

# Small Firms, Global Markets

Competitive Challenges in the  
New Economy

Edited by

Jerry Haar

and

Jörg Meyer-Stamer

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# 1

## Local Development, Global Value Chains and Latecomer Development

*Peter Knorringa and Jörg Meyer-Stamer*

### Introduction

In the course of the 1990s, the focus of productive sector development changed along two axes. There was a shift from promoting big companies and big development projects to emphasizing small and medium-sized enterprises (SMEs), and there was a shift from national-level development initiatives to localized activities. The clearest indication of these shifts is the demise of industrial policy. Thirty years ago there was little doubt that government had to play a crucial role in sectoral development, including industrial development, both in industrialized and in latecomer countries. Fundamental critiques of industrial policy were fringe phenomena. Much more common was criticism because of too little industrial policy; the political opposition would snipe at government for what appeared as inactivity that led to lost opportunities for wealth creation.

In the course of the 1980s and especially the 1990s, the picture changed completely. Industrial policy became a dirty word. Government intervention in industry was frowned upon. While in the 1980s Japan was still admired for the success of its industrial policy guidance in areas like microelectronics, since the 1990s selective government interventions, never mind guidance, were widely perceived as something that necessarily creates distortions and thus welfare losses (World Bank, 1993; Pack and Saggi, 2006). The focus of policy interventions shifted from discretionary interventions to efforts to create a more enabling environment for competitiveness through liberalization, deregulation and an effort to cut red tape (World Bank, 2004). Effectively, national governments both in industrialized and developing countries have gradually pulled out of active industrial development policies (and in developing countries also out of active agricultural development policies).

This has created both an opportunity and a necessity for regional and local governments, such as provinces/states, districts and municipalities. The necessity was due to the fact that structural change in many locations led to job losses, and that the pressure to create jobs was felt almost everywhere. Local politicians who wanted to be elected or re-elected could not ignore this issue. They could not stand at the sidelines and wait for markets to work their miracle – maybe. They needed to be seen as doing something here and now to create jobs. In many developing countries, the pressure on regional and local decision-makers was reinforced by decentralization processes, which effectively delegated many responsibilities to provincial and local governments. In some countries, like South Africa and Bolivia, economic development policy nowadays is a statutory task of local government. Thus, there has been a strong pressure on provincial and local politicians to launch economic development initiatives. The result has been a massive increase in government-driven local economic development (LED) efforts all over the world.

More recently, LED efforts have been complemented and sometimes reinforced by value chain promotion initiatives, both at a regional and at a national and international level. Practical experience and research showed that national and international markets are by no means an atomized world of infinite numbers of suppliers and customers (Rauch, 1999). Many market segments are governed by a small number of very powerful players, such as big retailers (Gereffi, Humphrey and Sturgeon, 2005). Entering the market often means moving onto the radar screen of the buyers of those retailers. Thus, policy-makers realized that promotional activities must not only strengthen the supply capability but also make an active effort to establish links with the gatekeepers to relevant markets.

In this article we will argue that a focus of economic development policy on LED and value chain development suffers from intrinsic limitations in terms of the outcome that can be expected. While it improves the environment for business and can thus be expected to have a tangible effect on growth and welfare, it will only induce an incremental change in terms of economic growth and improved standard of living. In particular, an economic development policy that focuses primarily on territorial initiatives will do nothing to change the position of developing countries in the global economic hierarchy. Countries like South Korea, Taiwan, Malaysia and Chile would never have emerged as newly industrializing countries if they had limited themselves to territorial development activities and value chain initiatives. LED and value chain development are important approaches, but they need to be complemented with

strategic national initiatives if developing countries want to move out of a dependent integration into global value chains (GVCs).

## **Local economic development**

Before having a closer look at value chains, we will examine local economic development (LED). We start with the upside, that is, the potential of localized development efforts. We then investigate the downside – the limits and dilemmas involved in LED.

