



Università degli Studi di Ferrara

DIPARTIMENTO DI ECONOMIA, ISTITUZIONI, TERRITORIO

Corso Ercole I D'Este n.44, 44100 Ferrara

Quaderni del Dipartimento

n.24/2003

Serie "America Latina"

Quaderno n.10

**An Integrated Approach for the Development of SME Clusters and its
Policy Implications for Developing Countries: the Case of Nicaragua**

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November 2003

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Abstract

This paper analyzes the most important theoretical approaches to SME cluster development and their influence on policy making. Its context is the author's five year personal experience of SME clusters in Nicaragua. The paper discusses the strengths and limitations of cluster development approaches, and integrates the findings into a comprehensive framework for analysis and policy development. The author hopes that his conclusions can respond to the difficulties encountered by international and local development agencies in promoting significant growth within local production systems. In particular, the paper responds to the apparent failure to involve the "real society that exists behind the market" in the development process of SME clusters. Taking the social environment into account would increase local people's reactivity to economic policies and instruments and make them more effective.

Keywords: SME clusters, industrial development policy, social policy, Nicaragua, developing countries.

J.E.L.: B0, B2, O0, O2, P0, P4, R1, R3

Acknowledgements

I would like to thank Roger Sugden and Jennifer Tann, of the Business School at the University of Birmingham for their valuable comments on earlier versions of this paper. I also appreciate the excellent suggestions offered by Patrizio Bianchi, Dean of the Faculty of Economics at the Ferrara University, Nadya Delgadillo and René Mendoza of the Central American University in Managua, and the colleagues and students that participated to the EUNIP Conference in Vienna, the Central American School in Industrial Development and SME Policy in Managua and the Summer School in Industrial Development Policy in Ferrara where earlier drafts were presented.

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Introduction

Evidence shows that SMEs are not individually successful, but flourish by working together. They combine forces and exploit joint scale, scope and agglomeration economies that permit them to compete with larger firms in the global market. Such enterprise networks are important in developing countries. National governments and international cooperation agencies however do not often adopt such models in their development projects.

Historically, the most relevant SME clustering experience concerns the late nineteenth century industrial districts of Victorian London (e.g. jewelers, watches) as studied and theorized by Marshall (1916). Similar industrial conglomerations have grown and developed in the centre-north of Italy since the 1970s, and are known as the “Third Italy” (Bagnasco, 1977). In the past two decades, these have been among the most studied cases of dynamic local production systems, and have motivated a number of theorists to study and develop different analytical and policy approaches.

This paper investigates the most important theoretical approaches to SME clustering in order to identify the most important variables for better understanding this economic reality and its development process. It also substantially identifies the way these different perspectives influence the policy development framework.

The work is motivated by a doubt. The literature on SME clusters in developing countries refers mainly to a limited number of successful cases. Since the lessons that are drawn from these cases may be distorted, doubts have arisen about the true understanding of development processes in a wider variety of SME clusters. This reservation is confounded by the limited success of international and governmental agencies in promoting the development of competitive industrial districts and clusters in developing countries. It is possible that current theoretical, methodological and policy frameworks need to be modified to take into account the lessons learned from a wider variety of clusters, most of which are not particularly successful (Altenburg and Meyer-Stamer, 1999; Asheim, 1994; Knorringa, 2002).

Some theoretical approaches are considered benchmarks in the field of SME cluster development. For practical purposes, we have arbitrarily stylized them into four

approaches on the basis of their key concepts. These approaches, which can be called “spontaneous”, “macroeconomic”, “governance” and “social” are discussed in detail in the next four sections.

In recent years, the main multilateral international organizations and cooperation agencies have started applying a systemic approach to SME territorial development¹. In doing so, they seem to have adopted mainly the “spontaneous” and “macroeconomic” approaches. Experiences from several Nicaraguan SME clusters demonstrate that these approaches alone are not sufficiently effective. The same result may extend to other developing countries. An explanation could lie in the basic hypothesis of this study, that limited results could be due to the low consideration attributed to the governing environment (i.e. local power structures and institutions) and to the social features of the “real society that exists behind the market” (Platteau, 1994).

The basic features of the four approaches are highlighted below. The Nicaraguan evidence is then considered, and the four approaches analyzed with reference to their impact in this country. In the final section, a brief discussion is offered on the consequences for policy-making in developing countries.

2. The “Spontaneous” Approach to the Development of SME Clusters

Over the past decades, the mounting difficulties caused to developing countries by the internationalization of markets has motivated neo-liberal think-tanks to criticize the old approach of import substitution industrialization. This has led the main international organizations to apply free market policies such as the elimination of trade barriers, inflation and exchange rate management, the reduction of state deficits and privatization programs (Krueger, 1983; Bueno et al., 1986; Singh, 1992).

