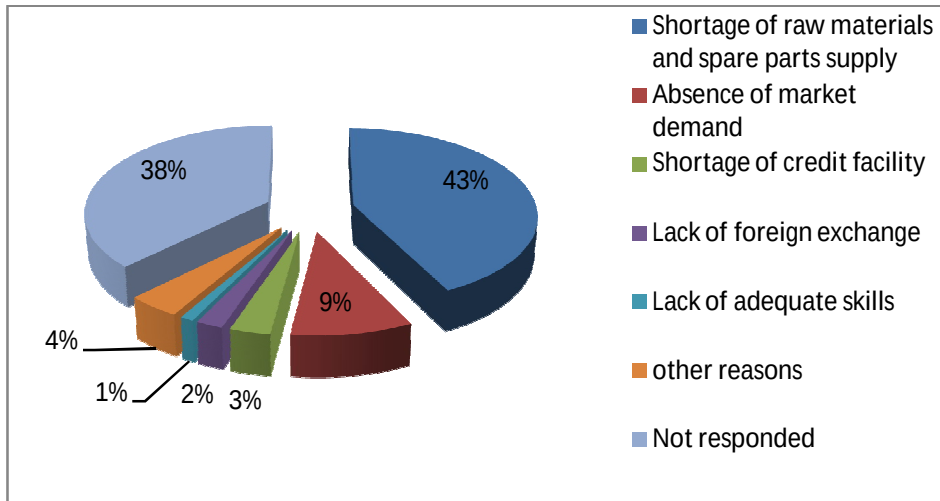
- **Situations in Leather Shoes Manufacturers:** Partly the footwear and generally leather garment and goods manufacturing activities in the country are highly informal and artisan, small in economies of scale and scattered and difficult to address by this type of research. But in the same fiscal year, the daily capacity of formally established eleven leather footwear firms reaches about 14,250 pairs of shoes, excluding companies under expansion and construction that will be fully operational soon. However, as depicted in **table 5**, it is frustrating to say that even the existing footwear manufacturers are working far below full capacity mainly due to lack of major input (finished leather) supply, among other constraints, alike tanneries.

As supplement, the seriousness of the raw material supply shortage can be indicated from CSA's⁴⁰ 2010 survey on the sector. From these data analysis (**chart 1** below), about 43% of respondents from large and medium enterprises point out that shortage of raw materials (hides and skins or finished leather and components and accessories) is the first major reason for not working at full capacities followed by distant second 9% respondents to complain on the absence of market demand. Unexpectedly, producers put technical skill as the least affecting reason for not working at full capacities.

Actually, as seen in **annex IIB**, for small scale enterprises in this sector, the first major reason for not working at full capacity is lack of market demand followed by absence of working premises. This is a warning sign that expecting the small scale enterprises to export is a nightmare; unless these enterprises are made clustered so as to improve their efficiency and use this national resource properly. Please see from **table 5** that how export performance is related to firms' economies of scale.

⁴⁰ See data extract from **annex IIA** of CSA Statistical Bulletin 2011

Chart 1: Opinion distribution of 96 large and medium enterprises in the sector by 1st major reason (i.e. No1 problem) for not working at full capacity



In own micro survey (see table 4), in a benchmark plan of 280 working days per year, sample tanneries could achieve practically only 58.6% of the plan which is almost close to the previous aggregate estimate (57%) based on raw input constraint and of shoe factories only 54%. In other words, according to this aggregate planned capacity, these sample tanneries could have produced their actual production achieved (44,007,000 ft²) within only 184 working days with the existing facilities and labor if the raw inputs were available as required; and similarly shoe factories could have produced their actual production (1,508,725 pairs) within only 151 working days . If we think of it in terms of sales loss in real terms, it reached 625,800,000ETB, which is 72% of the gross annual sales achieved by sample tanneries; and for shoe factories it reached 204,400,000ETB, which is 85% of the gross annual sales achieved due to input constraint, citrus paribus.

If you are not bored to see, still huge additional sales losses will be presented due to input quality problems among others.

- **Products Marketing:** Tanneries' major markets are mainly segmented based on the raw inputs they have processed. Their major markets for processed skins are Europe as they are highly demanded due to breed types while it is mainly the local market for products processed from hide input as presented in table 4. That is, in terms of upper and lining finished leather consumption by sample shoe factories, they used about 78% from hide and only 22% from skin sources; while the total production of skins in

ft² was a little bit higher than that of from hides. The annual tanneries' and shoe factories' share of exports to their respective gross sales are 59% and 33% while their export performance to their annual plan is 82% and 18% respectively. Miserably, the 2011/2012 six months export performance to their plan drops to 76% and 16.5% respectively. Thus the current trend (compare the 2010/2011 and 2011/2012 export performances) shows that footwear manufacturers are enjoying the lucrative, relatively less competitive, practically import substituting and logistically less complex local markets to their products mainly produced from relatively low quality hide leather and are struggling for export market. Back to **table 4**, in real terms, the average retailing price of representative products, offered by consumers, in the local market reaches 325ETB while it is about 12USD or 212ETB for export markets or whole sellers. Moreover, it is logical to be convinced that the maximum 35% import duty rate levied on both leather and non-leather footwear products makes the local footwear producers protected from import competition.

Anyhow, the local tanneries' and shoe factories' major cost drivers and their shares are as summarized below.

Table 4: Major costs to sample tanneries and footwear manufacturers*Quantity in 000' or cost in 000'ETB*

Major cost drivers		Quantity consumed /produced/used		unit	Annual cost	aggregate cost/ price	Av. cost or price rate
Tanneries							
Raw	Hides and skins	hide	19,851	ft ²	66,249.8	401,747.9	Birr/ ft ² =9.13
		sheep	19,042		290,667		
		goat	5,114		44,831.1		
	chemicals	local	-	kg	19,056.8	249,256.2	Birr/ ft ² =5.66
		import	-		230,199.4		
Labor		-		Hr	26,489.7	26,489.7	Birr/ft ² =0.6
capital		-		Hr	18,748.2	18,748.2	Birr/ft ² =0.4
Overheads		Administrative, rent, lease, tax etc.		Hr	142,469.3	142,469.3	Birr/ft ² =3.23
		Utility and supplies costs		-	5,473.9	5,473.9	Birr/ft ² =0.12
Logistics cost		Related to inbound	-	-	68,511.6	122,045.1	Birr/ft ² =2.77
		Related to outbound	-		53,533.5		
Total costs						966,230.4	Birr/ft ² =21.9
Gross sales value		44,007		ft ²		867,645.1	Ave. price /ft ² =19.72
Shoe Factories							
Upper and lining leather (78% from hide and 22% from skin source)		6,285.5 (used to produce 1,508,725 paired shoes)		ft ²	75,487.3	75,487.3	Birr/ft ² =12.01 (for locally)
Soles, accessories and finishing chemicals		local	-	pair	19,037.3	108,888.9	Birr/ paired shoe=72.17
		imported	-		89,851.6		
Labor		-		hour	22,853.6	22,853.6	15.14/pair
capital		-		hour	8,519.9	8,519.9	5.65/pair
Overheads		Administrative, rent, lease, tax etc.		hour	22,228.9	22,228.9	14.73/pair
		Utility and supplies costs			640.3	640.3	0.42/pair
Logistics cost		Related to inbound	-	-	567.5	2675.7	1.77/pair
		Related to outbound	-		2,108.2		
Total cost					241,294.7		Birr/paired shoe= 159.9
Gross sales		1,508,725 paired shoes (Consuming 4.17 ft ² leather/ paired shoe)		pair	238,823		price/paired shoe=158.29 Birr
Customers willing to pay for average representative shoes		local		pair	325Birr in local retailing		
		foreign			212Birr for whole sellers or export market		

Source: Own Survey from sample tanneries and shoe factories (2010/2011 fiscal year)

Some cost drivers like raw materials, intermediates and accessories, labor and capital costs are self explanatory. But overhead and logistics costs are somewhat aggregated and complex. The former mainly include administrative, maintenance, rent, utility and supplies and professionals' salaries. The later may include transportation logistics (inbound and outbound) and cost of doing business or transaction costs. Transportation logistics in turn may involve distance related costs such as transportation cost of inputs and products and poor infrastructure related inland transport logistics costs; while transaction cost may embrace complex and time consuming customs procedures, costs related to rules of origin associated with preferential trade agreements or custom tariff, costs associated with the business environment: governance (cost of technical support and quality control), transparency, corruption if any, etc. order processing, storing and inventory handling costs etc., cost of searching market information, cost of negotiating contracts and monitoring and enforcing etc.

All these trade related costs reduce the global competitiveness of the sector and so does less conducive business environment. No doubt, inefficiency and incompetetiveness in Ethiopia could be partly worsened to landlockedness and weak infrastructure.

Here it is worth mentioning that usually the inbound logistics cost can fall to the total inputs cost; and outbound logistics cost can be considered as part of the products distribution and marketing cost or generally as part of overhead cost. But here they are treated separately for the sake of analyzing their influences individually.

The cost pressure on the sector from each cost driver in general and logistics costs in particular shall be presented in **chart 3** and **4**. As indicated there, particularly for tanneries, logistics costs which constitute about 13% of the total cost is really huge pressure on them. The cost elements of logistics cost related to distance is actually mandatory to micro level actors and unthinkable to reduce significantly as we will in shorter time. But cost elements related to transaction would be reduced as significantly as other competent countries achieve through administrative streamlining and granting of various incentive schemes. For this to happen, macro and meso level actors have to be committed and work in coordinated manner to make the value chain competitive. True, as

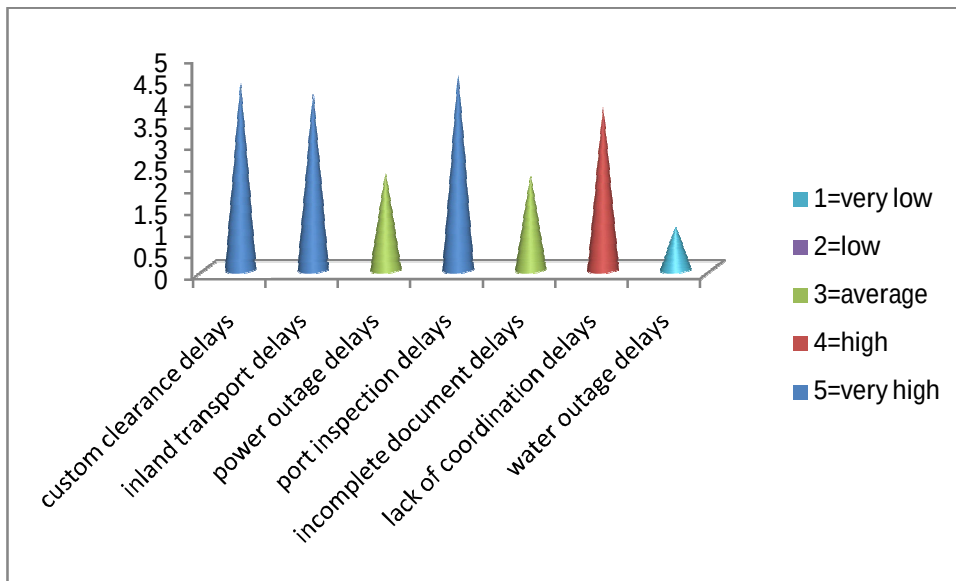
addressed later, there are various incentive schemes offered. But as numbers⁴¹ tell us-156 days of raw material stock holding period; only 1.78 times per annum of inventory turnover; up to 4 months lead time (from order processing to delivery to factory) while China, India and other competitors can achieve it in less than two weeks time; a month long custom clearance process while China does it in a day and Vietnam in 4 days; a must to get approval of 8 signatures (document processing⁴²) from scattered and poorly networked offices for importing of inputs and of 6 documents approval for exporting while competitors are required to process only 3 or 4 documents in well networked system from one-stop-shop-all these are sources of such high transaction costs and incompetencies for local producers and their customers called these activities waste or non value adding as addressed later.

Moreover, in terms of delays or timeline fulfillment failure or waste, the existing performance of the public and some private institutions has been evaluated by producers' level of satisfaction as given in the next chart. This particular finding indicates the competence level of service delivered to producers by these institutions in the country which has actually significant implication for producers' competitiveness.

⁴¹ Some numbers are supplemented with ECBP's findings titled: *Shoe order for Kangaroo, Ras Dashen and Jamaica Shoe Factories (2011)*

⁴² Include processing of bank permit, custom declaration, packing list, chamberized commercial invoice, insurance document, technical inspection report, bill of lading or cargo release order and terminal handling.

Chart 2: Average service competency of public institutions in the eyes of producers



Clearly, producers are highly compliant of port inspection, custom clearance and inland transport delays. Lack of coordination and networking between service providers is another problem area followed by occasional power outage. Still incomplete document presentation by customers, in this case by producers, which is the reflection of lack of clarity of procedures or lack of prior notification is among causes of delays not to be served timely.

On the contrary, end-users expect more from producers and other actors, even in terms of specifying the types of activities that give more value, as addressed up next.

Table 5: Gross sales, export, and production performances of sample tanneries and shoe factories

Company	Fiscal year	Gross sales (Birr)	Export plan (Birr)	Export performance (Birr)	Share of export to		Existing production capacity ⁴³	Production performance (in ft ² or pair)
					Gross sales	plan		
Tannery A ⁴⁴	2010/2011	429,533,871	348,000,000	288,809,981.87	0.67	0.83	26, 656,000ft ²	23,000,000
	2011/2012 ⁴⁵	-	181,871,360 ⁴⁶	163,881,344		0.90		
Tannery B	2010/2011	256,926,977	231,556,903.20	168,568,544.41	0.63	0.73	23,436,000ft ²	8,318,000
	2011/2012	-	121,936,320	86,774,160		0.71		
Tannery C	2010/2011	135,000,000	43,708,730.40	56,464,896.25	0.41	1.29	10,360,000ft ²	8,724,000
	2011/2012	-	26,401,760	13,006,928		0.49		
Tannery D	2010/2011	46,184,289	45,652,797.60	11,617,827.75	0.25	0.25	7,308,000ft ²	3,965,000
	2011/2012	-	26,400,000	10,829,104		0.41		
Sub total	-	867,645,848	623,265,633.60	513,843,422.53	0.59	0.82	75,068,000ft ²	44,007,000ft ²
Shoe Factory F	2010/2011	79,661,135	123,739,212.60	37,410,642.58	0.46	0.30	840,000 pair	459,440
	2011/2012	-	48,063,840	11,921,184		0.24		
Shoe Factory G	2010/2011	84,849,374	102,729,600	22,564,128.43	0.26	0.22	700,000 pair	651,380
	2011/2012	-	42,592,000	6,513,056		0.15		
Shoe Factory H	2010/2011	46,000,000	116,565,940.80	11,584,329.27	0.25	0.10	700,000 pair	280,000
	2011/2012	-	39,160,000	7,988,112		0.20		
Shoe Factory I	2010/2011	18,312,480	102,729,600	9,265,700.27	0.51	0.09	560,000 pair	117,905
	2011/2012	-	37,417,600	1,255,936		0.03		
Sub total	-	238,822,989	454,764,353.40	80,824,800.55	0.33	0.18	2,800,000 pair	1,508,725

Source: Own Survey from sample tanneries and shoe factories (2010/2011 fiscal year)

⁴³ Benchmark plan to be 280 working day per annum

⁴⁴ Here I have used letters (pseudonyms) instead of true names of factories to anonymise the firms' financial data incorporated in the study

⁴⁵ The 2011/2012 data cover only six months' export performance

⁴⁶ Numbers are stroked to show that they should not be added vertically

- **End Users and their Expectations:** Generally, end users (customers or consumers) in this sector use the competitive market opportunity available locally and globally. According to these end users verbatim in discussion (target participants of 2012 AALF, March1-3), the main attributes they put, as demand setters, on average, are the activities that add values on the final product type they buy or consume. Producers from developing countries not only face competitive and volatile market price globally but also to be price takers to access the developed markets. In this case, as end-users warn, production cost control and productivity is the major issues that make producers and the whole chain competitive and efficient.