### **The upside of LED**

One variety of local economic development in particular has attracted a huge amount of interest over the past 20 years, namely cluster development. Industrial clusters were rediscovered in the 1980s (Piore and Sabel, 1984; Becattini, 1990; Porter, 1990). Most striking was the case of Italy, where growth in industrial output and exports was to a significant extent sustained by highly specialized and competitive clusters of SMEs. Italian ‘industrial districts’ were not only agglomerations of small companies that happened to be co-located. Industrial districts tended to display a long history of collective efforts to build a location-specific competitive advantage. They seemed to represent an alternative trajectory in industrial evolution. There was the Chandlerian model of huge corporations, and there were industrial districts that consisted of SMEs who competed quite successfully with huge corporations. The competitiveness of these clusters was based on a combination of intense local rivalry, effective collective action, relatively low transactions costs, due to relational contracting, and intense learning – by interacting.

The phenomenon of SME-based clusters that compete successfully in the world market is not limited to Italy and its specific economic, political and cultural features. For instance, we found that the ceramic tile cluster in Castellón de la Plana, Spain, is even more competitive, and displays even stronger collective action at the local level, than its counterpart in Sassuolo, Italy (Meyer-Stamer, Maggi and Seibel, 2004). The Castellón cluster had a more effective industry association and, thanks to effective interaction between private sector and provincial government, a stronger capability in skills development and applied research.

Generally, successful clusters have been observed in numerous industrialized and a number of developing countries (Linde, 2002). However, the feature that is highlighted in the case study on Italy in this volume

also holds true for other countries: a disproportionate number of SME-based clusters specialize in consumer non-durables. Clusters are very effective in overcoming some of the obstacles to growth that stand in the way of SMEs, for instance, underinvestment in skills development. But they face limitations when it comes to creating capital- and/or technology-intensive industries.

Cluster promotion has become one of the most widely used LED approaches since the 1990s. Yet cluster promotion is only one of the elements of local economic development. In industrialized countries, where LED has been practiced for decades, it has evolved from a narrow focus at the development of real estate and locational marketing for investment promotion purposes to encompass a wide range of generic and targeted activities.

Regarding generic LED activities, a main focus since the 1990s was the local enabling environment, that is, an effort to remove unnecessary or outdated regulations and to speed up registration and permit processes. There have also been efforts to address market failure, such as coordination externalities and asymmetrical information, something that in particular benefits business start-ups and SMEs. Local fairs, networking events, or efforts to mobilize investment capital for start-ups are typical tools used in this respect.

Regarding targeted activities, there were not only cluster initiatives but also all sorts of other interventions, such as the creation of high-tech incubators or efforts to strengthen the links between local research centres and higher education institutions and private businesses in order to create a knowledge-based local competitive advantage. Whereas large corporations tend to have a routine of leveraging knowledge and innovation for competitive advantage, SMEs tend to behave more erratically, and local policy-makers are thus keen to encourage a more consistent behaviour among SMEs regarding the use of knowledge for innovation. To the extent that knowledge generation is based on localized processes, LED initiatives can make an important contribution to improved SME competitiveness.

### **The downside of LED**

What is the overall track record of LED in promoting growth and prosperity in general and in supporting SMEs in particular? Even in places where LED has been implemented for decades it is hard to find an answer. Dynamic local economies are usually the result of the interaction between market forces, entrepreneurship and chance, and occasionally the outcome of national government's planning and development efforts.



Success stories of genuine business-focused LED are few and far between, while stories of disappointments abound (Meyer-Stamer, 2003: 2ff).

Some success stories refer to generic LED, which is increasingly conceptualized as an effort to improve the effectiveness and efficiency of public sector service delivery to private businesses. An often quoted example is the US city Indianapolis, which in the 1990s, under mayor Stephen Goldsmith, tried to turn itself into an 'entrepreneurial city' by, *inter alia*, systematically eliminating outdated or unnecessary regulations.

