Making market systems work? For the poor?

JÖRG MEYER-STAMER

In contrast to recent emphasis on simply creating an enabling environment, the 'Making markets work for the poor' approach emphasizes that specifically targeted interventions are needed to make markets work for the poor. This article analyses the concepts underlying the M4P approach. While sympathizing with the approach as such, it argues that it needs a clearer perspective on market failure and on poverty, as well as a sound conceptual understanding of the relationship between market, hierarchy and network. It suggests that M4P should not spend an exaggerated effort on research but rather go for participatory, pragmatic, quick-win oriented action research.

THE ISSUE OF PRO-POOR DEVELOPMENT has recently been conceptualized around the problem of market failure. Markets often do not work well for the poor. This insight is the starting point of the 'Making Market Systems Work for the Poor' (M4P) approach. It does not share the view that creating an enabling environment is a sufficient condition for pro-poor growth, a view that is advocated by institutions like the World Bank (*World Development Report*, 2005). While underlining that an enabling environment is crucial, this approach acknowledges that focused interventions are needed to make markets work at all, and that specifically targeted interventions are necessary to make them work for the poor.

Specifically targeted interventions are necessary to make markets work for the poor

M4P has evolved from the BDS discussion of the late 1990s. The BDS discussion was based on the observation that the established donor approach for private sector development was not particularly effective. One of the main causes was the fact that it ignored existing business service markets, and indeed often created unfair competition to existing service providers through subsidized governmental business promotion programmes and organizations. The traditional approach to business development was a typical example of the donor approach 'need as the problem, supply as the solution, civil service as the instrument' (Pritchett and Woolcock, 2004, p193). With the BDS approach, the pendulum swung to the other extreme, emphasizing the need for market development yet not clearly defining the role of government in this process. Today, 'BDS market development terminology is fading in favour of a vocabulary that explains how market development can help the poor benefit from economic growth. What was understood as BDS markets are increasingly called business service markets, commercially viable solutions, or support markets' (Miehlbradt and McVay, 2005, p2). M4P shares with BDS the emphasis on market development, but it has at the same time a wider and a less clearly defined scope.

Jörg Meyer-Stamer is Founder and Partner with mesopartner Gmbh. This article is based on a study prepared for the GTZ Pilot Project 'Innovative Approaches to Private Sector Development' (Meyer-Stamer and Wältring, 2006).

The M4P approach

There is little doubt that markets in developing countries often do not work well for poor households. For instance, Prahalad and Hammond (2002, p6) found that households in one of Mumbai's shantytowns pay between 20 and 1000 per cent more for a variety of products and services than households in an upper middle-class neighbourhood. Traditional development policy tended to substitute markets with other modes of co-ordination, especially product and service delivery by government. More recent interventions addressed the macroeconomic environment, but not necessarily specific markets, and in particular not the way markets work for the poor. This is the point of departure of the M4P approach.

Recent interventions address the macroeconomic environment, but ignore the way markets affect the poor

The M4P approach has been promoted in particular by DFID, SIDA and the Asian Development Bank. With the M4P approach, they aspire to make their private sector development approach more pro-poor, thus aligning it with the Millenium Development Goals. The market concept of the M4P literature is summarized in Figure 1.

What this figure tries to depict is the fact that the functioning of markets depends on two sets of factors. Intangible factors (lower semicircle) include formal and informal rules. Tangible factors (upper semicircle) include infrastructure and other services, i.e. institutions in the terminology used by institutional economics. Both tangible and intangible factors are shaped by government, the private sector and its organizations, the third sector and informal networks (outer circle).

A specific element of M4P in this respect is the focus on institutions. What is meant by this? Quoting Ferrand, Gibson and Scott (2004):

> 'What are the most important formal rules impinging on the market and the poor? How do they impact on the market? They include:
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> - Generally applicable rules such as contract, property, consumer protection, weights and measures, health and safety, competition and tax laws. These are not market-specific but may be most important in shaping markets.