Considering tanneries as a central/entry point, it is customary to see from the producers side that they focus on upstream supply chains on how to integrate suppliers with own processes; improving efficiency, reducing waste and ultimately meeting end users value, besides clear trends to forward linkages by some tanneries; while value chains by definition focus explicitly downstream, on understanding what the end user's demand and value is and then delivering it as efficiently, effectively and quickly as possible. The former upstream business view is clearly observed while every tanner worries about the shortage⁴⁷ and its consequential expensiveness of local raw hides and skins rather than how to add value on his final product. Thus, the distinction often gets lost in translation as businesses become too focused on value as defined by their own organization and fail to recognize the importance of delivering value as defined by the final consumers of their products or services that generate premium value or price. It is the final consumer or value chain actor who ultimately determines where the value lies in a product.

⁴⁷ Actually these threats in these subjects are logical as shortage intuitively induces not only price rises but also causes market (power) control by raw material suppliers. From **Lerner's market power index**:

$LI = \frac{\text{Price} - \text{marginal cost}}{\text{price}} = \frac{-1}{E} \approx \frac{\text{price} - \text{total variable cost}}{\text{price}}$, where E represents price elasticity of demand; as demand ever increases due to large capacity, supply is not supposed to increase in parallel, as it is only dependent on slaughter rate or meat demand. That is, hides and skins are price inelastic commodities. That means, while the value of E approaches zero, LI goes to infinity, a potential indication to the existence of market or actor power that results ultimately in market failure or the absence of **fairer competition**. Market failure occurs when freely-functioning markets fail to deliver an efficient allocation of resources. The result is a loss of technical and economic efficiency as well as loss of social welfare. Market failures provide a rationale for government intervention, from simple competition law such as auction market facilitation up to price control.

But the current situation may not lead, at least to price control stage, as the local price is relatively lower than the world price. (See table 7 & 8).

Clearly, these modern end users, at each stage in the value chain, ask to confirm:

- How many of the production and processing activities truly add value? (End users demand higher efficiency improving investment to be made in these activities.)
- How many are necessary but do not add value? (What end users expect, if these activities have to persist is, to be accomplished with minimal resource allocation.)
- How many are unnecessary? (Which are wasteful or costly activities that must be eliminated and resources re-allocated to drive value creation and efficiency)

Accordingly, each activity in this value chain is found to be classified as one of the following, in the eyes of end users:

Value adding - those activities that, in the eyes of the final customer/consumer, help to capture their requirements and make a product more valuable. In the context of leather manufacturing process, type of tanning and dressing, type of finishing, design of the final product etc. are usually rated by the end users, on average, as 'quite important', so these could be classified as value-adding activities that necessitate further investment or upgrading. Meeting, if not exceeding end user's expectations is the goal here.

Necessary, but non value-adding – these are activities that, in the eyes of the final customer/consumer, do not make a product more valuable or preferable but are necessary unless the existing supply system and process is radically changed. For example, in the context of this value chain, raw input preservation, laboratory analysis and R&D works are rated by consumers, on average, as 'not very important', so could be classified as non-value adding attributes which do not demand the allocation of more resources than absolutely necessary. Here end users' desires are cost minimization, 'doing things right the first time' or pushing or outsourcing of these activities to chain supporters. Pushing here refers to that such activities should be overtaken by public support institutions in the form of technical subsidies or incentives so as to make the enterprises cost and price competitive worldwide as the newly emerging economies do.

Wasteful or costly- these are activities that, in the eyes of the end-users, they do not make a product more valuable, but making it expensive and hence unnecessary. These activities should be targeted for elimination in the near future. For example, in the majority of value chains, inventory would not be regarded by consumers as value-adding, yet inventory is invariably held, often at considerable cost/waste, at all levels of the

chain, due to remoteness to input sources, lack of coordination, low levels of inter-organizational trust and poor information flows. Moreover, any back log, e.g. due to inefficient trade regulation, to product flow is the major waste to these customers/consumers. Thus, elimination of these wastes and related transaction costs is priority number one interest of end users in the value chain subjected to price competition.

Having these classifications of activities by customers/consumers in mind, the current state of product flow of the value chain is presented as mapped in **Figure 3**.

4.1.2 Product Flow and Qualitative Efficiency Analysis in the Eyes of End-users

The objective of product flow mapping is to point out activities that can improve efficiency and effectiveness of the producer and maximize end users' value, in terms of:

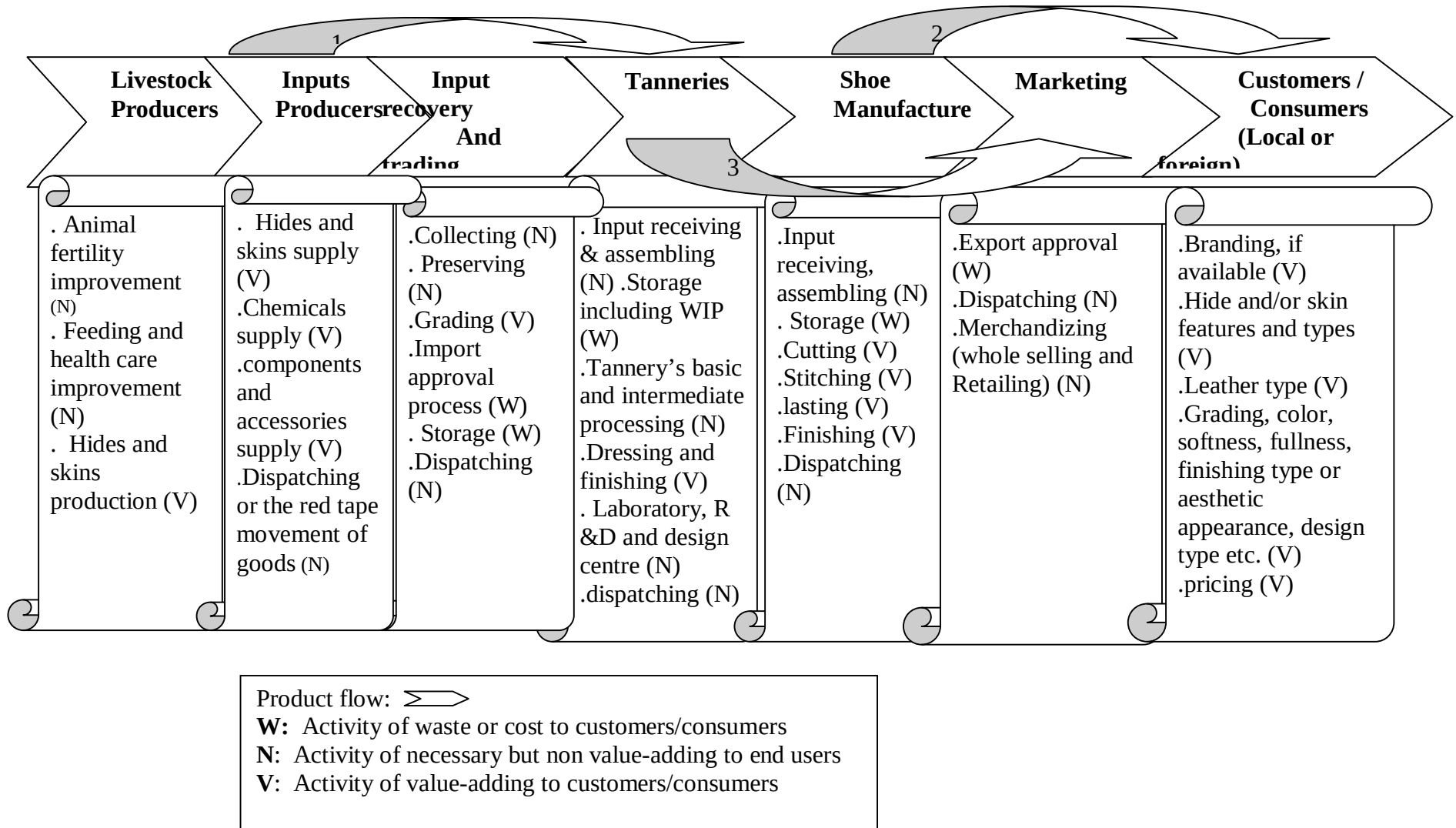
- Timeliness in allowing continuous, efficient flow through processing, while avoiding unnecessary inventory and product movements, and ultimately avoiding stock out or costs due to inventory scarcity in stores;
- Minimizing waste/cost caused by unnecessary business activities and using degraded or unusable raw material or over-engineered raw or intermediate inputs and ultimately erodes competitiveness, in the eyes of end users;
- Upgrading /leveraging for adding value or value creation.

The next diagram shows qualitatively that the efficiency of product flow is highly influenced by necessary but non-value adding or to the worst by costly activities, which implies a focus to efficiency improvement by meso or macro level practices respectively. These activities are labeled in detail at the value chain processes to identify possible leverage points (places to intervene in the system) for increasing efficiency and/or adding value, as per the classification of product attributes or activities by end users. This implies that value adding activities has to be primarily implemented by micro level actors, while non value adding and wasteful activities by meso level actors and macro level conditions respectively. Thus in the process of product flow, what makes customers/consumers satisfied and what makes the value chain competitive most is when the activities of chain operators would comprise at best only value adding activities or at least if the wasteful activities are to be eliminated.

Evidently, this classification of activities based on end users' expectations into the do's and not to do's is one indicator of their governance role; though there is no clear enforcing or commanding mechanism as part of transaction cost. End users expectations shall also be addressed in detail in terms of CSF's.

Needless to say that coordination between those three levels of actors is mandatory to develop such an upgraded value chain to meet the end users' wants and expectations.

Figure 3: Product flow and classification of activities in the eyes of end-users in the Leather Industry Value Chain



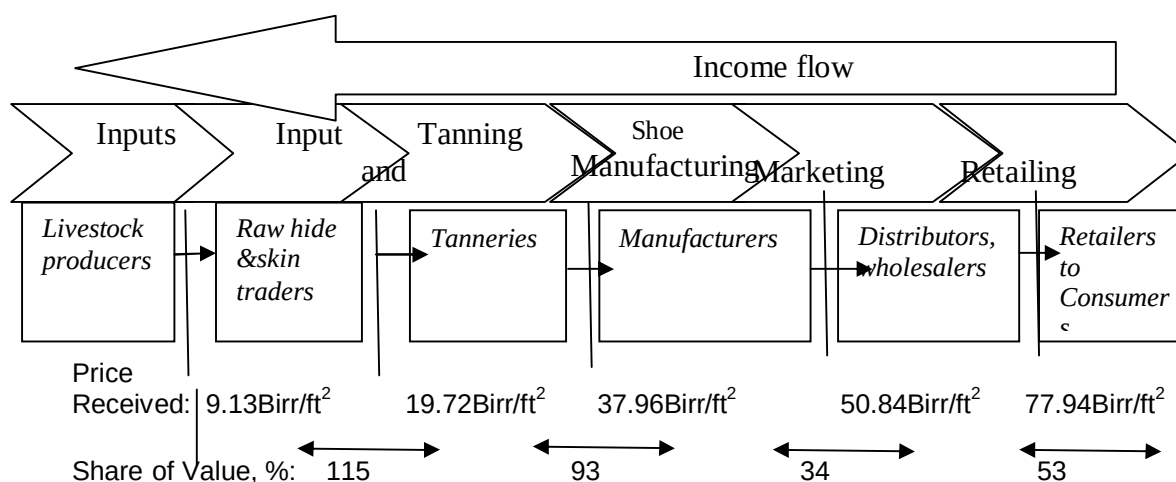
4.1.3 Income Flow and Value Added along the Fundamental Actors

Income flow or value-added analysis is one of the fundamental indicators used to measure the performance of value chain actors while materials pass along a specific stage. It is known that value added (**in this case at gate price**): is the difference between gross sales of all products and intermediate costs which include the cost of raw materials (hides and skins, finished leather, chemicals, accessories and components at the respective stages etc.) and other supplies and utilities service consumed, cost of industrial services rendered by others, cost of goods bought and resold without any transformation. Value Added at gate price minus net indirect taxes (i.e., indirect taxes less subsidies) gives **value added at factor cost**.

Thus, Value added represents the contribution of, and payments to, the primary factors of production.

On the other hand, the potential to add value to a product lies in a firm's ability to keep raw and intermediate input costs as low as possible and to increase the price of its finished product in the market. Given that the sector faces competitive market globally and most firms are price takers, value added in this sector therefore is dependent only on factors (labor and capital) of productivity or technical efficiency at firm level that enables higher levels of output so as to enhance competitiveness; and on costs of production or economic efficiency which are affected by policies, institutions, and the industry structure that governs the supply, quality and cost of primary and intermediate inputs. These could include tariffs on imported inputs, poor logistics that cause delays to import inputs or the poor enforcement of standards or governance that affect the cost and quality of inputs; poor utility services such as power, water etc. Having these conditions, the value-add of the chain by each core actor shall be presented up next.

Figure 4: Income flow (ETB) among core actors per ft²



In determining income distribution to each stage of the chain, as there are no significant value-adding activities at the stage of transaction of hides and skins between producers, traders and operational service providers; gross value of hides and skins at the traders' gate is sufficient to start and reflect the income flow. (See **figure 4** above).