Over the past 20 years, this approach enjoyed widespread recognition within academia and the relevant international agencies, among which there exists an important

¹ The United Nations Industrial Development Organisation (UNIDO) was the first organization to work systematically in this area by organizing entrepreneurial networks (Schmitz and Humphrey, 1996; Ceglie and Dini, 1999). The Economic Commission for Latin America and the Caribbean (Hernández, 2003) has also done so and, more recently, the Inter-American Development Bank (IADB) started a project on SME clusters and global value chains (Pietrobelli and Rabellotti, 2003).

group of development theorists dedicated to the study of SME clusters. They recognize the prime role of the market in the development of these networks. For them “the answer is unequivocal...effective demand has been the transforming force” of local production systems (Schmitz; 1995: 553-554; Brusco, 1990). These theorists take the international economic system for granted and consider market demand to be the driver behind the dynamics of growth at the cluster level (Humphrey, 1995: 1; Bessant & Kaplinsky, 1995: 129-130; 139; Nadvi & Schmitz, 1999: 1503).

These development theorists refer to the “Third Italy”² as the main reference point for their analyzes and growth models. In this context, development of the European Common Market in the 1970s was the catalyst for the structural upgrading of SME clusters from simple agglomerations of craft enterprises to the well-known “industrial districts” (Brusco, 1990: 12).

The same theorists indicate that the early growth and success of industrial districts was a result of the “spontaneous” capacity of small firms to create linkages among themselves to enable them to respond flexibly and efficiently to growing market demand. This refers mainly to inter-firm cooperation along the value chain through an accurate and competitive division and specialization of labour among firms (Brusco, 1990:11-13; Piore and Sabel, 1984; Best, 1990; Lazerson, 1990).

From the mid-1980s onwards however, this was no longer sufficient. Competition, stronger due to market globalization, forced the districts to develop new working methods based on innovation, marketing, information and communication technologies. In this new stage, “industry requires support from local and regional institutions in order to speed up innovation, expand into new markets and thus consolidate growth” (Musick and Schmitz, 1994: 902).

Blending together the main aspects of the current and previous phases of industrial district development, the “spontaneous” theorists focus on “industrial reorganization” as key to increasing the competitiveness of both individual firms and the cluster as a whole. (Humphrey, 1995:6) states however that although “the discussion on industrial organisation may appear to be narrowly focused...it has far-reaching

² This concept was elaborated by Arnaldo Bagnasco (1977), who described the economy of the Centre-North of Italy as being centered on geographical agglomerations of SMEs.

implications for the core issues of industrial development” The primary importance of this concept is based upon the key role assumed by fluid inter-firm and intra-firm linkages within the cluster. These allow the SMEs to reap increasing benefits from the spontaneous phenomena of co-operation, external economies, flexibility and market responsiveness, which are the main thrusts to the growth of SME systems (Schmitz, 1992; 1994; van Dijk et al., 1994).

Industrial reorganization has consequences for the most appropriate policies for local industrial development, which themselves emphasize the role of local economic intervention. In this sense, the experts agree that policy should prioritize the delivery of real services to local producers as a way of enhancing the economic efficiency of the local system (Brusco, 1990: 16-17; Capecchi, 1990; Schmitz and Musick, 1994: 903-904; Schmitz, 1995: 553)³.

3. A “Macroeconomic” Approach to SME Development

The second category of our four approaches to SME cluster development is neo-liberal in nature and has had the strongest influence over developing country policies in the past twenty years. Its most representative applications are the structural adjustment programs implemented by the World Bank. These have been based upon the conviction that "if the fundamentals are right", the economy allows the market to work efficiently and produce the highest possible rates of growth and welfare for the community as a whole. In this sense, the market mechanism needs to be oiled by eliminating all barriers to trade, private investment, price regulations, and so on (World Bank, 1993).

Through this logic, SMEs and their clusters will benefit from market liberalization since it involves the elimination of all kinds of production and market discrimination suffered by SMEs in relation to larger firms (e.g. subsidies and fiscal incentives directed to large exporting companies). Moreover, an efficient allocation of (state) resources,

³ Starting from a different approach of analysis, other schools of thought (e.g. Economic Geography and Regional Studies) arrive at similar conclusions. Indeed, they also focus on the importance of regions in the new global market and on a parallel need for policies at the intra-regional level (Audretsch, 1998; Scott, 1998; Garofoli, 1992; Pecqueur and Silva, 1992).

within the Heckscher-Ohlin comparative advantage theoretical framework, justifies and strengthens the traditional specialization of SMEs in labour intensive production (Krueger, 1983; Balassa et al., 1986).

Rather surprisingly, a recent and thorough analysis of fourteen Latin American countries, by the Economic Commission for Latin America and the Caribbean (ECLAC), seems to confirm the neo-liberal hypothesis (Peres and Stumpo, 2000; 2002). This study analyses the impact of a few possible determinants of SME performance during the 1980s and 90s, among which are market liberalization, macroeconomic stability, and industrialization and SME policies.

The outcome of this research shows the negligible effects that industrial production and market liberalization have actually had on SME competitiveness. With reference to SME policies, negligible efforts have been implemented by Latin American governments, which make this variable useless to explain SME performance (Peres and Stumpo, 2000: 1647-52).

In contrast, Perez and Stumpo emphasize the relevance of the macroeconomic environment on SME performance. In particular, they highlight the determinant effect that inflation and economic growth have had on output during the 1980s and 90s. This result seems to correspond to conditions in the local markets in which firms typically sell their goods. With more stability and slower prices hikes, risks are lower so producers invest more and increase their output.