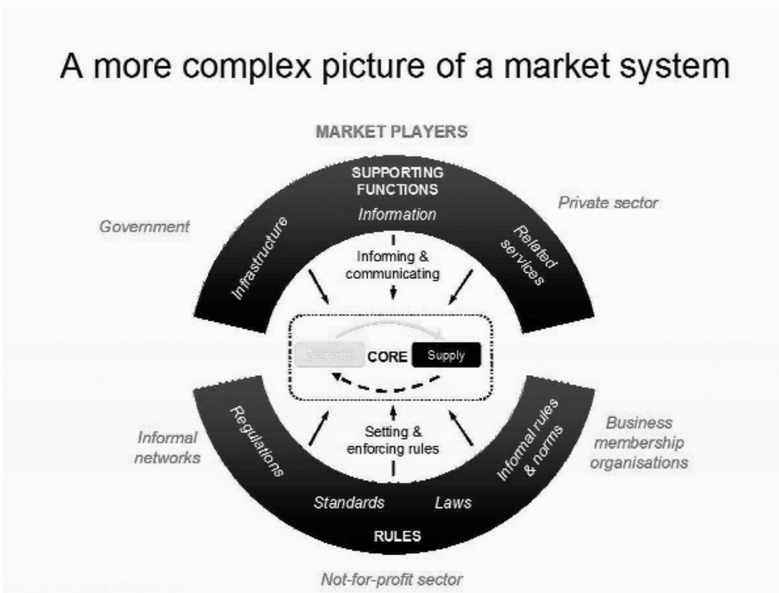

Figure 1. The market concept of the M4P literature.
Source: Presentation given by Marshall Bear, November 2005.

- Sector-specific rules such as banking law, electricity and telecommunications acts and land use and ownership laws.
- Non-statutory regulations such as industry codes of good conduct, quality standards and registers.

What (and who) are the most important formal mechanisms for enforcement of rules? How do they impact on the market? They include, for example, commercial justice institutions, government systems of regulation, inspection and licensing, tax authorities, company and land registries, industry regulators, local government tax offices, and self-regulation mechanisms in business associations.

What are the most important informal institutions impinging on the market? How do they impact on the market? The actual way in which rules are interpreted and applied is often shaped more by social norms and practices than the letter of the law. Where formal rules and their application are weak, the business environment is governed by the informal. For example, the general impracticability of commercial and contract law often means that business transactions become focused within established networks. In Africa, it is recognized widely that existing networks and trust – arising from particular conditions – are a key hindrance to trading and to collaborative business arrangements.'

The weakness of contract law often means that business transactions become focused within established networks

In a development policy perspective, the M4P approach effectively distinguishes three intervention levels (e.g. DFID, 2005):

- The micro level, where the focus is a creating functioning markets and effective BDS structures.
- The meso level, which, though it remains conceptually somewhat fuzzy, consists of para-governmental structures that are funded by external donors and that substitute defunct or ineffective national government structures in developing countries.
- The macro level of generic framework conditions, in particular the legal framework and the rules and regulations that guide its delivery.

At first glance, one might see an intrinsic problem of the M4P approach. Markets are about allocation, not about distribution. While 'making market systems work better' is an immediately plausible proposition, '... for the poor' apparently is not. The M4P literature overcomes this problem by looking at market systems, i.e. the interaction between markets and other forms of allocation, notably hierarchy (i.e. through government interventions or by the activities of major corporations). Moreover, the 'better' is not to be understood in the sense of 'better for the poor than for everybody else' but rather in the sense of 'better than so far'. The M4P literature points out that markets are often distorted or rigged in a way that benefits only a small group of the already well-off, and that levelling the playing field creates new opportunities for the not-so-rich.

The M4P approach looks at market systems

The M4P literature explicitly addresses different markets: not only product markets, but also, for instance, the labour market. The labour market is undoubtedly one of the most important markets in terms of making the economy more pro-poor. Distortions in the labour market are one of the most important reasons for persistent marginalization and poverty, not only in developing countries but also, for instance, in the US (Rosenfeld, 2002).

The argument of the M4P concept can be summarized in two points:

- Development-oriented interventions need to create effective markets, rather than distorting or substituting them in the way traditional donor interventions often did. This point takes the key insight of the BDS approach as its point of departure and applies it in a more comprehensive manner.

- Priority must be given to those market adjustment activities that have a strong pro-poor effect. The M4P approach emphasizes the need for systematic research in this respect.

Some interventions are permanent in nature since the market will never take care of them

A significant part of meso-level interventions is temporary in nature and needs to be designed in a way that does not compromise the phasing-out of interventions as a given market begins to work effectively. However, many M4P documents neglect the corollary, namely that some meso-level interventions are permanent in nature since the market will never take care of them; typical examples include, for instance, some activities in the field of quality assurance, certification, testing and calibration.