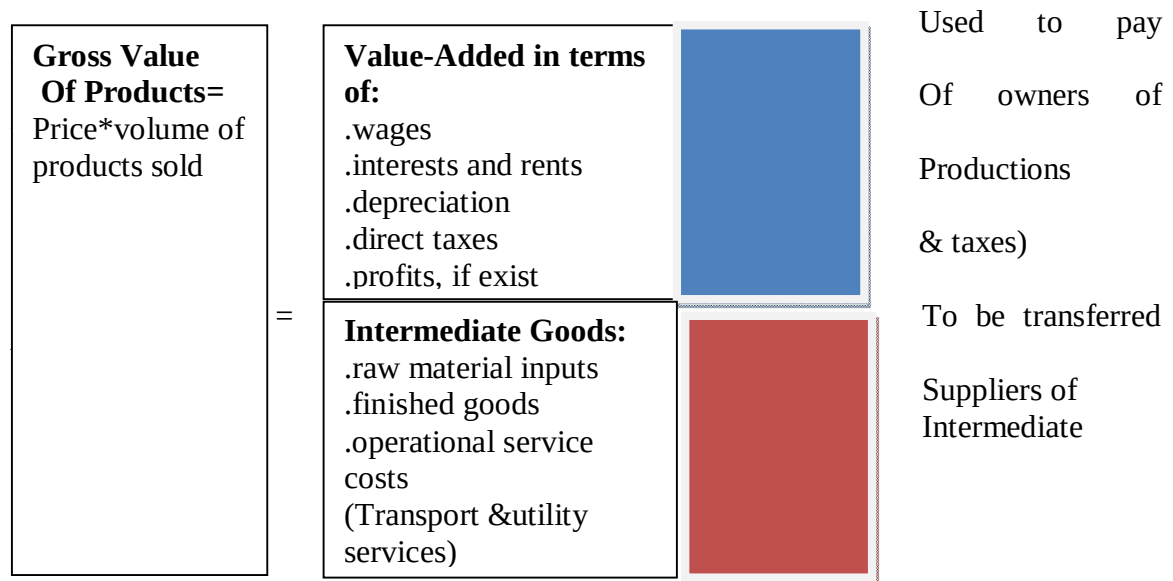
As it is known, income flow or share of value (also called income distribution) analysis answers the question of what percentage of the final price of a product given by the final consumers goes to raw input traders, to processors of the raw materials, manufacturers, distributors, marketing or whole-sellers/ to brands/ and any other activity in the value chain; computed based on **table 4**, considering only the cost of raw or intermediate input to be processed or manufactured. Thus, data is collected and computed on per unit prices (from gross output values or revenues) at the different stages in the chain. From this analysis, it seems that the maximum distribution (115%) is secured by tanneries followed by shoe manufacturers (93%), retailers (53%) and whole-sellers (34%) respectively. If we consider the whole-sellers and retailers as a single stage actors, as shown in the benchmark or world average⁴⁸, the distribution reaches 105% which is still less than the distribution by tanners. For the unusual maximum income flow to tanners, even with

⁴⁸ As a benchmark, the actors' income distribution at the world level, from the input of 10.5 mln tons of hides and skins at the same year, is 118, 185 and 150% to tanners, leather products manufacturers and retailers respectively from the sales value of 19.2, 41.9, 120 and 300 bln USD of raw hides and skins, finished leathers, manufactured products and retailers respectively. (B. Ramalingam, 2011). This shows also that in the world market, 1kg salted raw hide costs about 1.540USD while it is only 0.30USD in Ethiopia; and 1ft² salted sheep skin costs 1.48USD in the world market while it is about 0.90USD at home on aggregated average, as computed from **table 7 & 8**.

their lower relative sales value, though it is still lower than the world average, I strongly claim that it is due to lower raw input cost. (See table 7). In other words, the income flow to shoe factories is very minimal.

But in the case of value added computation at factor costs, total input and other supplies, utility and transportation⁴⁹ costs must be subtracted from the gross sales prices.

Figure 5: Components of value-added and intermediate goods



As presented in **figure 5**, the red color is the deducting components while the blue color represents the components or resultant of value added. Such value added information can help judge about which activities in the chain are more rewarding and which are not.

Thus, from **table 4 and figure 5**, the summary below is developed to illustrate the distribution of value added at factor cost⁵⁰ across all value chain actors, from hide and skin collecting/ trading up to the stage of delivering for consumers.

⁴⁹ Sometimes, transportation or logistics costs are controversial in including to value-added computation. But, the contract of sale will specify the point of ownership transfer through the specified INCOTERMS and this will in turn define who bears the costs of transport and logistics. Here it is assumed that tanneries and shoe factories should absolve inbound logistics costs while outbound logistics cost to be absorbed by buyers (whole sellers & retailers).

⁵⁰ As indirect taxes (VAT) is refunded for this value chain, it is omitted in this particular value-added computation.

Table 6: Gross sales values and value added by different actors in the chain *in 000'Birr*

Value chain actor	Gross sales value =P*Q	Sum of the cost of intermediate goods	Value added per ft ²	Gross value added	Remark (value added per pair)
Tanneries	867,645.1	724,988.8	3.24	142,656.3	-
Shoe Factories	238,823	185,584	8.45	53,239	35.26 ⁵¹
Whole-Sellers	319,849.7	240,931.2	12.54	78,918.5	52.29
Retailers	490,335.6	319,847.7	27.10	170,487.9	113

Source: Own compilation

But to reach here, several reasonable assumptions are made. For instance, whole-sellers are not only assumed to cover outbound logistics costs in the business contract but also they should buy all sample shoe factories' products by the average price they were willing to offer if their minimum requirements are fulfilled. The later assumption can also work for retailers. That means, value added for whole sellers and retailers are partly virtual. But as an illustration, value added increases in real terms from shoe factories to retailers in producing and distributing the same quantity of products. That is, retailers are positioned themselves in the part of the value chain that rewards them better. Evidently, though profit constitutes only part of the value added, relatively its share at the apex of the value chain (to whole sellers and retailers) is higher as the claims of labor and capital at this stage is minimal.

Coming back to the real figures of tanneries and shoe factories, even after those biased assumptions and incentives given, the value added by them is very scanty in both stages. Evidently, this can be attributed to poor quality and smaller quantity of input supply per annum, smaller productivity and higher intermediate cost related to higher transaction cost; and especially to tanneries is due to their higher material intensive nature and low functional and product upgrading status.

In the aggregate cost-profit analysis of sample tanneries and shoe factories, though the value addition by them is clearly seen irrespective of the magnitudes, slight business loss is observed if it were not due to oversight of important revenues such as sales from

⁵¹ But even the Egyptian shoe manufacturing sector value added is estimated to \$5.85 or 77.81 ETB per pair, (STEM-VCR s.r.l. 2005)

valuable by-products, long term receivables, VAT refund or double count of cost drivers or inventory item balance.

Still turning to the subject, there are two major reasons to be ascribed for this minimal value added at each stage. First, irrespective of their technical efficiency, factors of production faces poor productivity due to shortage of raw materials supply⁵², as discussed in detail in the preceding section. Actually, it is difficult to evaluate explicitly the annual productivity or the technical efficiency of factors of production in this constrained working environment. However, to judge partly that if the local firms are economically efficient⁵³ or not, the value of each cost driver indicated in **chart 3** can be compared with the benchmark index. Second, producers at various stages receive very low product price or value due to input quality problems and insufficient functional and product upgrading, particularly by tanneries, which are to be seen soon after.

From **table 4**, ratio of cost of labor to cost of capital for tanneries is about 1.14 while it reaches about 2.68 for shoe factories. This clearly shoes that relatively shoe factories are more labor intensives than tanneries. That means a good deal of the value added goes to the claim of labor wage. On the other hand, tanneries are more capital intensive than shoe factories. For the case of tanneries, still the ratio of cost of labor to cost of capital is higher than expected as the sample tanneries are established before several decades and their book values are diminished. This makes the capital cost minimum. Moreover, sample tanneries are relatively less capital intensive as they utilize cheap labor for several activities (substitution of factors of production) such as hair unraveling, inputs and products carriages, loading/unloading etc. that are usually accomplished by automation in Europe or Asia.

⁵² *Resource endowment or supply as comparative advantage has been considered as the fundamental determinant of productivity (even at the age of Adam Smith to gain from trade) by inducing more labor and capital.*

⁵³ *However, complete economic efficiency arises when inputs are utilized in a manner such that a given scale of output is produced at the lowest possible cost.*

Chart 3: Cost structure⁵⁴ of sample tanneries (on aggregate) to total costs

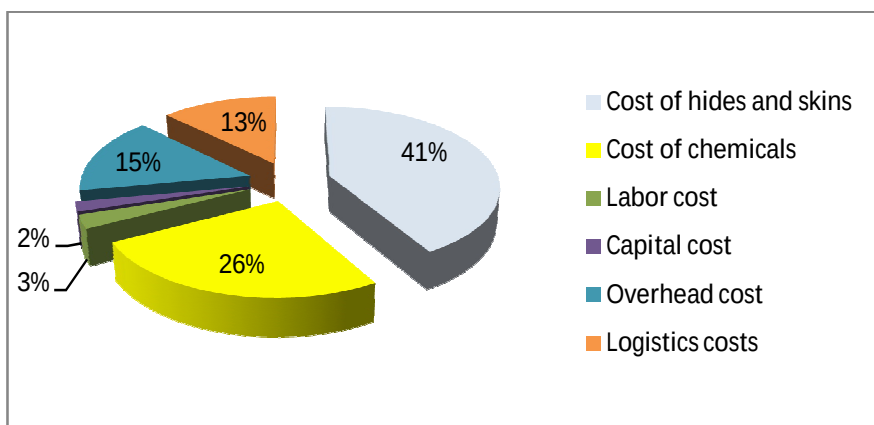
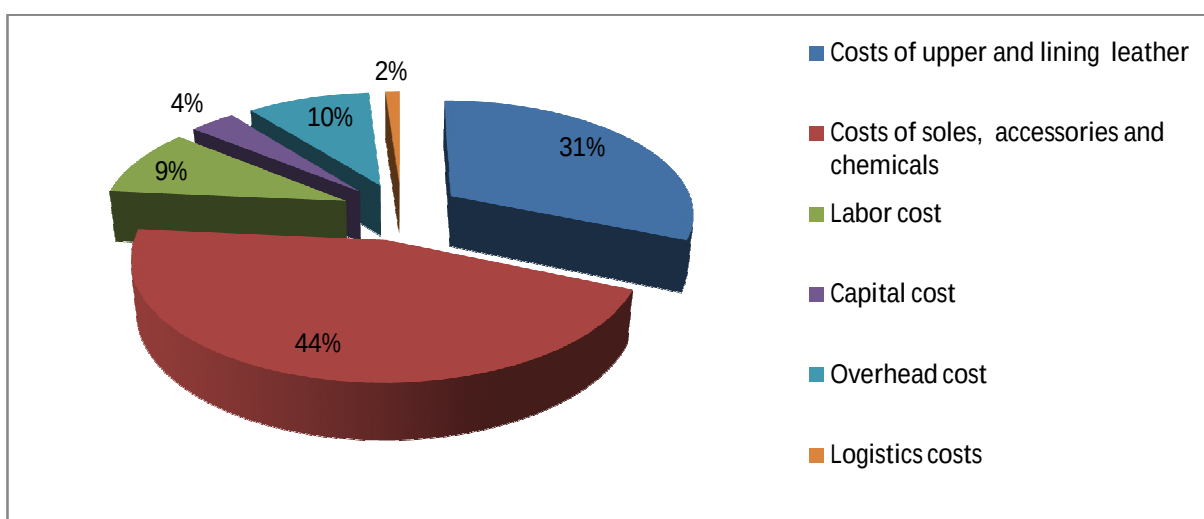


Chart 4: Cost structure of sample shoe factories (on aggregate) to total costs



As discussed elsewhere, the aggregate sales value of sample tanneries (867,645,100ETB) is secured from the sale of 44,007,000ft² of semi-finished and finished leather⁵⁵ to local and export markets with average price of 19.72ETB per square foot. But this average price rate was obtained from the then frustrating grade distribution of input and partly semi-processed leather although the market price rate to each grade distribution was as presented in **table 7** below. As an illustration, (see the table of **column 7**), even in the

⁵⁴ Leather tanning is a capital and material inputs (raw hides, chemicals) but not labour intensive industry with the benchmark production cost structure of 50-70% raw hides, chemicals about 10%, labour 7-15%...and others...Buljan J. (2007)

⁵⁵ The total product (44,007,000ft²) comprised of 45% hide, 43% sheep & 12% goat skins, calculated in ft².

existing grade distribution, if tanneries were able to compete to the global market price at least to the minimum range, mainly by functional upgrading from semi-to finished leather, what end-users call it value adding activity, they could gain about 22% more of the actual sales value. In this case the average price per square foot could reach 24.11ETB. Besides this functional upgrading activity, if all actors, in this case mainly macro and meso level ones, work coordinately towards improving the grade distribution at minimum to 40/30/20/10% for grade I-III, IV, V and VI respectively for all input types, sales value would increase from the actual one by about 58%, with the average price of 31.18ETB/ft². This is one of the leverage points where small works such as awareness creation to livestock producers, training, vaccination and skin disease control can result in huge changes in sales value.

In nutshell, one of the major reasons why leather products can't fetch better price is input quality problem and less functional upgrading. Still, in comparison to the seriousness of quality deterioration, the products from skins can exist in the world market. In other words, there are only few claims of customers relative to high quality deteriorations. The reason is no doubt that it is due to their intrinsic values of skins or breed types as discussed in chapter I. The major competitors, in terms of intrinsic value, to the Ethiopian breed internationally are Iran and Nigeria.

A single good news for tanners, regardless of their complain, hides and skins purchase price, compared to benchmarked world price, is not as such serious competitiveness eroding factor to them, at least during that fiscal year. (Compare tables 7 and 8 below). No doubt, the minimum labor cost in one hand and the more intensive use of it on the other hand can create the competitive edges to the sector; as it is enjoying now.

Concerning sample shoe factories, as presented in **table 4**, the aggregate sales value of (238,823,000ETB) is secured from the sale of 1,508,700 pair of shoes to local and export markets with average price of 158.30ETB. But these factories have no any market link with globally known branded retailers. Anyway, in producing such quantities of paired shoes, factories consumed about 6,285,500ft², which means 4.17 ft² of finished upper and lining leather that cost them, on average 12.01 Birr/ft², too. Imagine, tanneries' average sales price of 1ft² of finished leather being 19.72ETB, unless there should be something, local shoe factories can't get it for 12.01ETB. One can automatically infer that they used

very lower grade leather input from the lower cost they incurred per foot square; the lower average price rate they received from paired shoes and the larger amount of leather they consumed^{56, 57} per paired shoes. Technically, higher consumption of finished leather per paired shoe means that the cutting value of the leather is small and, in turn, the reject rate is higher. Here, the consumption of low quality leather which results in low purchase price distorts the cost structure⁵⁸ of sample shoe factories as indicated in **chart 4**. Still one can deduce that the subsector enjoys lower cost of labor, the intensively used factor of production; while the cost of components and accessories is higher pressure for manufacturers.

But to analyze the quality problem on average, as has been done for tanneries competitiveness problems, let me start from the benchmark index, the maximum possible of 3.65ft² leather consumption per paired shoes. If that were the fact, sample factories could produce 213, 350 more paired shoes that had the sales value of 33,773,300ETB at their actual price rate; which is 14% of the actual annual gross sales. Still the big sales losses were faced due quality incompetency so that manufacturers couldn't achieve the quality parameters but could have been given relatively premium prices for their major products. In this case, the average premium price bid per paired shoes in the local market was 325ETB and of 212ETB from outside markets. If shoe factories were to receive consistently either the local price may be due to short term profit interest or prefer the export price/market due to long term interest or demand to hard currency, the sales value would reach 559,666,250ETB or 365,074,600ETB respectively. This shows that if the current quality problem were resolved at least partially, even with the existing constrained input supply, the sales value can increase by 134% or 53%, according to the manufacturers' market preference, from the current actual sales value. Clearly, the local market is more lucrative, at least for short term, than the export market mainly due to that the local market is not only less competitive but also manufacturers promote their

⁵⁶ As a benchmark, UNIDO/MOTI (2004/2005) claims that the maximum finished leather to be consumed for upper is 2.50 ft² and of 1.15 ft² for lining, which is together 3.65ft².