Targeted LED is frequently a response to decline of old industries or to low growth in peripheral regions, and it is intrinsically difficult to measure its impact (Bachtler and Wren, 2006: 147). Looking at the specific case of cluster development, it is interesting to note that even its strongest proponents emphasize the long time horizon needed to see an impact (Andersson *et al.*, 2004: 77ff). In fact, there is relatively little evidence of an impact of cluster initiatives, and research found that government interventions have only a very small effect on the evolution of clusters (Enright, 2000). Successful cluster initiatives are usually driven by the private sector (Sölvell, Lindqvist and Ketels, 2003) rather than the public servants who populate conferences that target 'cluster practitioners'.

How about the prospects of LED making a significant difference to the growth performance of not-so-dynamic regions in industrialized and transformation countries, and to all sorts of locations in latecomer countries? We tend to argue that the currently dominating approaches to LED are intrinsically limited in their potential to make a significant impact on development, that is, they are unlikely to lead to a leap in growth and prosperity. In the following four subsections, we will outline key reasons why LED's impact is limited. Our argument refers primarily to transformation and developing countries, though some of the points apply to industrialized countries as well.

### **Planning instead of doing LED**

Most developing and transformation countries were governed in a highly centralized way until recently. LED is a new concept and task in these countries. The introduction of LED into developing and transformation countries is strongly influenced by foreign donor organizations. Institutions like the World Bank, UN Habitat and USAID promote an approach to LED that is primarily informed by urban planning concepts and methodologies. It has a strong bias for planning, and it is based on extensive stakeholder mobilization and consultation, such as

comprehensive workshopping. This is an approach that dooms LED (Cunningham and Meyer-Stamer, 2005):

- The planning approach to LED confuses strategy with strategic planning. It is crucial for actors in a given location to have a clear understanding of the strategic positioning of the location, and to implement projects that strengthen this strategic position, and such projects should be based on sound planning methods. Yet a multi-year strategic plan that guides the overall development effort is likely to be quickly outdated in any location that tries to compete in a constantly changing global economy.
- The planning approach fails to acknowledge the difference between urban development and LED regarding the underlying governance pattern. Postmodern urban development, with its strong emphasis on citizen participation, flourishes 'in the shadow of hierarchy', in other words, there is a strong incentive for citizens (including corporate citizens) to participate since otherwise local government might come up with a less-than-ideal spatial plan, zoning regulations, etc. In LED, on the other hand, there is no shadow of hierarchy since local government cannot credibly threaten with the formulation and implementation of something like an LED regulation.
- The planning approach is not informed by the reality of business, especially SMEs. Its engagement approach puts a heavy burden onto SMEs, which do not have time for endless stakeholder meetings and workshops. Effectively, it creates an incentive for local SMEs not to participate at all.
- The planning approach does not even pay lip service to concepts such as competitive advantage, and it fails to conceptualize the need to address market failure at a local level as a main reason to justify LED.

Evidence from Latin America, where many locations and regions went through strategic planning exercises during the 1990s, gives little support to the notion that strategic planning is a precondition for successful LED. Frequently, the effort in compiling a strategic plan seems to have been bigger than the effort in actually implementing it. The evidence that strategic plans have led to LED activities with a visible impact is thin (Helmsing, 2001).

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### **Social policy instead of promoting competitiveness**

In developing countries, there is more policy confusion around LED, often reinforced by donors who are under pressure to make their

interventions more 'pro-poor'. This sometimes leads to LED being approached according to a social policy logic, not a business development logic. The main objective of this type of LED is to address low-income groups and to promote 'income-generating activities', often through temporary projects that depend on external support, funding and facilitation and never become sustainable; this has been amply documented for countries such as South Africa (Tomlinson, 2003). It is not rare to find that the prospect of sustainability is further undermined by secondary objectives, such as gender promotion, a focus at marginal groups, or affirmative action. This leads to overload and exaggerated expectations.