In the body of literature on M4P, Dorward and Kydd (2005, 16 ff) are the only authors who relate to this line of reasoning. They observe that it can be entirely unrealistic, and indeed self-defeating, to take the principle of making markets work too far. They highlight the fact that highly fragmented markets can lead to prohibitively high transaction costs while at the same time creating barriers to entry that reinforce critical bottlenecks. One of the examples they provide is 'asset specificity'. If an entrepreneur buys a truck to transport mangoes, but it turns out that there are not many mangoes to be transported, she can still use the truck to transport, say, bricks. But if an entrepreneur invests in a highly specialized canning operation for mangoes, the absence of mangoes creates a serious problem. Therefore, in a competitive market with high information cost and little direct communication between market participants, entrepreneurs may hesitate to invest in anything that displays a high asset specificity. Dorward and Kydd present hierarchies, be they government institutions or private sector organizations, as a necessary complement to markets.

Hierarchies such as government institutions are a necessary complement to markets

Conceptual weaknesses: The market

The M4P approach is still at an early stage of conceptual development, and it is still searching answers to important conceptual as well as practical issues. One of the features of the M4P literature is its close connection to the BDS discussion and literature. Unfortunately, BDS did not really have an understanding of markets that was firmly rooted in microeconomics concepts. BDS, and especially BDS market assessments, is the market research world of A.C. Nielsen and Philip Kotler, not the world of the National Bureau of Economic Research and Joseph Stiglitz. Fortunately, the M4P literature also draws on other arenas of discussion, such as rural development economics which have developed insights into the functioning, and the frequent dysfunctionalities, of markets (Dorward and Kydd, 2005). What appears to be a nicely functioning market in the real world often turns out to be the opposite, once closely scrutinized. For instance, Geertz (1992) has shown that bazaars are quite dysfunctional markets, where price formation is extremely non-transparent and thus the price mechanism, the best feature the market has to offer, does not work properly. Dorward and Kydd (2005) point out that atomized agricultural markets in African locations create such high transaction costs that they are ultimately dysfunctional, too.

What is missing in most of the M4P literature are references to the widely accepted insight that markets are one out of three forms of coordination, the other two being hierarchies or organizations, and networks or communities. While economics research has formulated the market, hierarchy, network models of co-ordination (Powell, 1990; OECD, 1992), social scientists tend to distinguish market, organization and community (e.g. Wiesenthal, 2000). What is important in both strands of theorizing is the observation that in the real world it is highly unlikely that any pure mode of co-ordination will work. When a market does not work, the adequate answer is not, in all likelihood, more market but rather more hierarchy or organization, for instance in the shape of an anti-trust body (legislation to prevent monopolies that set prices) that dismantles monopolies that have spontaneously emerged from market processes.

It is essential to look not only at the markets but also at hierarchies or organizations and at networks or communities

The market analysis framework that is suggested in the M4P literature (see Figure 1) does not capture this conceptualization in an adequate way. In order to understand why markets work or, more frequently in poor countries, do not work, it is essential to look not only at the markets themselves but also at hierarchies or organizations and at networks or communities. There is no hierarchy between the three modes of co-ordination. Since they are ideal types that in a pure form are unlikely to work, and since in the real world we will usually find mixed forms where one of the three modes is stronger than the others, we need to understand the factors that underlie each of them and the interaction between them. Ultimately, this would require the application of a more comprehensive concept, such as systemic competitiveness (Esser et al., 1996). A first attempt to adapt it to the 'making market systems work' perspective is given in Figure 2 (see also Meyer-Stamer 2005, especially p17 ff). This framework addresses the ability of societies to generate structures that are actually capable of creating functioning markets, something that continues to be an issue of high importance since the diagnosis that developing countries tend to suffer from weak states and weak markets (Messner and Meyer-Stamer, 1992) is still valid today.