⁵⁷ Here it is also logical to assume that firms are relatively technically efficient or comparable to produce the same level of output from the same unit of inputs as a benchmark firm does.

⁵⁸ As a benchmark, the cost structure of Chinese footwear manufacturers are 10%, 63%, 20% and 7% of labor, aggregate material inputs, aggregate operational expenses and profit respectively, (Accenture 2011)

products to local consumers and access them directly through their retailing shops⁵⁹; higher logistics costs to the export market; and the intervention of middle men (whole sellers) between manufacturers and consumers in the later market with high bargaining power (due to their possible costs they may incur, quality know-how, market competitiveness and interest of rewarding profit margins) for price reduction.

All these issues actually need the value adding practices such as leveraging of quality problems, minimizing of trade costs (minimizing or avoiding the role of middle men) and functional and product upgrading. Actually, the main actors to resolve these problems are macro- and meso-level ones. Here it is worth mentioning that as the share of logistics/transaction cost is so minimal for shoe factories, the idea of intervening is less convincing. But one has to remember that currently these factories are largely using the local market which is temporary due to sector protection and low purchasing power of local consumers; not due to global competitiveness in quality, design or style.

⁵⁹ *All my sample shoe factories open local retailing shops at least in larger cities*

Table 7: Average actual purchase price of raw hides and skins by tanneries and minimum global market sales price of finished leather based on grade distribution

Type of input	Average input purchase price (ETB)	Grade	Average % of finished l/r grade distribution	minimum market price ⁶⁰ (ETB/ft ²)	Market price per grade distribution (ETB)	Price , if grade dist. were improved to 40/30/20/10 ⁶¹
Wet salted sheep	69.49/Pc (4,183,570pc)	I-III	11.5	49.60	107,320,190	373,287,620
		IV	23.7	40.00	178,365,250	225,778,800
		V	59.2	26.10	290,712,780	98,213,780
		VI	9.6	24.40	44,072,020	45,908,350
Wet salted goat	34.45/pc (1,301,440pc)	I-III	19.8	31.30	32,262,420	65,176,600
		IV	22.3	27.90	32,388,930	43,572,550
		V	30.7	24.90	39,794,690	25,924,880
		VI	27.2	13.90	19,682,090	7,236,060
Wet salted hide	78.16/pc or 4.90/kg (847,600pc)	I-III	1.4	30.50	8,553,660	244,390,400
		IV	6.5	24.40	31,770,750	146,634,240
		V	29.7	17.40	103,521,370	69,711,360
		VI	62.4	13.90	173,749,550	27,844,480
	split	TR	-	6.90	(58,484,400)	(58,484,400)
Total					1,062,193,700	1,373,679,120

Source: Own survey Compilation based on ELIA and Sauer Reports (2010/2011)

Table 8: Representative/Benchmark world Sales Price of hides and skins input

Type of input	Source country	Size	Unit	FoB price	Remark/grade
Wet salted hide	Turkey	-	USD/kg	1.85-1.90	TR
Wet salted hide	Brazil	-	USD/kg	0.89	TR, 1.30USD/ft ²
Wet salted hide	Australia	-	USD/kg	0.90	TR, 25-28USD/pcs
Wet salted hide	Italy	32-	Eur/kg	1.30	
Wet salted hide	Germany	24/26kg/pcs	USD/kg	2.28	Exported to Asia
Wet salted hide	Dominican Rep	18/22kg/pcs	USD/kg	1.10	
Wet salted goat	Greece	3.5/6ft ² /pcs	Eur/pcs	3.95	
Wet salted hide	UK	36+(pcs)	USD/ft ²	2.00	
Wet salted hide	Argentina	23/28 (kg)	USD/kg	1.75	Grade-original run
Wet salted sheep	New Zealand	-	USD/FT ²	2.25	
Wet salted sheep	Bulgaria	-	USD/ft ²	1.60	
Wet salted hide	Yemen	16kg/pcs	USD/kg	1.75	TR
Wet salted hide	Madagascar	14/16kg/pcs	USD/kg	1.15	
Wet salted hide	Kenya /Uganda	12/16kg/pcs	USD/kg	1.38	
Wet salted hide	Malawi	-	USD/kg	1.25	
Wet salted sheep	Finland	-	USD/FT ²	1.24	
Wet salted sheep	Sudan	-	USD/pcs	3.80	

Source: Own compilation based on Sauer Reports 2011

⁶⁰ Mainly refers to export market (FOB) price

⁶¹ This happens if input quality improvement were done radically and finished leather grade distribution for all input types had been achieved to be 40, 30, 20 and 10% for I-III, IV, V and VI respectively.

4.1.4 Information Flow through the Value Chain

Though it is difficult to address the level of information flow among the whole value chain actors, at least let's see it across the core actors.

It is less practical to observe free flow of information and feedback in this sector from buyers on improvement of technical working practices, quality and reliability; unless there is some binding contractual agreement or some degree of trust. This limitation in scope of information flow may be due to, usually agents, in this case buyers who know more information than principals or producers, would like to create asymmetric information environment that help them to gain long term economic rent through opportunism strategy that makes producers in the middle of the chain suffer from limited access to final consumers' data. This never leads producers in turn to strategic functional or product upgrading. More logically, the higher tendency of the sector to globally competitive market has been helping global buyers to reduce transaction cost or to load it entirely to producers and gradually to rely on codified information type only. As a result, this makes weak exporters refrain from exporting and look into only locally.

What so ever, in our leather sector there is at least some minimum information flow (both codified and non-codified), imposed vertically along the value chain from buyers to suppliers; in terms of their requirements, the assistance and consultancy they deliver and signal to conformity; with the aim of improving efficiency and effectiveness.

A clear form of codified information flow exists in 'International Contract Forms' framework by which buyers pass over the required specifications/information to suppliers who fulfill accordingly. In addition to price specification, payment terms, insurance agreement and time of delivery, International Official Contract No 6 &7, include such parameters as: grade (quality requirements), thickness, type of color, packaging etc. that suppliers, especially tanners, should fulfill which may reduce actually the threats of opportunistic behavior from both parties.

Besides, some non-codified information flow has been well known in the sector not only through those buyers' recipes named as Park Leather, Guarino Goat Crust, Rumania Sheep Crust, TATA crust, Pittards Crust, Jamaica Hide Crust etc. but also the respective technicians supervision and quality control in the local tanneries' work floor. These buyers also specify suppliers of tanners, especially chemical suppliers, on the issues of qualities and environmental issues. Still, more technical support and advice, in the

activities of product development and design, is delivered to tanneries and shoe factories by chemical and accessory suppliers than buyers do.

It has been seen also that the global leather sector defines the product price differentiation based on quality/grade. Unfortunately, in our case, this strong quality price signal is only observable between tanners and foreign buyers and between shoe manufacturers and consumers, local or foreign ones. In this case, signal to conformity in the feedback loop is common only between those respective actors. As will be discussed in the next CSF's sub topic, particularly foreign buyers are usually less satisfied with quality of the products and designs and as a result they usually influence producers to cut price. Still, generally, local tanners offer practically the same price to hides and skins suppliers who have the pivotal position to quality improvement regardless of input qualities. Thus information flow from tanners to hides and skins suppliers are very limited as most transaction is only arms' length; and there is no, at least partial, formal contracts (or strategic sourcing) between tanneries and raw input suppliers. This can even discourage visionary input producers and suppliers, if any, willing to improve their input processing and handling system as well as encourage myopic producers and suppliers to continue their incorrect production and handling practices that adversely affect the input quality. This may be one reason for not doing coordinately to input quality improvement.

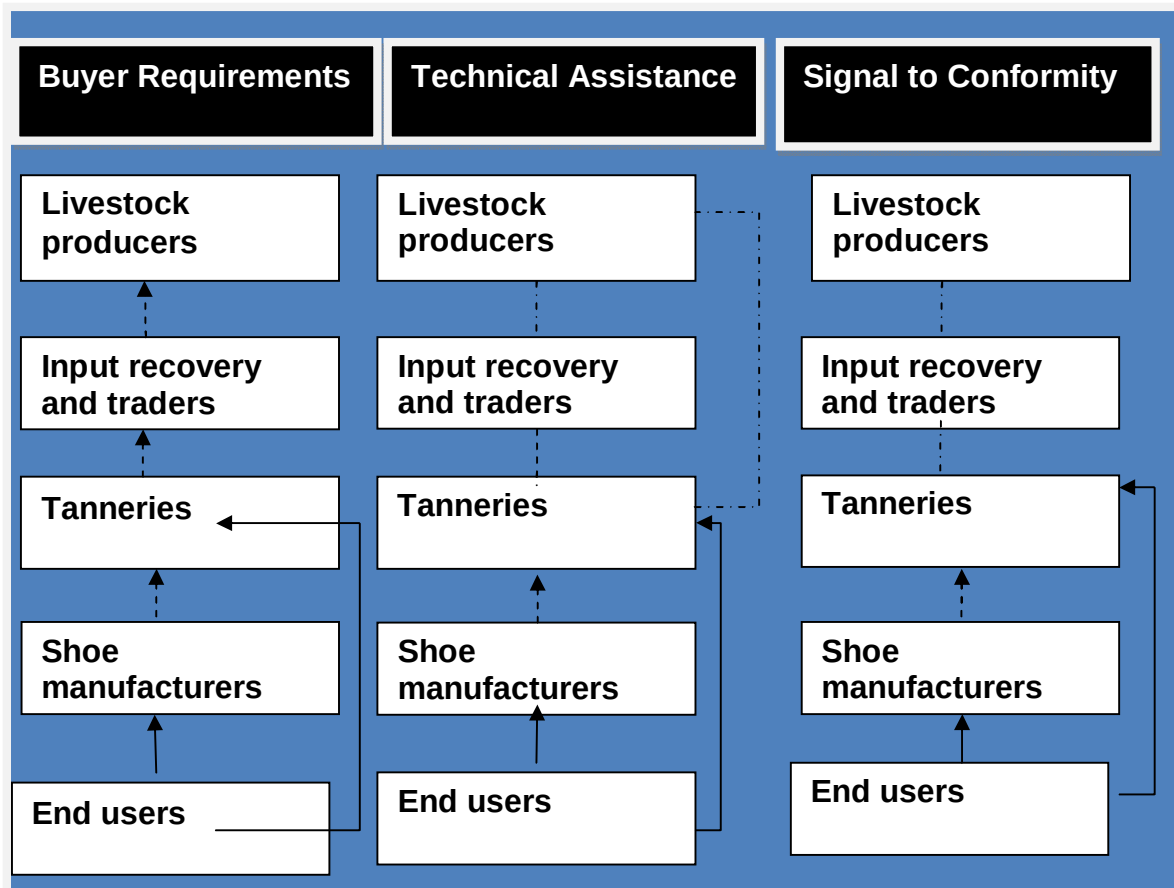
Information flow from local shoe factories to tanneries is practically there especially on quality improvement; but tanners are reluctant to implement the requirements as there is no enforcing power in shoe factories' hand. Because relatively tanneries have more transaction determining power due to higher shortage of finished leather supply to local market. Thus, shoe factories' requirements as buyers on the issues of quality parameters and product types are luxurious subjects, at least in the current situation as there is only limited use of end-users' insight or feedback in business decision making.

Still, with respect to horizontal information flow between local tanners, between suppliers or between shoe factories, it is very limited due to opportunistic or suspicious behavior of actors; what value chain thinking never tolerates.

To sum up, there is a weak link between the domestic producers and the global buyers vertically. Thus technology transfer in the form of technical assistance or efficiency improving support is very limited as information flow is highly codified in form. Evidently, ample international standards enable lead firms (MNC's) to codify their

information/demand to ODM partners than relying on assisting weak exporters; though some tacit information can't be codified as required at all. This has resulted in a business environment in which there is only weak influential and less strategic information flow characterized by less efficient, non-harmonized and un-synergized value chain. The next map summarizes the reality of information flow in the value chain.

Figure 6: Flow of Information in Ethiopia's Leather Industry Value Chain



Source: Own compilation

Legend

	: There is some influential or strategic information flow
	: There is only weak and informal information flow
	: There is no influential or strategic information flow

4.1.5 Analysis of Governance structure

It is recalled that the power of governance or firms relationships in a value chain is characterized by the ability of “lead” firms to set the parameters of products, processes and logistics that help to organize the activities along a chain, to control the distribution of resources within it and to pave the way for co-innovation. Evidently, strong value chain governance is the foundation to sustainable value chain, its development, efficiency, branding and learning. Thus, the key driver to governance formation is to reduce the risk of supply failure and the opportunism behavior (secretive self interest).

Strong relationships often drive improvement while poor relationships invariably cause stagnation in material and information flows as discussed in the previous sections. Some pre-conditions for better functioning of governance are availability of asymmetric power or relationships and sub-optimal contracting; both indicating the availability of implied powers (legislative, executive and/or judiciary) for managing activities such as sales, products and production processes, the use of input types, logistics etc. The sources of these powers in turn are the possible acquisition of knowledge/information, technical capability, scarce resource control, income share or/and legitimacy.

Now let’s determine/justify the existing type of governance pattern(s) or actors’ relationship in this value chain qualitatively through the help of international standards and theory of transaction cost economics (TCE) that relies on three behavioral assumptions-opportunism, bounded rationality (availability of partial legal contract and business trust) and risk preferences of actors – all together help to predict how firms choose among possible governance structures-arm’s length, modular, relational, captive or hierarchical. In the extreme case, we can extend the TCE assumptions to ascertain the level of asset specificity that in turn determines the degree of uncertainty surrounding it and frequency of interaction.

In seeking to evaluate the strength of governance, within and between organizations in the value chain, I focused on three key areas of relationships: governance in raw material provision; governance between tanneries and shoe factories; and governance between shoe factories and end users relationships, in local and export markets.

Till now in domestic leather sector, except for raw inputs and some processed leather, no national standard requirements are set or adopted formally from international actors to the

final leather products like shoes. Even the available standards in upstream are not strictly followed as tanneries offer the same value without price differentiation based on grade; while shoe factories have no option than to receive lower grade leathers with little bargaining power.

Still tanners have relatively better power to govern the chain at least domestically. Evidently, not only the flow of income and flow of information confirms this but also because, at least, they, together with macro level actors, exercise the legislative function by setting quality requirements; though they usually break the rules by themselves. This implies that it is frustrating to justify that the legislative functions of governance are not well enforced (failure of judicial function) as the system of price differentiation which should have given rewards to good quality raw inputs and products as well as sanctions to low quality ones up to even rejection is failing to conform to the minimum requirements. As mentioned elsewhere, this caused to inefficiencies to the upstream chain because the raw material producers and suppliers did not orientate their activities so as to meet the requirements defined by their end users. The executive function of the chain governance also failed since no sufficient supports by lead firms or by public chain supporters were done to enable the suppliers to comply with the set legislative requirements.

