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From trust to transformation: How institutional trust can drive local value chains and structural transformation

by

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How institutional trust can drive local value chains and structural transformation


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It is a privilege to present this policy note, 'From Trust to Transformation: *How Institutional Trust Can Drive Local Value Chains and Structural Transformation*,' at a time when geopolitical tension and political instability continue to impact commodity-dependent developing countries. From an economic perspective, two things strike one straightaway: first, the focus on institutions and the trust people have in them represents an opportunity to improve value addition along value chains. The second obvious feature is that if this trust in institutions is not strengthened, it can be accompanied by significant risks that warrant careful consideration.

In the remainder of this note, we explore why and how institutional trust is important, based on the reasonable assumption that building trust can drive local value chains. We offer brief lessons on how institutional trust enhances structural transformation in commodity-producing countries. For what it's worth, our aim is to highlight how essential it is for policymakers to optimise the benefits of institutional arrangements in building resilient and diversified economies. We conclude by emphasising that addressing existing policy gaps and staying ahead of emerging challenges is crucial.

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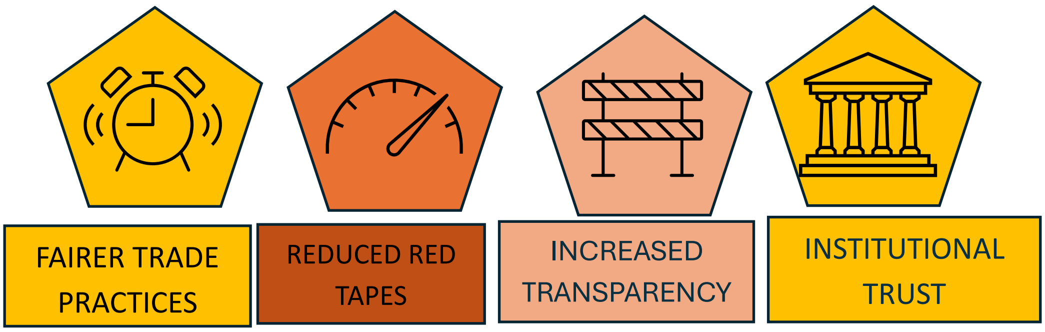
1. Context

Why and how is institutional trust important? How does rebuilding institutional trust drive local value chains? And how do the processes involved in repairing institutional trust enhance structural transformation in commodity-producing countries? Answering any of these questions requires taking a longer view. If that view is clouded by the inability of institutions to create the incentives needed to produce higher value-added products, reduce dependency on exports, and mitigate the impact of price volatility, then there is a danger that we will be unable to progress further. And we bring news on this front that, unsurprisingly, these questions are particularly challenging to address when institutional trust is viewed through the lens of local value chains in commodity-producing developing countries.

The most trite question is what are institutions and what is institutional trust? Institutions are the formal and informal rules, norms, and structures that govern social, political, and economic interactions. They include entities like governments, legal systems, markets, and organisations that create the frameworks within which societies operate. Institutions shape behaviour by providing guidelines and expectations for individuals, organisations, and communities. Institutional trust on the other hand, refers to the confidence that people or groups have in these institutions to act fairly, transparently, and efficiently. It reflects the belief that institutions will uphold rules, protect rights, and ensure stability, cooperation and long-term economic and social development

In reviewing the merits of understanding institutional trust, we note that one of the key advantages of having robust supply and value chains is their ability to enhance economic stability and resilience in commodity-producing countries. Taken separately, supply chain refers to the entire system involved in producing and delivering a product or service. This includes everything from the sourcing of raw materials to the manufacturing processes and the final delivery to consumers. In contrast, value chain covers all the activities that add value to a product or service throughout its production process, from conception to delivery. It includes both the supply chain and additional activities that enhance the value of the product. A significant challenge in this line of research is that when institutional trust is not established, stakeholders within local supply and value chains—such as farmers, suppliers, manufacturers, and consumers—are less likely to engage in collaborative relationships. After all, the presence of institutional trust within any society promotes transparency, reduces transaction costs, and encourages investment in both human and physical capital. That's the theory. The evidence suggests that, taken on its own, Ethiopia's coffee sector success showcases the transformative power of institutional trust. But a key question previously presented is the extent to which Ethiopia could achieve such a feat. In Ethiopia, government-led reforms have increased transparency, reduced red tape, and ensured fairer trade practices in their own right—turning a once inefficient industry into a booming export powerhouse. Using these insights and based on available evidence, we can see that Ethiopia's growing collaboration with related external institutions, such as the International Trade Centre, is further strengthening its position in the global market. This will substantially increase the export of higher-value coffee products made from its world-famous beans. Already, while green coffee exports are worth about $20 billion globally, Ethiopia produces about 7% of the world's coffee. This, so to speak, represents opportunities for thousands of livelihoods, a large percentage of export earnings, and a significant source of domestic consumption.

FIGURE 2. ETHIOPIA'S INSTITUTIONAL PILLARS



Our point worth noting is that, in terms of both Ethiopia's pace and scale of earning more from value-added tightening, we believe institutional trust is at its core. Why? A few reasons stand out for us. First, unlike in other commodity-dependent producing countries, when institutions are trusted, value chains strengthen, market access expands, and entire communities benefit. Second, the scale of Ethiopia's coffee boom illustrates how rebuilding institutional trust can drive structural change and unlock local industries' full potential. This no doubt reflects the underlying potential of targeted, institution-led policies, which are most obviously useful in supporting the transformation of raw commodity exports into higher-value products. But it also likely reflects specific ways in which institutional arrangements drive value addition.