Yet another important issue is the fact that the M4P literature does not provide a systematic treatment of market failure, i.e. imperfections that keep real world markets from operating in the way assumed by simple

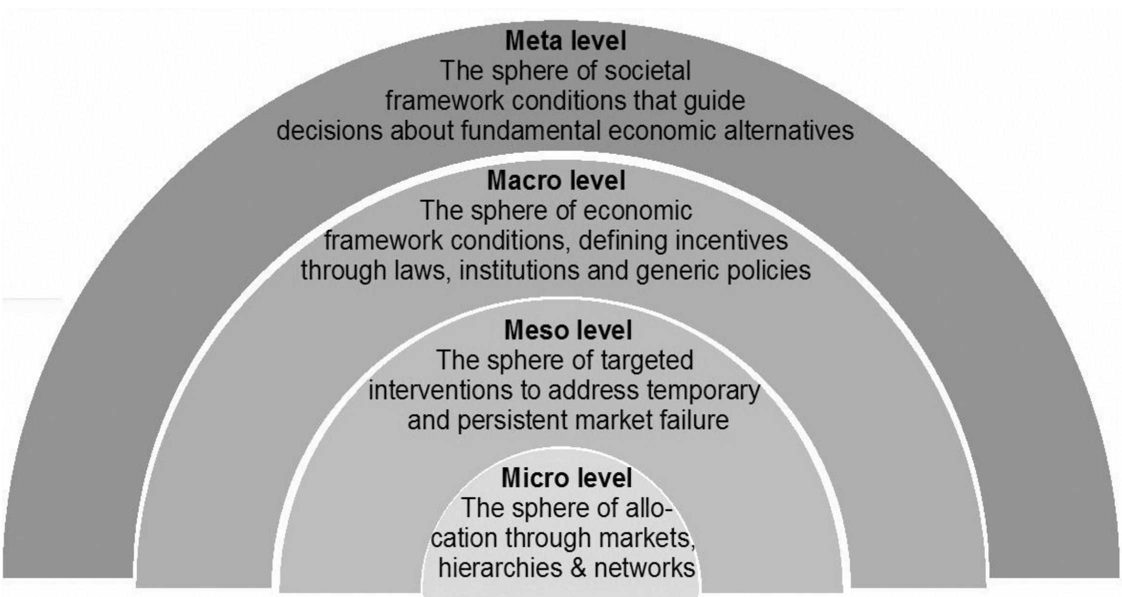

Figure 2. The four levels of systemic competitiveness

Table 1. Types of market failure

Type of market failure	*Example*	*Consequence*
Natural monopoly	Telecommunications in rural, thinly populated areas	Customers in rural areas pay much higher price for telecom services than urban customers, perhaps have no service at all, and suffer from delays in access to innovative telecom services
External effects	Investment in skills development	Companies invest less in the skills development of their staff than would be desirable from a macro perspective
Indivisibility	Size of a container (minimum 39 cubic meters) that needs to be filled by supplier	Small producers cannot connect to customers because the don't produce enough to fill a container
Asymmetric information	Information about residual toxics and other contaminants in fruit and vegetables in the absence of sophisticated and costly testing equipment	Customers don't buy fruit or vegetables if they suspect that producers have used more agrochemicals than they admit
Public goods	Availability of sophisticated and costly testing equipment in a region with predominantly small producers	Producers can't convince their customers that the level of residual toxics is low, and thus can't sell their products

microeconomics models. Table 1 gives an overview of the main types of market failure.

Market failure has three main consequences:

- It generates a low-level equilibrium. The examples given in the table explain how market failure issues can reinforce each other and thus keep rural producers disconnected from markets. Income stays low, investment capacity is low, there is little if any innovation and upgrading and producers remain mired in poverty.
- It generates suboptimal delivery of critical investment, for instance into skills development or research and development, thus reinforcing the competitiveness gap that keeps producers and companies from upgrading so that they might connect with dynamic markets.
- It creates barriers to entry, thus reinforcing monopolies and the high prices and service delivery shortcomings that come with monopolies.

Understanding market failure comes through researching markets, not market research

Any effort to make market systems work for the poor must be based on a sound understanding of market failure (and the economic, political, social and cultural factors underlying it), and it is important to understand that such understanding is generated through research on markets, not through market research. If and when thorough analyses must be conducted, they need to investigate the root causes of market failure, since only in this way is it possible to design scientifically precise interventions that go beyond fumbling with the symptoms of market failure. The M4P discussion may have something to learn from the discussion on privatization in this respect; for instance, Brücker and Hillebrand (1996) offer an excellent overview of market failure and options in addressing it. From a social science perspective, the issue of 'embeddedness' of markets (Granovetter, 1992) in social structures is something that should be elaborated much more strongly and consistently in the M4P literature.