This problem of confusion between social and economic policy objectives has also been observed in industrialized countries, especially in the context of efforts to address long-term unemployment and social marginalization. In his critique of mainstream approaches to urban poverty in the US, Porter (1995: 66) observed that 'many programs train people for nonexistent jobs in industries with no projected growth'. Assessments of skills development schemes in West Germany in 2000/1 found that less than 50 per cent of participants were employed half a year later, and employment promotion schemes for long-term unemployed (which are typically organized at the local level) only managed to launch less than 30 per cent of participants back into the formal labour market (Hirschenauer, 2003). At the same time, the practical part of skills development and employment promotion schemes, for instance via work in public parks or as part of brownfield conversion schemes, created unfair competition for private SMEs in sectors like gardening and landscaping.

Confusing social and economic policy objectives under the umbrella of LED tends to lead to a situation where neither social nor economic objectives are achieved, and where actually the private sector in the local economy may be damaged.

### **Focus on an enabling environment**

The focus on creating an enabling environment, which is currently the main thrust of the main donors' approach to private sector development in developing countries (cf. <http://www.sedonors.org>), encourages generic activities to the detriment of targeted interventions to create a competitive advantage in high potential sectors. There is nothing fundamentally wrong with addressing government failure and cutting red tape. But there is a good chance that this is an intervention that takes a

lot of effort without rendering significant results because it does not address the main impediment for economic development; this kind of paradox, created by the application of standardized recipes, has recently been highlighted by Hausmann, Rodrik and Velasco (2006).

In poor locations, be it in peripheral regions or in declining industrial locations, private sector development tends to suffer more from market failure than from government failure. Perhaps the most important market failures are coordination externalities, which obstruct the emergence of those new economic activities that cannot be run by individual small businesses on their own. Typical examples would be tourism in poor regions, where a couple of small businesses need to complement each other to create an attractive package of activities – accommodation, catering, transport and supporting services – or new high-tech activities in declining regions. Developmental activities in poor locations and peripheral regions, as well as declining regions, need to address such coordination externalities. A focus on the enabling environment may make it easier to close down a business that is no longer viable in a declining region. But the developmental challenge is to sustain business retention and to promote the creation of new companies, not to facilitate the shut-down of established firms.

### **The locational policy paradox**

LED tends to focus on small business since large companies, especially branches of large corporations, tend to be disinterested in LED initiatives that focus on creating a local competitive advantage (Meyer-Stamer, 2003). Companies of all sizes are interested in traditional, generic LED activities, such as development of real estate, infrastructure development and investment promotion. Yet when it comes to targeted activities to create a local competitive advantage, LED practitioners are battling to get large companies' participation, especially those that own hundreds if not thousands of facilities in almost as many locations across the globe. While companies may be strongly involved in local development activities at their home base, it is difficult to get them involved in genuine LED activities at branch level (as opposed to community involvement, sponsorship and similar activities).

Effective collective action at the local level is more than a rationally driven activity of maximizing utilization of economic actors. It is based on strong interpersonal networks. Creating them, and building the trust that is crucial for them to be effective, takes time. However, managing directors of local branches change frequently. Even if they have a

mandate to engage in local relationships, they tend to find it hard to quickly build such relationships. Opting for sponsoring activities offers a much more attractive cost/benefit ratio.

Things are complicated even further by the habit of large corporations of acquiring, selling or spinning off business units. A local firm that plays an important role in LED may abruptly cease to do so because it has just been taken over by a multinational corporation, and the local founder-owner has been replaced by a foreign manager. A local branch plant that pursues an approach of actively engaging with the local community, thanks to the parent corporation's corporate citizenship principles, may abruptly cease to do so after it has been sold to another corporate. A local unit that is spun-off will usually start its life as a medium-sized or big company and will be busy positioning itself in the world market, rather than contributing to a local collective upgrading effort.