However, relatively, both the legislative and the judicial functions are better exercised in the level of external/export markets. As indicated in information flow, foreign actors direct the local tanneries what to produce, how to produce and when to get the products to some extent. But this is incomplete as these customers are interested only in some versatile semi-processed products, where suppliers' failure is assumed to be minimum or little damaging; with little asset specificity; from skins that local producers can produce independently with minimum possible follow up and transaction cost to buyers which is equivalent to modular power pattern. More awfully, these buyers have shown little interest in hide products which have huge potential to expand.

By definition, the leather industry value chain at global level is buyer-driven, the global buyers establish governance parameters and control them on geographically-dispersed products, production and distributions systems often owned by others, nominally. This should also have been in Ethiopia by foreign buyers or locally by shoe factories as UNIDO/MOTI, 2004 Master Plan wishes it in the form of Top Down pull Approach Strategy; though not prevailing yet. This happens because basic market relationships are

often sufficient for such products that are largely semi-processed and versatile at tannery stage in the one hand and unreliable and less promising in quality and quantity supply at shoe products stage due to limited opportunities for greater efficiency, value adding or co-innovation on the other hand. In this case, it is a nightmare to get lead firms from developed nations that coordinate the chain.

In other words, if we think rationally at this setting, what is the advantage of global lead firms to form strong binding relationships with local producers that demand high transaction cost, at least if our raw material is very poor in quality, unpredictable in quantity supply and delivery time with incompetent business enabling environment and weak support services? Who really dare to assume this assignment?

Explicitly, the distortion of governance structure in this value chain is partly due to shortage of raw materials that erodes the buyers' confidence on one hand and gives power to raw material suppliers and causes adverse impacts to the whole chain upgrading on the other hand. True, raw material suppliers can't play the role of lead firms whatever their power is higher as effective information can't flow downstream in the value chain thinking. To the worst side, since there is lack of transparency and accountability in raw material supply system, there is potentially high risk of market failures/inefficiencies or oligopolistic market power. Lack of transparency in a sense that there is no a means to negotiate and conduct marketing price as per grade as well as to get timely marketing information nor where to get the input. This may lead to have some intervention like establishing auction marketing system.

Here it is worth mentioning that vertical integration⁶² has become common in this value chain as several raw material suppliers expand their business activities into tanneries and recently some of them, or by the name of their family members, establish their own shoe factories. But what is frustrating in this integration is that it is only based on simple hegemony behavior neither rather than identified core competency, business knowhow or experience nor due to high informational complexity, difficulty of codification of information or incapability leading to failure of independent suppliers.

⁶²Once the only core activity of the owners of Addis Ababa, Hafde, Dire and Kolba Tanneries was raw hides and skins supply to other tanneries; then they have not stopped by establishing their own respective tanneries but also recently they are the owner of shoe factories, most of them are operational while the rest are under project.

To sum up, there is no strong chain governance functioning optimally. That is, there is only weak relation in the form of arms' length coordination in terms of price and guaranteeing supply between local raw material suppliers and tanners and between tanneries and shoe factories while it is only in modular power pattern between local producers and export markets. This could not help for sustainable value chain development as value chain governance exists only when organizations are linked through strong non-market relationships. More clearly, legislative and judicial governance functions are interrupted at least at local level and cannot reach backward suppliers; while executive governance function is very limited from lead firms and weakly supported by chain facilitators.

4.1.6 Analysis of Critical Success Factors (CSF's)

Analysis of critical success factors usually serves as a benchmark tool to producers as they are ultimately expected to strive to fill the gap between their performances and customers' wants. Hence, one of the ways to know the satisfaction of customers by producers' performance is to analyze major critical success factors in a given value chain. In this respect, 10 possible critical success factors of the sector are identified and surveyed whether there is/are wants by end users to: improved product quality, faster lead-time, more reliable/ consistent deliveries (in quality, volume and lead-time), further price cut, improved productivity (in factors of production), increased flexibility (in sales volume), variety of (innovative) product lines, channel preference (shipping or air line cargo) to product distribution, better compliance with mandatory environmental standards and compliance with global labor standards (safety, minimum wage etc.) than the existing situations. The level of satisfaction to each critical success factor is then measured by comparing the views of buyers/customers and producers. This helps to discover differences in perception and identify problems that need to be tackled.

First, a set of mirror questions on the CSF's are applied to know the views of producers on the customers' expectations and their (producers) performances towards fulfilling the expectations; and then the views of customers' wants or expectations and the producers' performance from the point of views of buyers will follow.

Now let's begin to present the views or understanding of producers on their customers' expectations and their level of performances as per the expectations.

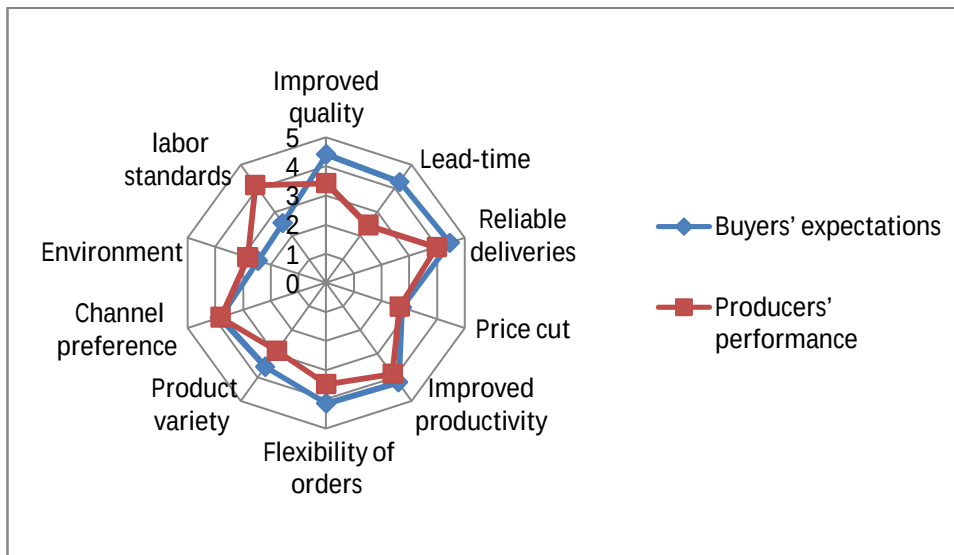
Table 9: Average expectations of buyers and performances by producers, from the producer's point of view; out of 5 of the scale of requirements

Parameters/ CSF's	Buyers' expectations	Producers' performance
Improvement to products quality	4.41	3.42
Faster lead-time	4.28	2.45
Reliable deliveries	4.45	3.98
Price cut	2.73	2.65
Improved productivity	4.21	3.86
Increased flexibility of orders	4.13	3.47
Variety of (innovative) product lines	3.56	2.89
Distribution channel preference	3.83	3.81
Compliance with environmental standards	2.46	2.83
Compliance with global labor standards	2.54	4.15

Source: Own compilation based on the views of producers situated at different stages

This comparison can clearly be depicted by Radar Chart presentation as follows. As indicated in the chart, even producers themselves admit and are frustrated that their performance on some CSF's such as product quality requirements, lead time, order flexibility and product variety are not satisfactory. But they feel also that, at least marginally, they are satisfying their buyers in some aspects, like reliable delivery, factors' productivity, price cut and distribution channel preferences; and even exceeding in some of them like meeting labor and environmental standards. But exceeding the buyers' expectations by producers' performance on the last two CSF's may be partially fictitious as buyers' expectations or influences seem minimal or they leave the issues for social activists as the numerical values indicate.

Chart 5: Comparison of buyers' expectations against producers' performance on CSF's; from the producers' point of view



The above results obtained from the producers' point of view can then be compared with the results obtained below from asking the same set of 'mirror' questions to the buyers and see how their perceptions coincide or diverge. In the table below, we can see how contrasting these results may be.

Table 10: Average wants of buyers and performances by producers, from the buyer's point of view; out of 5 of the scale of requirements

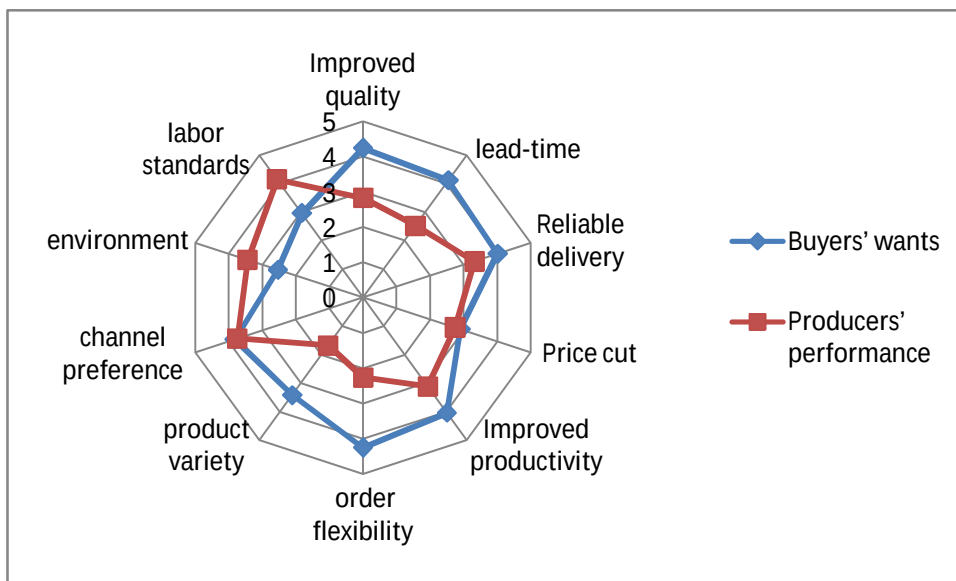
Parameters/ CSF's	Buyers' wants	Producers' performance
Improvement to products quality	4.24	2.83
Faster lead-time	4.11	2.52
Reliable deliveries	4.01	3.32
Price cut	2.91	2.74
Improved productivity	4.04	3.12
Increased flexibility of orders	4.25	2.27
Variety of (innovative) product lines	3.42	1.68
Distribution channel preference	3.83	3.75
Compliance with environmental standards	2.54	3.44
Compliance with global labor standards	2.96	4.15

Source: Own compilation based on end users view participating in AALF/2012

Once again, **Table 10** and **chart 6** shows that buyers often complain on their suppliers' performances as producers are falling short of their wants in many of the critical success factors considered; particularly on quality requirements, speed of lead-time and flexibility

of orders. Actually, the gaps are already known by producers as mentioned above, except some degrees of variation. The possible consequence of the gaps is that the unsatisfied demands and wants may create a space for other competitive suppliers in other countries to win the buyer's attention and eventually displace the traditional locally processed leather markets and reputation (mainly from skins) and the struggling shoe exporters. Thus, for local producers, knowing the gaps is only a beginning unless actions have to follow to fill the gaps, by benchmarking other competitors, in coordination with other value chain actors.

Chart 6: Comparison of buyers' wants against producers' performance on CSF's; from the buyers' point of view



4.2. Structure and Performance of Macro and Meso Level Business Environment

4.2.1 Structure and Performance of Business Enabling Environment

Generally the current macro level environment of the sector (Ethiopia) is characterized by stable political and economic situations, high security, very little crime and disorder, promising GDP growth and large domestic market particularly for consumer goods like footwear.

The country's strategic document, "Agricultural Development Led Industrialization, (ADLI), the framework for the national economic development efforts, is the peak

macro-level driver to the current reality; with ultimate development objective assumed to drive a structural transformation of the Ethiopian economy in which the relative importance of agriculture, industry and service changes significantly towards the latter two through a resource-based process of industrialization.

To make the transformation true, a package of policies is stated in the Government White Paper: *Ethiopia's Industrial Development Strategy*, August 2003. This strategy is rested on the creation of a business enabling environment for the private sector as it is called the driving force for economic development. Specifically, manufacturing industries are stated as the principal priority of the strategy. Moreover, the strategy identifies several priority sectors which focus on agro-based industry with the core issues of expanding export oriented labor-intensive industries and technologies, targeting micro and small enterprises. Thus government policies focus to support exhaustively those private micro and small enterprises and industry related programmes that fall within the priority list. Reasonably, in this short list leather industry is the one, among others.

It is in this spirit that MOTI, now called MoI, has taken the responsibility to support and follow up the performance of the leather industry and made established a Meso level chain supporter under it known as the Leather and Leather Products Technology Institute (LLPTI), now transformed to LIDI (Leather Industry Development Institute).

The LLPTI/LIDI, directly accountable to MOI, is the specialized institute whose activities are to serve as an engine for the development of the sector by providing training in technical, managerial and marketing, offering direct services to industry and promoting networking between the formal and the informal sector of the value chain. Thus its objectives of establishment are to facilitate the development and transfer of technologies in the leather and leather products industry and to enable the industry become competitive globally and bring about rapid development.

Huge expectations have been laid down to the newly re-established LIDI with additional assignments and objectives as envisaged in Regulation No 181/2010. Among them, the main duty is to establish efficient linkages of actors; stretching from supplying policy inputs to macro-level actors up to close supporting and following up of private actors in terms of training and technology transfer, expanding investment, R&D and design work, work floor operational technical and managerial support, market matchmaking, cooperation with local and foreign institutions having similar objectives etc.

However, the interaction between the MOTI/LIDI and the industry (ELIA) is not yet as such strong and coordinated, if we evaluate in terms of the assignments, except some efforts made in regular training delivered and some technology transfer through benchmarking programs. That means the coordination with the private sector and the government development support agent, chain supporter, yet to be improved.

Actually in the assessment of the macro and meso level structure and performance of the chain, what should come first are to see the activities of livestock husbandry, breeding system, hides and skins production and marketing system etc.; which need actually immediate attention to follow up and practical transformation. These duties are delegated to other government organ called MOA. MOA along with livestock institutes and bureaus under it is empowered to coordinate livestock husbandry and breeding or fertility improvements, all the raw hides and skins improvement activities such as collecting, assembling, warehousing, marketing based up on quality, transporting ,supervising and implementing of the Ethiopian standards while performing raw hides and skins marketing. For this, it has undergone restructuring in view of the decentralization to districts, and that hides and skins improvement activities have been further delegated to the regions. One of the most important activities is the implementation of the standards through the certification carried out using an Ethiopian Standards Mark, which indicates the conformity with the standards requirements. Another important activity is the licensing of raw hides and skins collectors through a technical evaluation in conformity with the Ethiopian Standards, according to proclamation No 457/2005.

Once again the performance of each activity on the ground is frustrating as the previous analytical and qualitative governance analyses in this paper have revealed.

Thus, there are missing linkages in the whole value chain starting from livestock producers, hides and skins producers, MOA, the Ethiopian Quality and Standards Authority and then the end-users (tanners in this case) and their facilitator, MOTI/LIDI. This is due to lack of commitment, synchronization and weak information system shared by the various parties. This weak coordination can't help even to solve such clear but major problems like "*Ekek*" which is related to poor husbandry, and has been eroding the competitiveness of the industry at least for the last two decades.