With this evidence, they conclude that "...possibly the most constructive step would be to overcome weaknesses in the implementation of support policies (for SMEs), in addition to creating macroeconomic conditions for price stability and sustained economic growth, which is no small thing to ask in Latin America at the end of the 1990s" (Ibidem, 2000: 1653).

In this sense, the neo-liberal and neo-structural approaches to SME development seem to lead to the same policy conclusions. The free market is an environment that can promote the development of SMEs, provided that the state guarantees economic stability through the control of important indicators such as inflation, growth, exchange rate, interest rates, etc.

4. The “Governance” Approach to SME development

A third important means for SME development derives from political economy. For some theorists, effective local development requires appropriate national and international institutions, strategies and policies. Otherwise, efforts to expand face a series of bottlenecks linked to the existence of “regressive coalitions” and “transnational powers” that tend to marginalize SMEs and their local business associations (Bianchi, 1998; Cowling and Sugden, 1997; 1999).

These theorists show that specific agents in the system, such as the SMEs and their associations, can encounter enormous difficulties in trying to grow. This is due to the path dependency that exists in this context which limits the options available (Puffert, 2000). In such a framework, the strongest agents use the market to maintain control over resources and decision-making. The major capital advantage that they enjoy permits them to invest in more innovative and costly activities (e.g. investments in R&D, promotion campaigns) that contribute to strengthening their edge over weaker competitors (Cowling and Sugden, 1997: 126-127).

These considerations explain why policy intervention matters as a means for changing “path” and allowing new entrants into the market. In this sense, proponents of the “governance” approach affirm that competitive industrial districts succeeded not only on the basis of the spontaneous efforts of SMEs, but also thanks to the robust involvement of policy-makers at the international, national and local levels. The benchmarking experience of the “Third Italy” proves this hypothesis. In fact, the first Italian nationwide laws for the support of craft enterprises were introduced in the 1940s, for SMEs as early as 1952 (Arrighetti and Serravalli: 1997: 358; Brusco and Paba, 1997: 324; Bianchi, 1992: 191) and were supported over time through a rich set of national and regional laws for SME development (Bertini, 1998: 317; Capecchi, 1990; Bellini, 1996)⁴.

⁴ Aspects of governance have been recently analyzed from another perspective, represented by new studies of experts from the “spontaneous” approach, on the relation between global value chains and the process of cluster upgrading. They have identified the need to distinguish among different types of cluster governance (e.g. hierarchical, network, market type, etc.), due to the particular insertion that these governance systems

The policy direction consequently taken by the “governance” theorists emphasizes a multi-layered approach in which the previous policies, advocated by the “spontaneous” and “macroeconomic” approaches to SME cluster development, are merged with national and international legal frameworks that protect the interests of SMEs and their clusters. In this sense, building up an efficient set of business associations and real services is important, but needs to be complemented with national and international institutions, and rules and policies that favour the development of SMEs and their local production systems (Bianchi, 1998; Sugden and Wilson, 2000).

5. The Social Approach

5.1 The Social Embeddedness of Economic Action

Certain sociologists, in discussing the social embeddedness of economic action, have proposed important considerations for the development of SME clusters. Simultaneously, other sociologists and economists, in directly studying the environments of SME clusters, recognize the importance of certain sociological aspects in their success.

The first group emphasizes the need for a new perspective that attempts to understand “the social embedding of economic action” and the context that lies “behind the market, where real societies exist” (Granovetter, 1985, Platteau, 1994). These wider analyzes of development would help to take into account the “social rationality of economic actors” (Dore, 1983), who act not only to maximize earnings or control

guarantee within global value chains. Upgrading opportunities for local firms and clusters depend strongly on the type of governance. For example, product and process upgrading tend to be easier in the context of “quasi-hierarchical” systems (i.e. clusters led by one or few large firms), while functional upgrading becomes easier in “network” systems formed by SMEs only (Humphrey and Schmitz, 2000; Gereffi, 1999). In terms of the policy framework, these theorists uphold the “spontaneous” approach, by emphasizing the importance of local policies in the specific case of network governance systems and the difficulty in influencing hierarchical systems.

markets, but for reasons related to existing social rules and institutions that acquire a strategic importance in specific territories.

Their analytical work discusses particular national societies and social features, such as the Japanese "goodwill", that takes the form of "obligational contracting" and "welfare corporatism" (Dore, 1983: 464-6; Sako, 1992), or the Italian "City-States" that take the form of "merchant guilds" (Platteau; 1994: 560). These are examples of national and local environments that have been able to construct strong social linkages and behavioural rules that support the development of SME clusters.

In this sense, policy frameworks are proposed to restore "moralized trading relationships", such that "these would spur the role of competition policies and job-tenure rights as opportunities for developing a sense of the community in business enterprises" (Dore: 1983: 480). Complementarily, they recognize the need for mechanisms of "co-ordination and enforcement required for thriving trade", which were organized by the merchant guilds in Italy. For this purpose, the state should take the role of leading the system towards a renewed "honesty... by organizing and strengthening information-pooling systems...enacting rules and designing measurement devices that ensure uniformity of interpretation and narrow down the scope for fraud opportunities" (Platteau: 1994: 566).