Conceptual weaknesses: The poor

The M4P literature is somewhat blurred when it comes to 'the poor'. It neither introduces different levels of poverty, from relative income poverty to absolute destitution, nor does it explicitly explain whether it is based on a static or dynamic concept of poverty. It also avoids the simple fact that the poorest of the poor, the 'destitute', will not benefit from M4P because they have neither assets nor access to the labour market. Recent literature has pointed to a number of ways to get a differentiated picture of poverty. Let us look at two of them.

First, discussions in the SEEP network led to a typology of the poor that addresses the question: To what extent are the poor likely to be producers that are active in markets? This perspective, illustrated in Figure 2, looks at poor producers. The main argument is that the destitute, i.e. the poorest of the poor, are unlikely to enter into markets as producers. It is important to note, though, that in the M4P literature, the term 'private sector' does not only refer to businesses but actually to all economic actors that are not public sector, i.e. all types of producers as well as workers. Nevertheless, the SEEP typology is helpful since it points out that only a section of the poor, namely those who are close to the poverty line, are likely to enter markets as producers.

> Only a section of the poor are likely to enter markets as producers

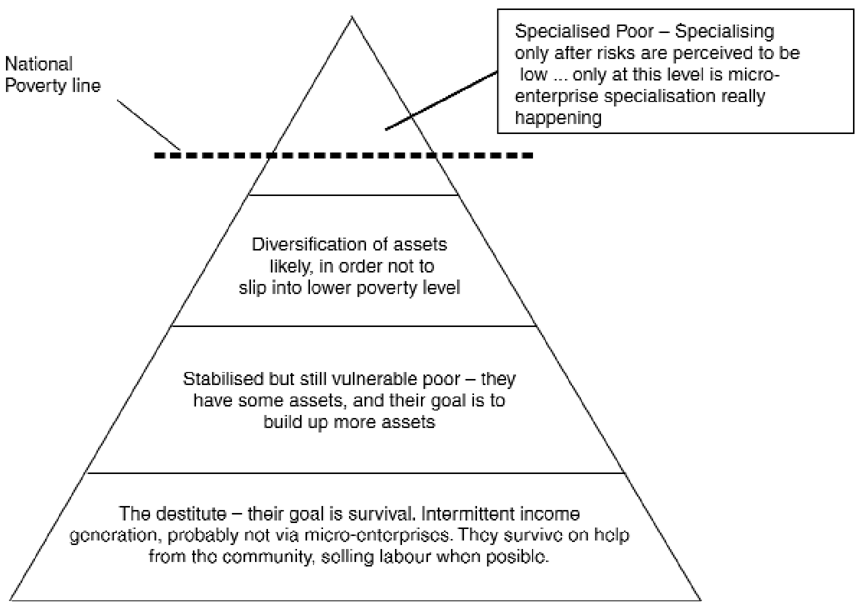

Figure 3. The context of poverty and microenterprise development (Eiligmann, 2005)

Second, even with a narrow concept of poverty, growth will not automatically benefit the poor. It is crucial to address the geographical and sectoral pattern of growth. Poverty is often concentrated in specific regions, in particular rural regions, and in one sector, namely agriculture. This argument is developed in detail by de Janvry and Sadoulet (2004), based on evidence from Latin America:

> 'There is increasing differentiation between two types of locations for rural poverty: MRA (marginal rural areas) and FRA (favourable rural areas).
>
> Some of the rural poor are geographically concentrated in low population-density marginal rural areas defined as areas with either poor agroecological endowments or isolated from markets and employment centres. The other section of the rural poor are socially diffused in FRA (favourable rural areas) defined as areas with good agro-ecologies and good connections to dynamic product or labour markets. The poor in this context are:
>
> - Individuals with low asset endowments, especially land, education and social capital.
> - Individuals with good asset endowments, but lacking opportunities to valorize these assets in the territories where they are located (lack of regional dynamics, discrimination).
> - Rural youth, elderly people, and disabled individuals for whom social assistance programmes are needed.'

Pro-poor policy must have a strong territorial focus

This perspective provides a much more tangible understanding of types of rural poverty. The authors' conclusion is: 'These contrasts between favourable and unfavourable areas (and the continuum of conditions in between) points to the relevance of a regionally differentiated approach that takes into account this heterogeneity.' In other words, any pro-poor policy must have a strong territorial focus.