QSAE, currently split into separate bodies including ESA-Standards Agency of Ethiopia and ECAE- Ethiopian Conformity Assessment Enterprise, are the national governmental

institutes for the formulation of national standards and for providing product certification respectively. In principle some standards of products are developed annually and samples are collected quarterly from licensed tanneries and leather products manufacturers and tested against the standards for the respective leather products. However, as per the scope of the chain, the variety of standards available and sample collection and testing are not adequate. As addressed in the value chain governance section, the buyers and suppliers do not efficiently utilize these standards or even sometimes do not apply them. The main reasons for not properly applying these standards include: market influence or shortage, absence of strict follow up and supervision, weak coordination and limited skill and experience of quality graders. As everyone's first imagination, lack of facility to quality assessment may be proposed; but the reality is that the LIDI Research Laboratory is there to support or even overtake the responsibility, if not still the coordination problem. But no doubt that it is of paramount importance to apply the standards at least so as to pass technical barrier to trade (TBT), if the sector strategy is to boost exports.

As a major meso-level chain supporter, the producers have a representative called ELIA (Ethiopian Leather Industry Association) with stated objectives of: Promoting business cooperation among members, representing members in cooperation with government for sector upgrading and quality improvement, negotiation with institutions or individuals in the interest of the industry and promoting activities in seminars, workshops, export promotions and trade fairs.

But these member actors are not as such horizontally cooperated or vertically coordinated in guarantying their strategic interests as they have temporary differences in the degree of major problems such as raw input securing and chemical and accessories and component importing mechanism which result in possible opportunistic behavior. For instance, as stated elsewhere, some tanneries are vertically integrated both upstream and downstream; and hence input scarcity is not relatively their problem. Capital tied up due to chemicals and accessories inventory piling is not the same for the incentive beneficiaries of duty draw-back and Voucher book. These are actually the result of antagonistic policy options and directions to be addressed later.

There are also other international meso level actors, what the government called 'development agents' to support the chain. The main ones are ECBP, ECF/WB and UNIDO. Most supports of these institutions are private sector value chain financing such

as for waste treatment and quality infrastructure set up or cost covering for international trade fair participation or (royalty) fees for expatriate experts or institutions deployment for the sector, usually in less coordinated manner.

Unfortunately most of the supports of these macro and meso level actors are lip service or less orchestrated as they have not brought any difference for upgrading the industry yet. For instance, no satisfactory extension work has been done by MOA or by regional offices delegated by it to eradicate the major ecto-parasite quality problems called ‘ekek’ which persists at least for the last two decades. Awfully, if the 73% of the off-take rate is ‘death’, it is difficult to conclude that the livestock sector is managed systematically. Still the major portion of hides and skins production (slaughtering) is made at household level in traditional way which contributes its own share to quality deterioration and skin recovery problem. Even the few existing modern abattoirs work below capacity due to supply problem. At least the last two cause and effect problems need some strategic policy issues. MOA clearly fails also to accomplish marketing system of raw inputs as per given the responsibility by proclamation No 457/2005.

The ELIA, producers in general, together with MOTI/LIDI and the so called development agents have no clear strategic marketing promotion and value link upgrading, such as branding of, at least the Ethiopian Leather from skins, in the world market; except some occasional local and international trade fair participation (of business owners) as ‘sponsored tourist’, by UNIDO or ECF/WB.

4.2.2 Trade policies, Incentive Regimes and Financing

Clearly global value chain competitiveness can be seriously affected by national and international trade policies. Trade policies in turn are dependent on macroeconomic stability or business enabling environment. Without stability, trade policies may not achieve the objective of increasing the tradability of the economy which is an essential element for increasing competitiveness and realizing both static and dynamic gains from trade. Given the recent global economic meltdown, relatively Ethiopia’s macroeconomic condition is stable to practice business activities with fair questioning of inflation, lack of exchange rates and current account deficits.

In this respect, the Ethiopian export business environment in general and the leather industry in particular are embraced with various opportunities of international and national trade policies and incentive regimes. Internationally the sector can access American, wider part of African and European markets through AGOA, COMESA and EBA respectively as per the opportunities given or agreements signed. Ethiopia also has additional duty free access opportunities to other markets. For instance, Canada, Japan, Australia and China have granted Ethiopia preferential export access or duty free export market for leather and leather products, among a large basket of goods. Here, it is worth mentioning that Ethiopia has the opportunity to export to COMESA market only by virtue of its membership which enjoys 10% duty rates less than MFN duty rates. But to have a strategic opportunity of market segment based on lower grade or price sensitive leather products which can't be entertained by other developed countries' market, as some producers say, it may be necessary to see the benefits of advancing the agreement to the status of COMESA FTA. True, all these opportunities are yet to be reaped, as domestic value chain incompetency is the bottleneck.

As it is known, unless exempted by law, items imported into Ethiopia are subject to a number of taxes including VAT. But thanks to the government/MoFED, the leather and leather products producers are not only exempted by law from taxes such as VAT for both semi-processed leather transacted between tanneries and finished leather sold for shoe factories by Circular Ref. No □□3/16/26/28/860 dated 10/02/2001 E.C. and Circular Ref. No □□ 3/16/28/227 dated 08/11/2000 E.C respectively but also they are allowed to import capital goods, chemicals, components and parts duty free on the condition that their products either directly or indirectly will be exported.

Thus the chain enjoys such huge opportunities and incentives such as duty free importation of inputs and protection of local firms with higher tariff barriers to imported leather and substituting products thanks to the national macro-level actor. Clearly, for a sector like Ethiopia leather industry that uses huge share of imported inputs, if these inputs were taxed, global competitiveness is unthinkable. But the sector doesn't reap this economic rent accruing or competitiveness enhancing measures or incentives yet due to mainly the inefficiency and incompetency of meso and micro level actors. Evidently, without going into the detail of calculation, though there is positive effective rate of

protection (ERP), in fact, with convincing magnitude as World Bank (2004) reports it⁶³ for the sector due the aforementioned incentives, the producers are not still satisfied with the incentives due to the administrative inefficiency in applying the schemes such as duty refund one or bonded warehouse arrangements, among others.

Moreover as described earlier, the existing import tariff restriction on leather and plastic shoes (substitutes) not only makes the importers disadvantaged in price competitiveness but also makes the local producers beneficial, of course only in local markets; if it does not result in negative implication so as not to participate in the export market. Practically, in this liberalized world, 21.3% average import duty rate including the maximum import duty band of 35%⁶⁴ on an industry's products, as the case in Ethiopian leather industry, can have the power to turn down the sectors' 'export strategy' on the paper to import substitution practically.

Since recently, (the Proclamation No 567/2008), the government has been convinced to levy a trade policy measure of 150% export tax on raw hides and skins, 20% on wet blue hide and 10% on sheep pickles both are semi-processed; with the stated objective that the tax system could serve as an instrument to functionally upgrade the industry and to shift to exporting processed leather than exporting less value added semi-processed ones. Moreover, by this declaration, MoFED has empowered to issue an increase or exempt (in part or as a whole) such export tax rates as it deems necessary. Based on this, even recently MoFED has issued a circular that declares the increase of 150% export tax to any semi-processed leathers including crust leather which has been effective as of January 10/2011. This indicates that practically export of raw hides and skins and semi-processed leathers is banned, with two sound objectives; to get better value addition and to relieve the hunger of input scarcity. Irrespective of the current sadness of traditional semi-processed product global buyers, gradually this direction may result in better global governance link on the assumption that buyers will back and guide local tanners, with some binding transaction costs, how to finish market winning products.

⁶³ $+71.9 = ERP_j = [t_j - \sum(a_{ij} * t_i) / (1 - \sum a_{ij})]$, where t_j and t_i are the nominal tariff rates on the industry and input-supply industry respectively, and a_{ij} is the input-output coefficient indicating the share of industry i 's production used as inputs in industry j 's output.

⁶⁴ Source: WTO/UNCTAD, World Tariff Profile, 2008

True, currently contradictory result has been arisen as producers have shown clear inclination to use the protected, less competitive and logistically less complex local market while the government interest is still earning better amount of foreign currency.

It is well known that among the indicators to measure the competitiveness of a country (industry) participating in the global market arena are credit financing and rules on foreign exchange. The available credit incentives in export activities in the industry include access to pre-shipment and post-shipment credit financing as working capital for 180 days; equivalent to the volume of the previous year's export proceeds without any collateral requirement for existing exporters (as stipulated in Directives No SBB/33/2002 and REL/05/2002). Besides, the directives allow not only all producers to acquire foreign source of finance from buyers, if any, to buy capital goods, raw materials, semi-finished goods, spare parts and other inputs but also Franco Valuta scheme for FDI ventures. Having all these incentives at least on papers, still working capital shortage is among serious problems what several producers face. This problem is particularly chronic for relatively small enterprises and for those highly concentrating in local market. But if we wish to gain productivity or efficiency before exporting, it may be imperative to avail credit incentive for the later group of producers, actually with some conditions.

A practical measure to support exports has been the introduction of a foreign exchange accessibility or retention scheme allowing exporters to retain part of their foreign exchange proceeds. At present, exporters are allowed to retain 10 percent of the export proceeds without a time limit and even to retain the rest 90% up to 28 days if they use it actually only for import-export activities in the meantime.

No doubt, the recent devaluation of exchange rates as a policy prescription has been expected to boom the export performance of the sector. But even after some time lag (J-curve effect), it doesn't result in a positive trend at sector level as indicated in **table 5**. Actually this policy works well only in the environment where less than full employment of resources and other competitiveness to export exists and hence real output increment potential is available; unlike our case where shortage of raw material resources and higher local demand of products prevail.

As proclaimed by proclamation No 543/2007, there are incentive schemes granted by macro level actor to assist direct and indirect exporters. These include using the option of 100% Duty Draw-Back, Bonded Manufacturing Warehouse and Voucher book incentive

scheme that make exporters free of custom duty for their imported inputs on the condition that they shall directly or indirectly export their products. These schemes aimed at providing exporters of manufactured goods imported inputs at world market prices.

But all these incentive schemes are not without any challenge. Despite the intention to promote exports using incentives, these schemes are not exhaustively used because of administrative bottlenecks and operational rules. The weak efficiency of the system to refund the incentive timely in the case of duty draw-back scheme- refund of duty paid on raw materials used in the production of commodities for exportation- requires a lot of officers' signatures and paper works including preparation of input-output coefficients; which result in working capital tied up due to time consuming up to a year or more. The Voucher Book scheme -document issued by the Customs Authority, to be used for recording the balance of duty payable on raw materials imported for use in the production of goods for export- lacks entertaining contingent issues as it is granted only as per the annual business and export plan. The exporter also needs to fulfill several legal preconditions and documentations including input-output coefficient. On the case of exporters to be eligible in the Bonded Manufacturing Warehouse Scheme, they need to be the only producers who 'wholly engaged in exporting their products'. This does not only exclude partial exporters but also the target beneficiary producer needs to pay license fees and allowance for custom officials as well as designing special warehouse which is insured. All these additional costs are frustrating to the beneficiary, besides the obligatory paper works and bureaucracy alike the previous two incentive schemes. That may be the reason that no tannery or shoe factory applies for this incentive scheme individually yet. Still if the later scheme is revisited somewhat and the warehousing service is outsourced, say for chemicals, components and accessory producers, potentially it can be the most efficient scheme of all.

Chapter 5: Conclusion and Recommendations

5.1 Conclusion

From experience, the prerequisite to competitiveness of global leather value chain include: lower labor cost, higher resource base with best quality embedding breed or intrinsic attributes, technology know-how, technical efficiency, lower transaction cost with faster logistics, availability and easier accessibility of chemicals, components and accessories, better coordination and networking of actors and competitive final product price in comparison to some benchmark indices and activities. Thanks to global value chain methodology, the level of competitiveness of Ethiopia's leather industry in terms of these attributes are analyzed through mapping of value chain actors, material flow, value-added, information flow, availability of asymmetric power or governance patterns, CSF's and coordination of all level of the value chain actors.

In Ethiopia leather value chain context, there exist three levels of 'active' actors: micro-, meso- and macro-level ones with specific roles. Starting from the major Macro level actor, the Ethiopia's Government has proposed several strategies towards improving the competitiveness of the chain in terms of the attributes but with no actors created to dispose it efficiently and effectively yet. In other words, this sector has common experience in falling short of performance against a desired goal; except the GTP of the sector to be seen on time. One can deduce from this that the proposed strength of the spring board that helped to hit the final goal was weaker. The weakness is mainly related to weaker asymmetric power and looser coordination of actors, among others.

I may not have a specific comment why Ethiopia prefers 'the Agricultural Development Led Industrialization'. But as a priority base sector, in this case the livestock production, husbandry and management subsector, it doesn't play a promising role to support the apex subsectors, especially the leather industry, in providing the required quantity and quality of inputs. Needless to say that this issue is not only the questions of the quality and quantity of hides and skins; which is the 'byproduct'. But it is also a barometric measure to reflect the overall weaker economic performance of the livestock sector.

Usually, tanners claim that 'Leather is made in the beam-house,' the first most operation in leather manufacturing process. But by observing the current situation, I can challenge

them to rephrase their old saying into ‘competitive leather is made at the stage of livestock production and husbandry practice’.

Currently, Ethiopia’s leather value chain is characterized by very low supply of raw materials with poor quality, complex routes of input recovery, sluggish material flow with wider gap between end users expectations and producers’ performance, very low value added, dysfunctional information flow, weakly exercising of governance functions and less coordination among macro-, meso- and micro-level actors.

As the recent CSA survey declares, proudly Ethiopia is endowed with large livestock resource base that can potentially give huge quantity and intrinsically high quality hides and skins. But it is a great shame to find out that raw hides and skins supply shortage is found to be No 1 problem of the leather sector followed by raw material quality problem. According to the survey and related official documents on the subject, it is frustrating to realize that the huge part of off-takes (73% on aggregate) was taken place due to death than planned commercial transactions in all the three livestock breeds; livestock exporting is considered as one of the strategic fair businesses without any value addition as the figures indicate and GTP claims so high; the country is highly porous in all four directions for smuggling of this resource; rate of annual local slaughtering was very small relative to the resource base; number of annual births or fertility rate was very small that in turn affects off-take rates or revival of the breed if we think of the other side. All these affect the number of production of hides and skins.

Here it is worth mentioning that the macro-level actor seems to work well in attracting higher level of FDI to the sector that may help technology transfer embedding capital and skill, still with its own negative side as it may replace domestic production instead of increasing competition in the current setting. In other words, the sector seems to go beyond its saturation point for new investment with the current situation of slaughtering off-take and fertility rates.