This approach captures the importance of emphasizing earlier aspects of co-ordination and enforcement in moralized trading relationships as a way of easing systemic economic efficiency. Nevertheless, it leaves unanswered what actually encourages local economic agents to stay together and reach a higher competitiveness as a coordinated unit (i.e. the cluster). This aspect is analyzed in the next section through a stream of literature that stresses the aspect of trust in industrial districts.

5.2 Trust in Industrial Districts and SME Clusters

There is a group of sociologists and economists interested specifically about the social features that characterize SME clusters⁵. They highlight the role of the cooperation

⁵ A few of them use this analysis to confirm the hypothesis of the "spontaneous" approach to SME cluster development (Schmitz, 1999; Nadvi, 1999; Dei Ottati, 1994; Humphrey and Schmitz, 1998).

among local actors which characterizes successful SME clusters and districts. Such social factors partly explain what compels economic agents to stick together and work as a coordinated unit.

These theorists study factors that facilitate economic transactions and constitute key aspects of the Marshallian industrial atmosphere. In this sense, they underline the concept of trust as a facilitator of economic transactions which allows firms to reduce their operating costs and creates what is known as the cluster's "collective efficiency" (Lorenz, 1992; Dei Ottati, 1994; Schmitz, 1999; Nadvi, 1999).

These scholars highlight the role of the local social environment in the creation of an "ascribed" type of trust, which turns out to be a key aspect of the spontaneous growth of the cluster in its first phase of development. The shift to an "earned-type" of trust however provides the foundation for a more advanced stage of industrial development, in which the district finds itself amidst more competitive global markets. In this phase, a new type of trust arises to gain competitive advantage and to overcome "the costs of non-cooperating" (Schmitz, 1999). This new type of trust seems based upon a sort of "cost and benefit analysis".

Regarding trust, this analysis of the social environment of SME clusters can take two directions. The first links the creation of trust to the social environment of small town clusters, in which people create their own norms of behaviour and interaction (Taylor, 1982, in Lorenz, 1992: 196). The second ties trust to the continuous interactions that take place among economic agents in these small towns. Repetitive interactions reduce the risk of opportunistic behaviours, since the system is more likely to punish free-riders (Axelrod, 1984, in Platteau, 1994: 546-7; Lorenz, 1992: 198).

The first interpretation of trust follows the "spontaneous" approach to SME cluster development, which leaves little room for strategic intervention beyond local policy-making. In this perspective, the social environment is local-specific and scarcely possible to replicate elsewhere, at least within the required timeframe for development. That is why it is preferable to focus on more manageable economic issues.

The second interpretation of trust presents a different type of conclusion, since in some cases trust can be built up with assistance from institutions at the state and local level. An interesting example is the creation of a dynamic furniture cluster in Ceará, the

north-eastern state of Brazil, out of public procurement contracts and technological assistance from the state organisation SEBRAE (Tendler and Amorim, 1996). This second perspective on trust incorporates the creation of a proactive social environment that promotes growth in local SME systems.

The second perspective correlates with the sociological school of industrial districts, whose theorists recognize the importance of the “Marshallian industrial district as a socioeconomic notion” (Becattini, 1990; 2000; Bagnasco, 1988; 1999; Trigilia, 1992; Brusco, 1982). They stress the importance of “the spread of family-based agricultural smallholdings (e.g. sharecropping, peasant firms), helping to create the original supply of a cheap and flexible workforce, whose skills and motivations were well-suited to the development of small business”. Moreover, they indicate the relevance of local political traditions and institutions, such as the Catholic Church and the Socialist and Communist movement in the early twentieth century (Trigilia, 1992: 36-37; Bagnasco, 1999: 93-94; Capecchi, 1990).

Relevant studies emphasize the significance of these forms of social capital as a basis for economic democracy and competitiveness (Putnam, 1993; Locke, 1995). If policy-making does not take trust into account, social capital can be destroyed (Bagnasco, 1999: 75). The theorists reaffirm the need to “construe” the social environment in local production systems as part of a competitive industrial strategy.

“It is necessary to stimulate the creation of strong interlocutors within civil society...The political construction of them is an essential part of the development strategy because these organizations might eventually internalize the advantages deriving from the production of collective goods and might, as a result, develop a longer-term view of individual interests, inducing them to cooperate more effectively...Unless a more autonomous and better-organized civil society is created and unless a more autonomous and technically trained bureaucracy emerges, any new policy is liable to prove inefficient and to stimulate the growth of political entrepreneurship rather than economic development” (Trigilia, 1992:46-47).

In spite of these peculiar considerations, policy making tends to follow a well trodden path. Within this stream of the “social” approach, regional development is enabled through policies aimed at encouraging the creation of collective goods that lead

to the spread of technological know-how, trade promotion, business skills training, worker training, and so on (Trigilia, 1992). Interpreting these words however, economic development is less a result of social forces applied to market, and more the result of economic mechanisms and agents coordinated in an efficient way.