Conceptual weaknesses: government

Developing countries, and in particular poor developing countries, suffer from the fact that their hierarchies tend to be weak; and this includes not only government but also major private corporations. Advising government in a poor country that it should make markets work as much as possible is certainly a valid proposal. But this advice does precisely nothing to address the weakness of hierarchies in that country. The advice to make markets work, and to make sure that they work for the poor, has a more tactical than strategic quality.

The first dilemma is then that you need a strong state if you want to have strong markets across the board (and not only in a limited number of fields where they emerge spontaneously, even in a non-state like Somalia). The second dilemma is that many markets in many developing countries don't work effectively because the ruling élite at national or local levels does not want them to work. This is part of what meant by terms like 'patrimonialism', 'clientelism' and 'nepotism'. 'A fundamental obstacle to economic development in all states, not only dictatorships, can be posed by groups whose political power is threatened by progress' (Hoff and Stiglitz, 2000, 425). To a significant degree, market distortions exist, and create anti-poor markets, because of the interests of the rich and powerful to sustain riches and power.

Many markets don't work effectively because the ruling élite does not want them to work

The M4P literature is silent about this issue. In the way it is summarized in the most recent concept paper (DFID, 2005), the M4P concept even fails to address the issue of sustainability of intervention vehicles / structures for market alignment. It establishes high requirements on the effectiveness of government structures, yet delivers no visible contribution to strengthening government structures. In fact, existing government structures in partner countries are effectively sidelined with DFID's programmes like ComMark in Southern Africa. In Nigeria, DFID's PrOpCom acts like any meso-institution anywhere that has decided to build a powerful value chain on the basis of currently weak, fragmented structures, very similar to what, say, Scottish Enterprise has done since 1999 in its 'Scottish Food & Drink' initiative, except that at some stage PrOpCom will terminate, while new types of market failure will continue to emerge.

Another issue is that not everybody trusts that markets in themselves are an effective and efficient mechanism to co-ordinate economic processes. Some development actors, and many government officials, are very concerned about the fact that markets work without anybody micromanaging and controlling them, since this is precisely what they like to do. In their view, the self-organization capability of the market is highly suspicious, not least because they are frequently confronted with efforts to rig markets and they thus assume that markets are rigged as a rule. The conclusion is then that rather than leaving the rigging of markets to dubious business persons, government should come in and manage the market in a way that benefits the nation and its citizens. In fact, we often observe in our practical work that development practitioners have an intuitive preference for hierarchy, particularly government. They also have a preference for networks, not the least because of the thrust to pursue a participatory approach. But they do not trust markets. For M4P proponents, it is essential to understand and address the fundamental doubt many development practitioners harbour regarding markets, rather than assuming that everybody understands the elegance and efficiency of decentralized co-ordination through markets. It is also important to address the interaction between markets, hierarchies and networks in a consistent conceptual way, perhaps drawing on the experiences of M4P projects that appear to address all three modes of co-ordination.

Many government officials are concerned that markets work without anybody micromanaging them

Practical issues

The M4P approach emphasizes the need for analysis. According to DFID (2005, 19):

'The M4P approach will draw upon the following types of data:

- Poverty reports including household surveys and PPA surveys.
- Specific market and transactions studies using participatory and other techniques to complement existing poverty data.
- 'Doing Business' and Investment Climate Surveys.
- Trade, production and price data.
- Market outcomes and data from the operation of value chains.
- The rate and direction of the evolution of key markets for the poor, especially the: process of market deepening and the expansion of the access frontier; crossing of key thresholds for participation, outreach, choice, economies of scale and sustainability; and the effects of cross-market linkages.'

The M4P literature so far does not provide any practical tools to analyse market failure efficiently

In other words, the M4P approach involves a rather comprehensive effort in conducting studies, more comprehensive indeed than the already quite comprehensive 'BDS market assessments' of the recent past.

While emphasizing the relevance of market failure and the need for market adjustment tools, the M4P literature so far does not provide any practical tools that would permit efficient analysis of market failure. A development practitioner who needs to prepare Terms of Reference for a consultant who is supposed to analyse market failure is pretty much left to her own devices. The M4P literature names some types of market failure, such as public goods and externalities, market power and economies of scale, asymmetric information, and the costs of establishing and enforcing agreements (DFID, 2005). However, we have not been able to locate a toolkit that would guide practitioners in identifying market failure, understanding the underlying reasons, and finding efficient and sustainable means of addressing it.