Evidently, the annual gross demand and the justified hides and skins supply potential to tanneries are estimated to be about 13 and 23 mln m² respectively. That means, in the current situation there is about 43% aggregate supply gap or unsatisfied demand. In the practical case of sample tanneries and shoe factories analysis, if they worked in full capacity continuously, citrus paribus, they could work only 184 and 151 days per annum respectively with this constrained input while they were idle in the rest of the year. This

led to not only huge sales loss but also caused higher fixed costs accruing. In supplement but with qualitative approach, from 96 representative firms, about 43% of respondents from large and medium enterprises of the sector point out that shortage of raw materials (hides and skins or finished leather and components and accessories) is the first major reason for not working at full capacities followed by distant second 9% respondents to complain on the absence of market demand while 38% are actually non- respondents. But for small scale enterprises in this sector, the first major reason for not working at full capacity is lack of market demand followed by absence of working premises. This is a warning sign that expecting the small scale enterprises to export at least in the current setting is a nightmare, except consuming the expensive resource extravagantly.

As raw input shortage relieving mechanism, the government has proposed importing of hides and skins from neighboring countries several years ago. This would have been practical first and for most if the raw materials were available, the price was competitive and quality was reliable. But all the above attributes mentioned are affected in one way or together by:

- Higher export taxes at least 40% to de-incentive raw export by the targeted countries
- Serious quality problem
- Limited availability due to China and other East Asian competition to this resource
- Logistically difficult to manage in our current infrastructure
- Risky business due to the fear in disease transmission

Hides and skins production process and trading system are among other problem areas of the sector seeking policy issues. Because in Ethiopia, hides and skins production occurs without any specialization, capacity, or accountability and transaction is practiced literally at the livestock production gate or at any other points where the animals are slaughtered, to the next several non-value adding hands and routes. These practices affect the quality and quantity or recovery of hides and skins. All these need strategic trade policies and operational coordination.

However, at least during the fiscal year of this study, the purchase prices of hides and skins and finished leathers were not found as competitiveness eroding factors in comparison to other cost elements.

On the contrary, the chemical cost of tanneries which constitute about 26% of their total cost, out of which 92% by cost is imported and cost of shoe factories' accessories and components which constitute about 44% of their total costs, not less than 83% by costs are imported are really the major incompetencies of the subsector in comparison to the benchmark indices. More awfully, large inventory handling experience of the sector that causes chronic working capital shortage is characterized by the average raw materials stock holding period of 156 days for the sector, with a little worse in shoe factories (195 days) than tanneries (128 days) and the average inventory turn-over in times per annum of 1.78 for the whole sector, 1.69 for tanneries and 1.90 for shoe factories.

Seeing that, end-users urge producers that production cost control and productivity is the major issues that make them and the whole chain competitive and efficient. In the eyes of end-users, activities in the value chain are classified into: value-adding activities- that necessitate further investment by micro-level actors for value creation; non-value adding activities- necessary but do not demand the allocation of more resources so as to minimize cost and unnecessary activities-activities which result in accruing transaction and production costs and to be eliminated. Especially the end-users recommend that the second class of activities should be overtaken by public support institutions in the form of technical subsidies or incentives so as to make the enterprises cost and price competitive worldwide as the newly emerging economies do. According to these end-users, especially in the process of product flow, what makes them satisfied and what makes the value chain competitive most is when the activities of chain operators would comprise at best only value adding activities or at least if the wasteful activities are to be eliminated.

Actually, the Ethiopian Government or the macro-level actor grants a lot of incentives to this sector as the end-users recommend though some wasteful activities are still there. However, even after being granted those incentives and incorporating some biased assumptions to the sector, the value added secured by it is very scanty at each stage. Evidently, this can be attributed to low functional and product upgrading, poor quality input, smaller production per annum and higher intermediate cost related to higher transaction cost. Irrespective of their detail technical efficiency, factors of production face poor productivity due to shortage of raw materials supply. Actually, in comparison to some benchmark cost structure; the lower costs of labor, capital, hides and skins and finished leather show that the sector is economically efficient or competitive while it is

chronically economically inefficient in the costs of chemicals and components and accessories and logistics costs. Besides, producers at various stages receive very low product price or value due to input quality problems and insufficient functional and product upgrading, particularly by tanneries. For instance, if tanneries functionally upgrade their semi-processed products, they could gain about 22% more of the actual sales value. Besides to this, if there is some improvement in current grade distribution of raw inputs and processed leather, tanneries could gain about 58% more of the actual sales value. With respect to shoe factories, they have used very lower grade leather input which resulted in low average sales price of their output per pair. Similarly if the quality problem were resolved at least partially, even with the existing constrained input supply, the sales value of shoe factories can increase by 134% in the local market or 53% in the export market from the current actual sales value, as per the manufacturers' market preference and availability of information flow and strong governance.

Actually, the level and type of information flow in the value chain is partly affected by the global tendency of the sector to higher competitive market. This has been helping buyers or lead-firms to reduce transaction cost or to load it entirely to producers and to rely only on codified information type based on international standards from time to time. Explicitly, there is a weak link between the domestic producers and the global buyers vertically and technology transfer in the form of technical assistance or efficiency improving support is very limited as information flow is highly codified in form. This has resulted in a value chain in which there is no influential and strategic information flow that helps efficiency improvement and harmonization of actors. Consequently, this makes weak exporters refrain from exporting and look into only locally, among other reasons. With respect to horizontal information flow between local tanners, between suppliers or between shoe factories, it is very limited due to opportunistic or suspicious behavior of actors; what value chain thinking, i.e. actors' integrity, alliance or cooperation and trust, never tolerates.

But as value chain concept claims, no access for producers to the lead firms (global buyers) means, it is being excluded from the world's main export markets. True, the level and type of information flow among actors can help judge the governance pattern in the value chain. Evidently, the chain governance in this value chain is not functioning optimally. That is, there is only weak relation in the form of arms' length coordination in

terms of price and guaranteeing supply between local raw material suppliers and tanners and between tanneries and shoe factories while it is only in modular power pattern between local producers and export markets. These could not help for sustainable value chain development as value chain governance exists only when organizations are linked through strong non-market relationships. More clearly, legislative and judicial governance functions are interrupted at least at local level and cannot reach backward suppliers; while executive governance function is very limited from lead firms and weakly supported by public chain facilitators. The main reasons for not properly working these governance functions include: the tanneries manufacture semi-processed products according to the detailed instructions of the foreign buyer, and maintain full responsibility for the case of the modular power pattern. Clearly, for the case of the local arms' length relation it is market influence or shortage, and partly weak coordination or support. Explicitly, the distortion of governance structure in the later case is partly due to shortage of raw materials that erodes the buyers' confidence on one hand and gives power to raw material suppliers and causes adverse impacts to the whole chain upgrading on the other hand.

But still, there is a gap between end-users' expectations and producers' performance. Taking some CSF's as benchmark tools, end-users' expectations and producers' performance are compared. The result indicates that even producers themselves admit and are frustrated that their performance on some CSF's such as product quality requirements, lead time, order flexibility and product variety are not satisfactory; though they feel that, at least marginally, they are satisfying their buyers in some aspects, like reliable delivery, factors' productivity, price cut and distribution channel preferences; and even exceeding in some of them like meeting labor and environmental standards. However, from the point of views of buyers, the issues seem more serious and they often complain on their suppliers' performances as producers are falling short of their wants in many of the critical success factors considered; particularly on quality requirements, speed of lead-time and flexibility of orders than the producers expect. The point is that, the possible consequence of the gaps in views and expectations and the unsatisfied demands and wants may create a space for other competitive suppliers in other countries to win the buyer's attention and eventually displace the traditional locally processed leather markets and reputation (mainly from skins) and the struggling shoe exporters.

Before that, actors are expected to be well coordinated and pave the way for functioning of strong value chain governance.

True, the macro level actor delegates MOTI/LIDI to accomplish the duty of establishing efficient linkages of actors; stretching from supplying policy inputs to macro-level actors up to close supporting and following up of private actors in terms of training and technology transfer, expanding investment, R&D and design work, work floor operational technical and managerial support, market matchmaking, cooperation with local and foreign institutions having similar objectives etc. But the interaction between it and the industry (ELIA) is not yet as such strong and coordinated, if we evaluate in terms of the assignments, except some efforts made in regular training delivered and some technology transfer through benchmarking programs. That means the coordination with the private sector and the government development support agent, chain supporter, yet to be improved.

Moreover, to streamline and upgrade the upstream supply chain of the sector, the responsibility has given to MOA with explicit duties of improving livestock production and husbandry system, hides and skins production, trade licensing, collecting, transporting, warehousing, marketing and enforcing Ethiopian Standards in transaction. But none of the duty of MOA has ever been implemented.

Unfortunately most of the supports of these macro and meso level actors are lip service or less orchestrated and without commitment as they have not brought any difference for upgrading the industry yet. For instance, no satisfactory extension work has been done by MOA or by regional offices delegated by it to eradicate the major ecto-parasite quality problems called 'ekek' which persists at least for the last two decades. Awfully, if the 73% of the off-take rate is 'death', it is difficult to conclude that the livestock sector is managed systematically. Still the major portion of hides and skins production (slaughtering) is made at household level in traditional way which contributes its own share to quality deterioration and skin recovery problem. Even the few existing modern abattoirs work below capacity due to supply problem. Besides, the private actors are not as such horizontally cooperated or vertically coordinated in guarantying their strategic interests as they have temporary differences in the degree of major problems such as raw input securing and chemical and accessories and component importing mechanism which result in possible opportunistic behavior. For instance, some tanneries are vertically

integrated both upstream and downstream; and hence input scarcity is not relatively their problem. Capital tied up due to huge inventory of chemicals and accessories is not the same for the incentive beneficiaries of duty draw-back and Voucher book schemes. These are actually the result of antagonistic policy options and directions.

The ELIA, producers in general, together with MOTI/LIDI and the so called development agents have no clear strategic marketing promotion and value link upgrading, such as branding of, at least the Ethiopian Leather from skins, in the world market; except some occasional local and international trade fair participation (of business owners) as 'sponsored tourist', by UNIDO or ECF/WB.

I can't deny that the Ethiopian leather industry export business environment is embraced with various opportunities of international and national trade policies and incentive regimes. The leather and leather products producers are not only exempted by law from taxes such as VAT for both semi-processed leather transacted between tanneries and finished leather sold for shoe factories but also they are allowed to import capital goods, chemicals, components and parts duty free on the condition that their products either directly or indirectly will be exported. Moreover, the existing high import tariff on leather and plastic shoes (substitutes) not only makes the importers disadvantaged in price competitiveness but also makes the local producers beneficial, of course only in local markets; if it does not result in negative implication so as not to participate in the export market.

There are also credit incentives for export activities in the industry which include access to pre-shipment and post-shipment credit and financing as working capital for 180 days; equivalent to the volume of the previous year's export proceeds but without any collateral requirement for existing exporters. Besides, the rules allow not only all producers to acquire foreign source of finance from buyers, if any, to buy capital goods, raw materials, semi-finished goods, spare parts and other inputs but also Franco Valuta scheme for FDI ventures; though working capital shortage is still among serious problems what several producers particularly smaller and non-exporting ones face. Foreign exchange accessibility or retention scheme allowing exporters to retain part of their foreign exchange proceeds is another incentive given to exporters to retain 10% of the export proceeds without a time limit and even to retain the rest 90% up to 28 days if they use it actually only for import-export activities in the meantime.

Still the sector doesn't reap this economic rent accruing or competitiveness enhancing measures yet due to mainly the inefficiency and incompetency of meso and micro level actors. Evidently, the producers are not still satisfied with the incentives due to the administrative inefficiency in applying the schemes such as duty refund one or bonded warehouse arrangements, among others.

True, leather industry is one of the strategic sectors which are assumed to generate huge amount of foreign currency. But each fiscal year, the performance is far below the country's expectation.

The government has taken a trade policy measure in the form of higher export tax which is practically equivalent to banning on raw hides and skins and very recently on semi-processed products on the objective of enhancing export earnings. Irrespective of the current sadness of traditional semi-processed product global buyers, gradually this direction may result in better global governance link on the assumption that buyers will back and guide local tanners, with some binding transaction costs, how to finish market winning products as long as they are interested in Ethiopian leather.

However, as a result of this regulation, currently contradictory result has been arisen as producers have shown clear inclination to use the protected, less competitive and logistically less complex local market while the government interest is still earning foreign currency.

The annual tanneries' and shoe factories' share of exports to their respective gross sales are 0.59 and 0.33 while their export performance to their annual plan is 82% and 18% respectively. Miserably, the 2011/2012 six months export performance to their plan drops to 76% and 16.5% respectively.

5.2 Recommendations for Upgrading Strategy

Specifically economic value chain upgrading or better value creation is understood as moving to activities that offer higher survival opportunities and higher returns by either shifting production towards higher priced products (product upgrading) or by acquiring new functions in the value chain such as participating in finished products, design and marketing (functional upgrading). It also includes practices of learning by doing and leveraging of bottlenecks.

The main question is upgrading with what strategy? If we plan to participate in the global market (for us) through upgrading, we have to have some special competency such as: low cost opportunity (due to technical and economic efficiency); high quality and quantity resource base; technology knowhow, R&D, design, brand etc.

The world leather market functions mostly in low cost strategy that leads to price competitiveness. China has conquered the world market footwear on low cost strategy.

An ordinary person can claim that the Ethiopia's leather sector competency lies also on low cost and high resource base. But it has seen that the claim is highly questionable in both cases at least at the current setting, except its potential.

Evidently, the persistent weaker export performance of the sector due to shortage of raw inputs, nontransparent and inefficient marketing system and serious quality problem are currently aggravated by the availability of rivalry strategies such as simultaneous livestock export promotion and leather and leather products export promotion; SME expansion program on leather products which have little exporting capacities; local market protection which has potential to induce import substitution market; levying of generic export tax on semi-processed products etc.

Thus, the issues of the above policy paradoxes should be reconciled, on one hand; and the value chain should be upgraded to achieve its efficiency and effectiveness on the other hand. But the desired efficiency and effectiveness is unthinkable without mutual involvement of all actors as the problems can't be solved at factories' gates. That means, to make upgrading effective, the sector's major problems should be alleviated simultaneously. The creation of governance functions and coordination of actors must be performed simultaneously, since addressing one of them and ignoring the others will not bring any success, as learnt from the former development efforts which have partial approach on the problems.

As it is mentioned several times, all the three levels of value chain actors exist structurally though they are functionally less coordinated or nonexistent. Thus, the major upgrading issue of this value chain is not structural formation or restructuring but commitment, coordination, communication, help work governance function etc.