5.3 The Social Strengths of SME Clusters

Our analysis now turns to the “black box” of society. This is important since the analysis of economic issues alone cannot explain all the effective elements that promote dynamism in SME clusters.

For example, let’s discuss the issue of “self-realization” as a social force that promotes cluster dynamism. Under certain approaches, this aspect could be analyzed through the economic concept of “entrepreneurship”. In our view, however, this is insufficient because strong entrepreneurship does not only depend on economic variables (e.g. maximization of incomes, financial incentives or market opportunities), but also and mostly on social rules and institutions. In dynamic SME clusters (e.g. Italian industrial districts) this is shown by people’s desire to set up their own businesses, to be their own boss, to decide their own timetable, products, clients, suppliers, workers and to be in a position to succeed on the basis of their own skills and capacities. These aspects cannot be understood through an analysis of the economic incentives to entrepreneurship.

They represent an individual’s move to “self-realization” that takes place in SME clusters. In other societal contexts (e.g. big cities), people dream of careers in large companies and institutions. In SME clusters, usually within rather small towns, the status of being an entrepreneur is very much respected and considered a desirable position. These individual choices, although often contradictory to economic objectives, are nevertheless important factors in decisions to create their own firms .

That is why we need to investigate the social characteristics of successful societies. What social features can help SME clusters to develop? In our view, two main forces are at work: social cohesion⁶ and self-realization. With reference to the first for

⁶ This concept can be understood in the same kind of way as that of “self-realization”. Using only economic concepts such as “joint action” and “participation” would not explain why local societies tend to cluster and

example, there is a close link to the concept of trust. The afore-mentioned literature (5.2) emphasizes the concept of trust as “oil” that facilitates transactions.

Research by Schmitz concerning the passage from ascribed to earned trust indicates that trust changes, “comes and goes”, depending on particular social and economic conditions (Schmitz, 1999). In his study, ascribed trust comes from ethnic ties, while earned trust stems from economic advantages. Although their origins are very different, both represent trust. Trust is a sort of “homogeneity” in the behaviours of local people that helps the working of the economy, because it makes the people understand each other easily and thus lowers transaction costs. It does not seem to matter upon what the trust is based, as long as all local agents know each other and share common social and economic values (Dasgupta, 2002: 35).

In this sense, a wider concept than trust needs to be discussed, that of social cohesion. This represents the force that helps a cluster to develop as a unique, collective agent, avoiding internal fractures and dualism. Trust is rather an effect. It is like a beautiful dress, but just a dress, which needs “content” in order to be appreciated. This content is ensured by the individual and collective values and objectives shared within the local community. It refers to the "commons", the "values" or even the “priorities” of local societies at a certain point in time, which define the way people interact with one another (Lorenz, 1992; Dasgupta, 2002). Cooperation, conviviality, family work and personal and collective reputation are representative of these values within a trustworthy society. If these are not agreed upon within the local culture, it becomes hard to produce common development plans and outcomes.

Social cohesion can be an element of a static environment in which people get on well, as often happens in very traditional surroundings (e.g. small country villages). In SME clusters, the widespread adoption of entrepreneurial habits represents a key for collective success. This pushes the locality and its agents however towards dynamic and competitive practices (e.g. innovation, exporting, and credit consortia).

Since social cohesion is not enough to explain the dynamism of SME clusters, “self-realization” needs to be discussed. Thus, the discovery of the social features that

work together through time even in the absence of economic benefits. For instance, entrepreneurs tend to associate to local and national institutions independently from the use that they make of these.

motivate dynamic entrepreneurship becomes essential for policy development purposes. The concept of “self-realization” seems to perform this function well. In fact, many people in SME clusters prefer running their own business rather than participating as an employee in someone else’s. They aim at maintaining an independent business. It is a matter of choice however, since in other contexts many people prefer alternative ways to succeed⁷.

A variety of studies on the history of very successful experiences in the “Third Italy” highlight mechanisms that helped to create a strong social fabric and the corresponding economic concept (i.e. entrepreneurship). For example, the long standing practice of sharecropping and the municipal history of arts and corporations helped peasants and urban dwellers to familiarize themselves in managing economic activities directly and responsibly (Brusco, 1982; Putnam, 1993; Platteau, 1994).

The reading of the Italian, but also of Latin American and East Asian contexts (Kantis et al., 2001) nurtures a complementary hypothesis which points to society being responsible for the approval and implementation of policies, institutions and rules. Understanding the essential social features (including more generally the historical and institutional background) at a given moment in time therefore becomes crucial to determining the potential of SME clusters, and the mechanisms and institutions likely to promote their development process.

In conclusion, “social cohesion” is essential because it permits the system to grow as a unique, integrated agent. “Self-realization” is vital to a dynamic local environment moving towards higher levels of individual satisfaction and collective competitiveness. Having one without the other would generate a suboptimal outcome, because society could end up being static (in the absence of self-realization) or result in an aggregate “zero-sum-game” in terms of local development (without social cohesion). Targeting a set of social policies to support these interdependent characteristics becomes a strategic objective for motivating a proactive social environment to actively respond to and benefit from economic policies.