Conclusions

The M4P approach is concerned with market adjustment. It is explicitly pro-poor. It aims at improving the effectiveness of market mechanisms, so that barriers to entry are lowered and more economic opportunities are created. The poor may become small business owners or employees in emerging or growing businesses. Moreover, more effective markets are expected to lead to lower prices and thus an increase in the effective purchasing power of the poor.

The M4P approach is, both conceptually and practically, an important move in developmental practice. It is not a development strategy, though. 'Making market systems work for the poor' is a pragmatic proposition. Co-ordinating through hierarchy or a network is a costly, time-consuming activity, whereas a functioning market does not require active governance. From a development practitioner's perspective, making a given market work implies that she can leave it to its own devices and move on to address another development challenge or opportunity. Given the scarcity of resources, this is an attractive proposition.

At the same time, it is almost trivial to note that any society and economy will involve a combination of markets, hierarchies and networks for

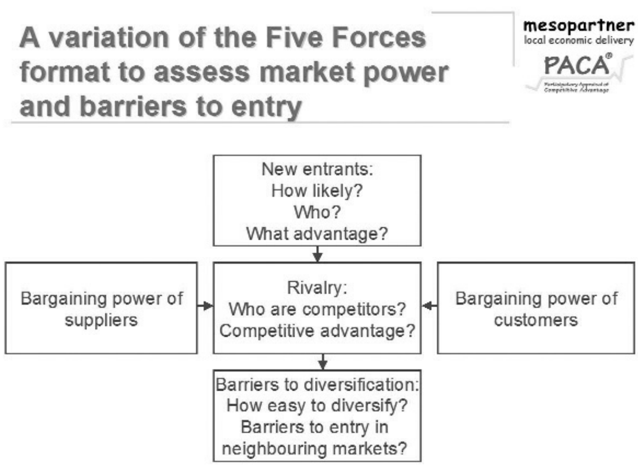

Figure 4. A variation of the Five Forces format to assess market power and barriers to entry

Markets will only function if property rights are secure

its functioning. When a given market does not work, the solution is not more market but more hierarchy, and rather more effective hierarchy, such as an effective anti-trust body. For instance, we should not forget that the existence of very competitive markets in the EU is to a significant degree the result of a strong and powerful hierarchy located in Brussels. Also, markets will only function if property rights are secure, something that requires a strong state with a monopoly on the use of force.

The next steps that are required to make sure that the intrinsic potential of the M4P approach can be realized are the following:

- Develop a coherent conceptualization of market failure that is based in microeconomics and economic sociology rather than marketing.
- Assess the existing literature on poverty and consolidate it in a way that is digestable for development practitioners.
- Develop a concept of the interaction between market, hierarchy and network that is immediately useful for practitioners, for instance through a tool that helps them to check whether a given co-ordination task is best solved through market, hierarchy or network.
- Develop toolkits for analysis of markets and market failure, and organize exchange of experience among practitioners using them.

Regarding the last point, our practical experience (e.g. Meyer-Stamer, 2003) has shown that it is possible and useful to analyse market failure at a territorial level, i.e. in local or regional economies, in a quick yet structured way. A possible angle is to look at barriers to entry, as many instances of market failure will ultimately manifest themselves as barriers to entry. A useful tool is a modified version of Michael Porter's Five Forces Analysis (see Figure 4).

The modification refers to the bottom box, which looks at barriers to diversification (into related products, spatially neighbouring markets, or a neighbouring market segment) instead of substituting products. The other four forces are directly related to market power and barriers to entry, i.e. they generate information about possible market failure. While incumbents may hesitate to highlight the barriers to entry they are creating, business people are usually more than happy to complain about the barriers to entry they are facing, and this is why the changed bottom box is useful.

In fact, action research that uses tools like this in interviews and mini-workshops with business people from a local subsector can offer a shortcut to the analysis of localized market failure, and pave the way for practical action. Barriers to entry are sometimes the result of anti-competitive behaviour. Frequently, though, they are the result of co-ordination failure. For a territorial development initiative, addressing this kind of market failure offers the opportunity to achieve quick yet significant wins.

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