At this stage, it is worth mentioning to note that almost all efficiency eroding factors are emanated from local incompetencies and the long term and short term upgrading strategies to the sector in turn are also luckily only inward looking; tackling of local

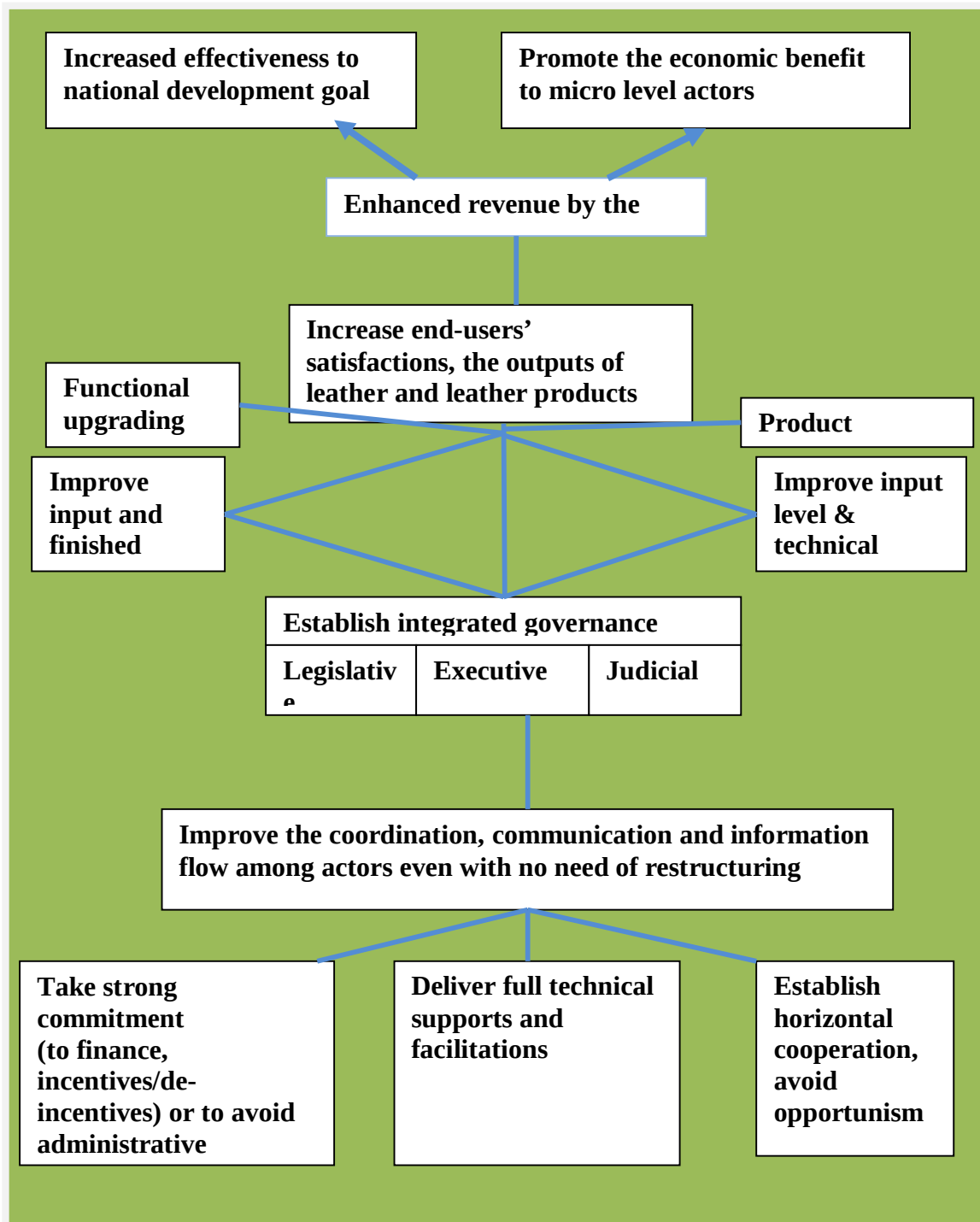
efficiency and competitiveness eroding factors, promoting and managing local resources and improving export performance.

More explicitly, the possible recommended activities and strategies to be performed are short listed, followed by generic action ladders to be consulted.

- ▶ Creation of local governance by enforcing the existing rules and by setting new ones, if necessary, and implementing them through firm monitoring
- ▶ Improving raw material marketing system, horizontal and vertical information flow and cooperation (promoting to auction system) and arranging pricing to be based on quality as Western and Asia experience
- ▶ Not only legally prohibiting household level slaughtering but also promoting and practicing modern and responsible abattoirs, attracting “big” local and export (meat) packers, incentivizing and promoting live animal exporters to meat and meat product exporting activities by working on market linkage, capital investment and training, etc. so as to increase the quantity and to keep the quality of hide and skin production and recovery rate, to shorten the chain (to cut out non value adding actors) and to improve accessibility of the input to tanneries and create business contracts, the way to coordination etc. This is more feasible idea than trying to approach in training and awareness and coordination of the mass and scattered private producers across the nation.
- ▶ By working with households, improving the livestock fertility rate, husbandry practice including health care (the lion share to the off-take rate is death) which lead to achieving high quantity and quality of raw hides and skins.
- ▶ Supporting tanneries to expand and adjust their facilities to use hide raw materials more intensively and using price sensitive local and foreign markets
- ▶ Being committed at least temporarily to omit the indirect tax refund system on raw materials as the efficiency of the system to refund seem less competitive
- ▶ Tackling of working capital eroding factors like longer inventory holding period in chemicals and accessories say by amending and making workable the bonded warehouse incentive scheme, giving OSS service for the sector
- ▶ Retreating at least temporarily to allow hide crust exporting while de-incentivizing or prohibiting of local sales of leather products from skins so as to improve the current export performance

- ▶ Expanding (investing on) price sensitive footwear, including shoes from synthetic rubber and textile inputs, so as to make the local market less lucrative and more competitive against leather shoe makers
- ▶ Designing a clear/written export development strategy that are free from antagonistic directions with the tactics of matchmaking and global governance linking

Figure 7: Generic actions ladder to the value chain upgrading



Source: own compilation

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Annexes

I: Questionnaire Applied for Tanneries and Shoe⁶⁵ Factories Survey

Company name.....Your position in the Company.....

1. Which are your common **experiences** in your business practice? Please tick your position in a cell of a column.

delays	hardly ever	rarely	some- times	often	nearly always
Major delays due to compulsory warehousing/ trans-loading facilities					
Major delays due to pre-shipment inspection for export					
Major delays due to pre-arrival document inspection /activities for import					
Major delays due to maritime transshipment, if any					
Major delays due to the availability of criminal activities, say existence of threat to drive at night					
Major delays due to poor coordination /communication between actors in the chain					
Major delays due to incomplete document submission by you which in turn due to lack of information to fulfill requirement					

⁶⁵ This questionnaire is also basically applied for shoe factories survey except for some important modification

2. From your 2010/2011⁶⁶ financial and commercial data, please fill each of the given spaces with relevant figure that match with the specified unit, or with the **relevant unit you may specify**. (e.g. *ft² by unit piece, Birr by USD etc.*)

Parameters	Unit	figure
Total installed production capacity (for both hides and skins) as of 2010	ft ²	
Total annual (2010/2011) production/sales plan	ft ²	
Total annual actual input(raw hides, skins and intermediates) processed/ in 2010/2011	ft ²	
Annual costs to buy the different raw inputs + VAT:	hide	Birr
	sheep	Birr
	goat	Birr
Total annual inbound logistics (service costs like transport and other official charges in sourcing the raw inputs)	Birr	
Total annual costs to purchase the local and imported chemicals and other consumable inputs used to process the inputs	Local	Birr
	Imported	Birr
Total annual logistics cost to source the local and imported chemicals and other consumable inputs	local	Birr
	imported	Birr
Total annual cost of direct labor to process the raw inputs	Birr	
Total labor hour annually used	hour	
Annual cost of capital (depreciation of machine, equipment etc.)	Birr	
Total capital investment (on machinery, technical facilities, human capital etc.) of the company (total book value of machines and other fixed assets)	Birr	
Total annual overhead costs (administrative, distribution, maintenance, utilities, lease, rents profit tax etc.) of the company	Birr	
Annual gross sales revenue based on average factory gate price (EXW), average price the customers willing to pay for your total annual products	Birr	
Total annual cost of distribution and other costs of the firm's outputs (outbound logistics) to the local and export market:	local	Birr
	Export (FOB)	Birr
Annual average factory gate price (EXW), for your single “ major finished product ” per unit ft² ; please take in this case <u>leather for upper</u> as a representative product	Birr	
Opinion 1: What is the average annual price that the final consumer pays for a unit product, usually paired shoes; made from your intermediate ‘ major ’ product?	locally	Birr
	foreign	Birr
Opinion 2: What is the average total annual cost incurred by your intermediary buyers (manufacturer and marketer) to make ready and available this unit product (paired shoes) for final consumer?	locally	Birr
	foreign	Birr

⁶⁶ It can mean also ‘Sene’a 2002/2003 E.C.

3. CSF's mirror questions for comparing of the views of buyers and producers

Parameters/ CSF's	Scale of requirement				
	1	2	3	4	5
Improvement to the current products quality/ standard					
Faster deliveries than the current lead-time					
Reliable deliveries/consistency in standards, volume and lead time/					
Reduction in prices					
Improved productivity in factors of production					
Increased flexibility (flexible in sales volume)					
Variety of product lines/product mix variations					
Innovative product by your own R&D or design centre					
Distribution channel preference (air line cargo or shipping line)					
Compliance with mandatory environmental standards (TBT)					
Compliance with global labor standards (safety, min wage etc.)					
Other parameters, (put separately and rate Accordingly)					

Annex II

A. Annual Data (2009/2010) Excerpted from the Survey of Large and Medium Scale Leather Industry; Tanning and Dressing of Leather; Manufacture of Footwear, Luggage and Handbags

Opinion distribution of 96 establishments in the sector by 1st major reason (i.e. No1 problem) for not working at full capacity

	Type of reasons							
	Shortage of raw materials supply	Shortage of spare parts supply	Absence of market demand	shortage of credit facility	Lack of foreign exchange	Lack of adequate skills	others	Not stated
No of firms	38	3	9	3	2	1	4	36
%	39.58	3.13	9.38	3.13	2.08	1.04	4.17	37.50

Source: CSA Statistical Bulletin 2011

B. Annual Data (2007/2008) Extracted from the Survey of Small Scale Leather Industry Manufacturing; Manufacture of Footwear, Luggage and Handbags
First Major reason for not working at Full capacity during: 2000 E.F.Y (2007/08)

	Type of Reasons								
	Absence of market demand	Lack of working premise	Shortage of raw material supply	Absence of credit facility	Spare part supply shortage	Lack of forex	Lack of skill	others	total
Number of firms	16	11	7	3	1	-	-	6	44
%	36.36	25.00	15.91	6.82	2.27	-	-	13.63	100.0

Causes of Lack of Market: 2000 E.F.Y (2007/08)

	Causes of Lack of Market					
	Unable to compete local product in price	Unable to compete foreign product in price	Unable to compete foreign product in quality	Unable to compete local product in quality	others	total
Number of firms	17	4	3	1	8	33
%	51.51	12.12	9.09	3.03	24.24	100.0

Source: CSA Bulletin 2010

Annex III: The existing and the pipeline capacities for tanneries and shoe manufacturing companies

No.	Name of the tannery	Installed Soaking capacity a day, pcs			Installed Crust capacity a day, pcs			Installed Finishing capacity a day, pcs		
		Sheep skin	Goat skin	Cattle hide	Sheep skin	Goat skin	Cattle hide	Sheep skin	Goat skin	Cattle hide
1.	Ethiopia Tannery	12,000	2500	1300	12000	2500	1300	12000	2500	1300
2.	Dirre Tannery	6,000	0	600	4500	0	600	1500	0	600
3	Hafede Tannery	5500	3500	500	3500	3000	200	2750	1750	150
4	Walia Tannery	4000	3000	300	4000	2000	300	4000	2000	300
5	Batu Tannery	2000	1000	1000	2000	1000	1000	2000	1000	1000
6	Mojo Tannery	2500	3200	200	1375	1760	108	825	1056	66
7	ELICO	9000	6000	800	9000	6000	800	6000	4000	800
8	B/Dar Tannery	3000	0	100	2000	0	100	2000	0	50
9	Blue Nile Tannery	3000	2000	0	2000	1000	0	2000	1000	0
10	D/Birhan Tannery	4500	1500	0	2400	600	0	1500	500	0
11	Addis Ababa Tan	1000	0	900	500	0	450	1000	0	900
12	Sheba Tannery	4000	2000	600	4000	2000	600	5500	2500	1000
13	Kolba Tannery	6000	3000	400	3600	2400	400	0	0	0
14	Bale Tannery	0	0	600	0	0	300	0	0	300
15	Kombolcha Tann.	0	0	0	1000	1000	0	0	0	0
16	Hora Tannery	4700	0	0	0	0	0	0	0	0
17	Galan Tannery	3000	1000	0	1500	500	0	0	0	0
18	Dessie Tannery	2500	3000	0	0	0	0	0	0	0
19	Abbay Tannery	2500	1500	0	0	0	0	0	0	0
20	Mesako Global	2400	600	0	0	0	0	0	0	0
21	Shewa Tannery	6000	500	0	0	0	0	0	0	0
22	Mersa Tannery	5000	5000	500	3000	3000	300	3000	3000	300
Total		88,350	39,300	7,800	53,875	25,760	5,808	47,675	21,706	7,166
Skins Total		127,650			79,635			69,381		
under investment capacities										
No.	Name of the tannery	Installed Soaking capacity a day, pcs			Installed Crust capacity a day, pcs			Installed Finishing capacity a day, pcs		
		Sheep skin	Goat skin	Cattle hide	Sheep skin	Goat skin	Cattle hide	Sheep skin	Goat skin	Cattle hide
1	China Africa Over Sea	5425	2795	0	5425	2795	0	5425	2795	0
2	Sun Industrial	1650	850	0	1650	850	0	1650	850	0
3	Ariston Holota	2000	0	0	2000	0	0	2000	0	0
4	Blossom	0	0	0	1320	680	0	1320	680	0

5	Crystal	0	0	0	5000	2000	1000	5000	2000	1000
6	Kedir Mohamad	2000	1000	600	0	0	0	0	0	0
7	FriendShip Tannery	10000	5000	0	10000	5000	0	10000	5000	0
8	Farida Tannery	5000	2000	0	5000	2000	0	5000	2000	0
Total		11,075	4,645	600	15395	6325	1000	15395	6325	1000
Skins Total		15,720			21,720			21,720		
G/Total		99,425	43,945	8,400	69,270	32,085	6,808	63,070	28,031	8,166
G/Skins Total		143,370			101,355			91,101		

Company Name	Production capacity in pair/8hr
Anbessa Shoes Share C.	3000
Peacock Sheoes	2500
Ramsay Shoes	2000
Wallia Shoes	900
Kangaroo Shoes	1000
Ras Dashen Shoes	800
Tikur Abay Shoes Share C.	2500
Ok Jamica Shoes	800
Bostex Plc	500
Ara Shoe factory	1550
Sheba shoes	2000
Total capacity	14,500

Source: LIDI 2010/2011 Report

Annex IV: Assumptions and Facts:

- On average, a piece of wet salted hide from Ethiopian breed weighs 16kg which is about equivalent to the average weight of 12 Ethiopian breed wet salted skins (sheep or goat).
- On average, it is possible to produce about 24ft² finished grain leather and 10ft² split finished leather from a piece of cattle hide, 4.5 ft² finished leather from a sheep skin and 4.0ft² finished leather from a piece of goat skin.
- 16.6265ETB=1.00USD after devaluing by 20% as of Nov 30/2010 (GTP doc.)
- 1ft²=0.0929m²
- On average, 17.40ETB=1.00USD in 2010/2011
- On average, 17.60USD=1.00USD in 2011/2012