⁷ It is very interesting that a recent study of the Inter-American Development Bank focused on the main motivations for creating small businesses in Latin America and East Asia. The aspect of “self-realization” comes out as the main motivation amongst the entrepreneurs (Kantis, Ishida et al., 2001).

The next section examines, through the case of Nicaragua, how the different approaches to SME cluster development work in reality, and considers the need to integrate them in a complete framework for interpretation and effective policy-making.

6. Empirical Evidence from Nicaragua

Nicaragua is a developing country which has similar problems to many other Latin American states. GDP, per capita income, exports, trade balances and foreign debt offer little stability, as does the governance environment. Notwithstanding this, a set of positive elements is nowadays visible.

For example, a wave of public investments in basic infrastructure has eased the transportation of production from the countryside to towns and export markets. Astonishing growth of foreign direct investment in traditional manufacturing and agro-industrial products has also occurred. These sector specific factors are complemented by the rather successful management of the main macroeconomic indices such as inflation, the exchange rate and the budget deficit. The end result of these efforts has been the capacity to generate continuous growth over the past ten-fifteen years (BCN, 2000).

Despite these positive indicators, income distribution remains a serious problem, since a large part of the population lives below the subsistence level, often earning a living through informal activities such as petty trading and manufacturing (UNDP, 2001; Speer, 1997). As in many other developing countries, society is divided between a small element able to adhere to international production and consumption standards, and a large majority of the population living below or slightly above the subsistence level and which is anchored to the traditional local economy or to the informal sector (Parrilli, 2003).

In Nicaragua, SMEs are representative of this large sector of the national population that suffers from a lack of higher income opportunities. In this context, a number of small towns form classic configurations of SME clusters (i.e. geographical and sector concentrations of SMEs), with special reference to furniture, milk and dairy products, coffee processing and shoe production (Parrilli, 1999). Conscious of this situation and lack of opportunity, international organizations and cooperation agencies

have been setting up support programs for SMEs alongside the government, national business associations, NGOs and Universities⁸.

In order to assess the impact of public programs on SME cluster development in developing countries, our analysis now turns to searching for evidence of usage of the main theoretical and policy approaches to cluster development.

6.1 The “Spontaneous” approach and its limitations

UNIDO and several government agencies have worked intensely to promote SME clusters in the past ten years. They have adopted what we have called the “spontaneous” approach through programs led by network brokers who try to encourage small producers to work together to find joint solutions to common competitive problems (Ceglie and Dini, 1999; Schmitz and Humphrey, 1996).

After many years of support, the performance of these groups of firms has not improved significantly. Most small firms remain subsistence workshops. They continue to work by themselves, doing everything internally. They often completely omit certain phases of production, or shoddily attempt them internally, rather than subcontracting to or partnering with more specialized SMEs in the cluster (Barahona and Parrilli, 1999; Parrilli, 2002).

On the whole, these firms disregard the benefits of inter-firm cooperation that the institutions have tried to stimulate. This posture may be due to two reasons. The first is linked to the negative attitudes that entrepreneurs hold towards SME clustering. They fear the close presence of other firms due to the risk of losing clients and to the risk of imitation from competitors owing to the absence of legal protection.

The second reason is linked to the market where producers sell their goods. Since this is a poor local market, they are forced to manufacture cheap products. The only way to cope with this condition is by holding down production costs, buying cheap materials,

⁸ Among the most active organizations working for SME promotion in Nicaragua are the United Nations Industrial Development Organisation (UNIDO), the Inter-American Development Bank and the governmental Agencies for Development of Germany (GTZ), Switzerland (COSUDE) and Holland among others.

hiring cheap labour, saving on production techniques and technology and dedicating as little time as possible to producing each final good (Narváez and Parrilli, 2000).

The example indicates weaknesses in the policy approach and possibly even in the theoretical approach. Why is this approach not enough to make small firms compete successfully? Are there any aspects that are being neglected? Is there anything missing that would spur the necessary structural changes in the local organisation of production?

6.2 The “Macroeconomic” approach and its limitations

This has been a commonly applied approach in Nicaragua in the past fifteen years. The economy grew by an average of 5% per annum in the 1990s, during which time the government successfully applied a controlled exchange rate devaluation to hold down inflation. Devaluations of 12% per annum (10% since the beginning of 1999), allowed a sensible reduction of inflation to less than 10% per year (BCN, 2000).

Other fundamental macroeconomic measures have also been successfully applied, among which, trade liberalization has turned Nicaragua into the most open Central American economy. Other measures have included the privatization of state enterprises, improvements to basic infrastructure, control of public expenditure and public deficit reduction.

Despite these successes, the economic performance of SME clusters does not seem to have significantly improved. Low competitiveness is shown by the increasing gaps between imports and exports in relevant production sectors⁹. SME clusters (i.e. the supply side) cannot respond adequately to international and national consumers, (i.e. the demand side) who therefore prefer imported goods, which leads to ever increasing trade deficits.

The growing informal sector is another indicator of the failure of macroeconomic policy to address the problems of competitiveness of SME clusters. Non-existent under

⁹ In recent years, foreign penetration of the Nicaraguan market has increased dramatically, and is quite evident in the case of shoes and furniture. Production for local consumption is about \$3m and for export about \$ 0.5m (furniture) and \$2.5m (shoes). The country imports however \$9.5m (furniture) and \$13.5m (shoes) of these final goods (BCN, 2000).

the former regime, the informal sector is currently estimated to employ around 50% of the economically active population (Agurto and Guido, 2002; Speer, 1997).