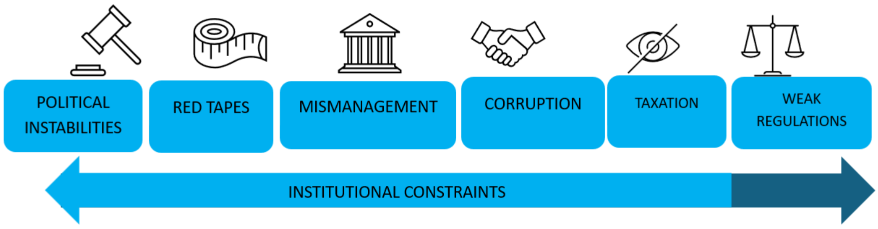
2. Institutional trust as a pillar for development

But this is not to say that there aren't other success stories. The overall attractiveness of Colombia boosting value-added coffee exports isn't just a stand-out from an international perspective. Development in Uganda's economic implementation of policy measures to attract investment in value-added processing of cotton is also noteworthy. At the same time, Indonesia's national mining policy seeks to significantly increase downstream manufacturing and domestic value, in addition to Brazil's national programme promoting ethanol production by offering incentives such as reduced costs and stability, including lower risks for producers. These four examples are by no means exhaustive, but we think they may be the biggest examples of improved institutional arrangements and the trust they have been able to promote. So, it seems that one reason for this could be the different government responses in promoting a strong regulatory framework and incentives to diversify the economy.

We would like to explore why this might be the case. Economic institutions that facilitate mechanisms to drive value addition are often different from those that do not offer the same. One such feature is that in countries with weak institutional arrangements, barriers play a crucial role at every stage of the value chain, which are sometimes insurmountable but are a product of dysfunctional arrangements. This is because institutions create different incentives for commodity markets and commodity-dependent developing societies, and this, in turn, determines whether they can compete internationally. Barriers include corruption, expensive approvals, and the many red tapes that must be cut through, as well as a lack of fiscal incentives such as tax breaks and duty exemptions, and operational constraints.

Corruption accounts for most of the issues facing many commodity-dependent countries and creates barriers to investment in local industries. It plays a key role in determining the extent to which the mismanagement of natural resources has eroded public confidence, making it difficult for governments to build the long-term partnerships needed for structural transformation. Therefore, understanding what drives corruption and how it can be tackled is crucial to restoring trust in overall institutions.

FIGURE 2. **Constraints Corresponding to Weak Institutional Deficiency Across Commodity-Dependent Countries**



3. Outlook and assumptions

At the heart of our outlook for institutional trust are some assumptions: corruption in resource-rich countries tends to lower trust in government institutions and limits the effectiveness of public policies designed to promote development. This is a very delicate balance and can lead to political instability, which is often fuelled by conflicts over resource control, further weakening institutional trust. In many commodities dependent countries-specifically those within Africa- power struggles over natural resources have led to governance failures, thereby disenfranchising local communities and undermining the potential for value chain development. It is worth noting that many of the regulatory inefficiencies we list here, such as weak enforcement of contracts, poor infrastructure, and inadequate financial systems, exacerbate the problem of institutional trust by discouraging domestic capital growth. While the magnitude of these issues may differ across various weaknesses in institutions, the general trends of discouraging employment and reducing technological innovation, including incentives to sustain economic development, remain constant.

But that is not to say we have nothing to learn from these assumptions. On the contrary, in the face of advancing local value addition and developing regulatory frameworks aligned with national plans, we prefer to emphasise that, in order to address all those crucial questions we listed earlier—on institutions, how they drive local value chains, and the need to repair trust to enhance structural transformation—policymakers need to ensure that institutions are strengthened. That said, to further explain our stance and offer insight into our current thinking, we note that rebuilding institutional trust requires stable, transparent, and inclusive governance structures. And we believe that this will be useful for ensuring equitable resource distribution and fair participation from all stakeholders in the economic process. Of course, this will further encourage diversification in commodity-dependent developing countries.

Again, it may not be news to many that strong institutional policies imply setting mandatory regulatory due diligence for operators, traceability and certification arrangements for stakeholders in value chains, and increased transparency, all of which enable them to compete more effectively in both domestic and international markets. What might be less well-known is that a persistent weakness in institutions means that, without trust in them, efforts to build robust and sustainable local economies often collapse under the weight of corruption, inefficiency, and political instability. The inescapable conclusion, therefore, is that strong and efficient institutional trust forms the foundation for robust value chains.

This naturally brings us to the issue of structural transformation and our remaining assessment of the immediate conjuncture. For what it is worth, structural transformation involves a shift from an economy predominantly based on agriculture or raw material extraction to one driven by manufacturing and services. What is distinctive here is that, in the context of commodity-dependent producing countries, structural transformation is necessary to break the over-reliance on exporting raw materials and instead build domestic industries capable of adding value to these resources. We see merit in the fact that transformation requires not only technological advancements and infrastructure development but also institutional reform that encourages local production and investment. That said, and for the reasons above, we emphasise that structural transformation requires a strategic focus on building strong institutional trust to enable sustainable economic growth and development. We also need to be alert to the fact that implementing robust industrial policies that prioritise local content and capacity building is essential. For us, this need for caution points to the promotion of local content laws; as seen in Nigeria and Ghana, this serves as a crucial first step, yet scaling these initiatives across various sectors remains challenging.

It is clear that strong institutional trust is essential in this context, and we have learned that it enhances the legitimacy of policies and collaboration among stakeholders. However, with the right structures in place, we need to double down on efforts to improve our institutions so that we can build trust by ensuring that government actions are transparent and inclusive. Looking ahead, policymakers should engage the private sector and civil society in a shared vision for economic transformation to allow businesses to flourish and drive the structural transformation necessary for long-term economic resilience. This is the best way to support resilient and competitive institutions and strong, commodity-producing developing economies.