These features indicate that this approach to the development of SME clusters also falls short and that certain key aspects are again missing from a more effective development policy framework.

6.3 The “Governance” Approach and its limitations

In Nicaragua, the governance approach to development is tackling some major problems. Regressive coalitions such as the importers and traders of international brands, one of the strongest lobby groups, are fighting for lower tariff and non-tariff barriers to trade. Partly for this reason, Nicaragua has incurred the fastest trade liberalization in Central America, which has led to “tariff perversion”, allowing the entry of imported intermediate inputs with higher tariffs than for the related final goods. This has discouraged national production and led domestic players to import final goods to the national market and therefore become traders themselves (Solórzano, 2000)¹⁰.

Another example of regressive coalitions at work involves financial policy, which affect SME’s access to acceptable credit rates. The oligopoly maintained by the national banks prevents the growing sector of non-conventional financial institutions (NGOs) from collecting people's savings. Opening this market would make the banking sector more competitive and offer lower interest rates to SMEs.

These examples clarify the importance of analyzing a country’s governance system, in this case revealing the conflicts of interest between economic and political lobbies in respect of SMEs, their associations and clusters.

After decades of import substitution policies, aiming to create and support national sector “champions” (Reyes, 1993; Bianchi, 1998), it was only during the late 1980s and early 1990s that successive Nicaraguan governments started to implement policies to support SMEs, at both the national and local level (Bouchier, 1998).

¹⁰ The former Minister of Industry and Trade, Norman Caldera, confirmed the existence of this problem and its negative economic effects for the national industrial sector during a Conference at the Princess Hotel, in Managua, 11th July 2000.

1990, for example, saw the creation of the Program for Supporting Microenterprises (PAMIC), which evolved in 1998 into the Institute for supporting the Small and Medium Enterprises (INPYME). In the first half of the 1990s, the United Nations Industrial Development Organisation (UNIDO) created a program to support both horizontal and vertical groups of SMEs. Another important project, for SMEs involved in furniture production this time, was set up by Nicaragua, Finland and Chile (project “*Nicamueble*”). In 2000, the Nicaraguan Ministry of Development, Industry and Commerce (MIFIC) agreed financing subsidies with the Taiwanese government for the technological upgrading of SMEs (FNI, 1999). International organizations such as the German Cooperation Agency (GTZ) are currently working in close contact with business associations to establish laws to promote SMEs.

Obstacles persist however. For example, only 5% of total amount of available credit under the Taiwanese agreement had been lent to SMEs after two years (BCIE, 2000). After years drawing up a new law for SMEs, it is currently short of the required support to successfully pass through the National Assembly.

The lack of progress of Nicaraguan SMEs begs the question that an important piece of the development mosaic is still missing. The governance approach does however offer insights into understanding the real dynamics behind the development of SMEs and their clusters. At the end of the day though, it reveals neither the type of cluster society “strong” enough to spur significant development, nor its relevant roots and features.

6.4 The “Socio-Economic” Approach and its Novelties

Many attempts have been made in Nicaragua by government and international agencies to spur the development of SMEs and their clusters. Whilst the above examples provide evidence of policy support, firms and institutions are not able to efficiently take up such support.

The analysis of social cohesion and self realization discussed in the theoretical section on the “social approach” provides interesting results. Social cohesion has remained quite low through the past decades of liberalization, as indicated by the feelings that SME producers express about cooperation which they tend to assimilate with the

1980s cooperative system, which was controlled by the state. Market liberalization in fact marked the end of the previously closed economic system and end of the road for its uncompetitive cooperatives. This crisis led many cooperatives to close and caused much conflict regarding the assignation of capital between members, a situation which led the people to acquire a negative stance on cooperation. Nowadays, the fact that the word “cooperative” is hardly mentioned indicates the country’s low level of social cohesion.

At the same time however, market liberalization altered the social and economic prospects of the most dynamic and richly endowed individuals. It inspired them to develop their own initiative, skills and capacities, which had remained dormant under the centralized system. There are several interesting individual cases of producers on a dynamic entrepreneurial growth path in Nicaragua. They are relatively young people, determined to learn and apply the best international practices to their own activity, by investing in technology, buying appropriate materials, hiring and training good workers, and searching for customers outside the local market (Parrilli, 2001; Magfor, 1999)¹¹.

The concepts of “entrepreneurship” and “small and medium enterprise” are not yet however sufficiently respected. Being a small entrepreneur is still associated with “living in subsistence”. Many young people therefore prefer to seek career opportunities elsewhere within large corporations and public institutions (e.g. finance, banking, and international cooperation projects).

For the social approach as a whole in Nicaragua, self-realization through entrepreneurship seems more prevalent than social cohesion. Such individual dynamism will not go far however unless incorporated within a project bringing together all the local economic agents. The economic system would otherwise produce a "zero sum game", with no positive local effects. A few producers would be better off, while the large majority remained in subsistence conditions.

This analysis indicates quite clearly that few “social” approach initiatives have been successfully implemented. Aspects of “social cohesion” and “self-realization” have been left to the spontaneous mood of producers and institutions, a situation which offers local economies little potential to develop.

¹¹ An interesting joint project on innovation between the World Bank and the Ministry of Agriculture discusses a number of dynamic entrepreneurs and commercial ideas in the wood and furniture value chains (MAGFOR, 1999).

7. Conclusions on Policy-Making in SME Clusters in Developing Countries

This paper has discussed the relevance of some important approaches to SME clustering in both the interpretation and encouragement of the development process. The approaches individually highlighted herein are proposed as necessary aspects of an effective integrated development policy scheme.

The “spontaneous” approach proves to be of strategic importance at the local level where action and development in fact take place. It focuses on the responsibility of entrepreneurs and their associations to set up strategic joint initiatives to reap the benefits from collective economies of scale and scope, and from external economies. A “macroeconomic” approach to development is also essential, since it can provide a stable context that facilitates the operations of the local economic agents and the realization of their projects. The “governance” approach is strategic too, since SME clusters need adequate legal and institutional frameworks and tools to overcome the more or less open opposition of competing economic interests. The “social” approach is equally fundamental because it allows us to understand the entrepreneurs on the ground, and their inner motivations and incentives for economic action. This makes it easier to involve them in the development processes and projects in their local production system.

Not applying these four approaches together is an action equivalent to an engineer omitting one of the supporting columns of a large building. Although the building would stand, it would be somewhat shaky and unable to support subsequent extensions. Likewise, SME clusters might always grow with limited support, but will do so at a much slower pace than if they benefit from integrated policy support.

It is important therefore to bring together all the relevant aspects in a framework of industrial development policy. If policy does not involve strategies and actions to strengthen the social environment, local people will hardly benefit from the economic policies in action. The case of Nicaragua seems consistent with this hypothesis. Different sets of policies have had limited success over the past ten to fifteen years, but remain

unaccompanied by actions targeted to prepare and motivate society for their benefits. As a consequence, industrial and SME clusters advance more slowly than necessary.

An integrated policy-making approach involving a social aspect is more likely to produce effective results in the development of SME clusters. This is because such an approach focuses on strengthening the relevant social features (i.e. social cohesion and individual self-realization), which increase the motivation of the local society to actively endorse the economic policies at work.

For example, one of the most common programs in Nicaragua is the “networking program”, which has been encouraged by important organisations such as UNIDO, GTZ and INPYME. SMEs are pushed to work together through the activity of “network brokers” who provide specific support to help them produce, export, participate in trade fairs and so on. No social policy is present however to make these small producers more sensitive to the many advantages of working together. Thus, they remain suspicious about imitation risks and the predatory attitudes of other producers in the cluster.

Within this context, a comprehensive development framework could involve parallel social and networking programs. This could mean creating forums, especially at the local level, in which several agents are invited from local governments to participate in the setting up of a medium to long term development plan. In this way, the producers and their associations, banks, local authorities and support agencies, retailers and service providers are more likely to get to know each other better, and start creating a more cohesive and dynamic “industrial atmosphere” within their SME clusters.

Another application of a more comprehensive framework could imitate the recent trend in development programs of setting up business incubator programs and industrial parks in developing countries and clusters (Kantis et al. 2003; Schmitz and Musick, 1994). These programs have also been discussed and applied in Nicaragua, but with contentious outcomes. In the tanning industry in León, the country’s second town, groups of producers have been pushed to join an initiative supported by the Austrian cooperation agency and UNIDO. It was de-emphasized two years later however and local producers returned to work in their obsolete workshops.

A typical interpretation by producers was that a lack of coordination caused such an outcome. This response seems consistent with comments about the absence of local

social cohesion and a lack of dialogue between the designers of the project and the local people. The hypothesis offered is that people accept the development program as a gift, from the outside, rather than as the final outcome of a participatory decision-making process. This situation occurs because policy-making tends to be a top down process in which SMEs are not involved (Sugden and Wilson, 2000). On the whole, the large majority of the population does not seem strong enough (i.e. socially cohesive and individually dynamic) for a place at the decision-making table.

On this basis, a comprehensive scheme for policy could involve a social program that accompanies the business incubator program at its outset. This strategy would help to prepare and motivate people for the economic program to work effectively. For example, social policy could involve not just some of the ideas mentioned above, but also a campaign inside and outside the formal education system in León. This might guarantee more respect for entrepreneurial action and attitudes enabled by the organization of important local and regional events in which a few successful entrepreneurs and enterprises are rewarded with a local and/or national prize, and are asked to present their success stories in different schools, universities and institutions. This strategy is likely to increase the number of young people, both students and workers, involved in private initiatives and to consequently drive the dynamism of SME clusters in developing countries.

In conclusion, these examples indicate some of the missing links that can be identified in the growth process of SME clusters and that can help to set up effective development policies. An approach to SME cluster development that integrates the relevant and interdependent economic, governance and social targets is more likely meet the objectives of both the development organizations and the local people within a reasonable timeframe.

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