So is it good news for SMEs if they are the primary target of LED activities? The answer is both yes and no. SMEs benefit from generic interventions, be it infrastructure development or an effort to create a local enabling environment by cutting red tape. Large companies tend to be in a strong position vis-à-vis local government in both respects, especially when they can threaten with the downsizing or shut-down of local plants. SMEs need strong collective organizations to make their voice heard. A proactive effort by local government reduces the need for SMEs to get organized (and the transaction and opportunity costs involved in this). So with respect to generic LED activities, SMEs will usually enjoy benefits.

Things are more complicated with respect to targeted activities, and this is not only the result of the problems in involving local large firms. We have argued above that dynamic locations are the result of market forces, entrepreneurship and chance, and to some extent government intervention. This statement refers to the initial phase in the life cycle of a dynamic location. There is not really evidence that local government can play an active role at this stage, for instance, through 'local industrial policy', trying to target a specific emerging sector. Many local governments have tried this, and they have usually failed or created what Enright (2000) calls 'wishful thinking clusters'. Local industrial policy tends to be driven by fashions, not by competence and solid evidence. Following a widely acclaimed fashion ('nanotechnology is *the* future growth sector') makes it much easier for local policy-makers to justify their selective intervention, but it also minimizes the chance of success. A selective intervention that does not follow the fashion of the day, on the other hand, is difficult to justify and to sustain over a period of time.

In the growth phase it is common to observe the emergence of collective action within the local private sector, especially in areas with a strong propensity to market failure, such as skills development. In the maturity phase, the focus of collective action often expands to political articulation, trying to defend the achievements of the past. Local government sometimes plays a role in the growth phase, and it frequently plays a role in the maturity phase; and if the interventions at the maturity stage were not sufficiently effective, it will try to play a strong role in the decline phase. However, maturity and decline are typically phases of consolidation, that is, local SMEs merge into big companies or are acquired by large external companies, and this limits the latitude for local government action. In other words, there is only a limited time window for promising selective local government interventions during the growth phase of an emerging local cluster.

#### **Interim conclusion: LED and SMEs**

LED can make some difference. It can turn a given location into a place where it is easier to do business, for example, where the infrastructure is more efficient and transaction costs are lower than elsewhere. This is the result of generic LED. Efforts to pursue targeted LED are difficult, and there is little evidence that it has made a significant difference in the past.

LED can in particular make some difference to SMEs. Business owners often spend a disproportionate share of their time complying with government regulations so streamlining regulations and procedures generates an immediate benefit. One can make a strong argument that generic LED, which also includes infrastructure development, creating a more transparent real estate market, and other activities, benefits SMEs more than large companies.

At the same time, LED puts a burden on SMEs. A large business will typically send somebody from the corporate social responsibility department to LED strategy workshops, while an SME has to delegate somebody who otherwise would create direct value for the business; thus, the elaboration of an 'LED strategy' creates an opportunity cost for SMEs. SME projects that assist poor communities in generating some income sometimes create unfair competition for small local businesses.

More important, though, is the fact that LED rarely succeeds in launching catalytic interventions that open new growth opportunities for SMEs. Traditional national-level industrial policy focused mainly at large enterprises, but their growth created huge business opportunities

for suppliers in the SME sector. Other national-level approaches, such as export promotion, were effective in some countries in opening new markets to SMEs. There is little evidence that the demise of these national-level, strategic interventions has been compensated for through LED. The experiences with value chain initiatives are instructive in this regard.

## **Value chains**

Value chain promotion is emerging as an approach to link local producers to global markets. It is based on the observation that many markets are far from being the anonymous meeting places of numerous sellers and buyers, as assumed in simple microeconomic models. Instead, access to global markets nowadays often is controlled by a limited number of gatekeepers, namely global buyers that act as the spiders-in-the-web of global value chains. Supplying these global buyers has created new opportunities for exports from developing countries, leading to employment generation, foreign exchange earnings and fast-paced but selective upgrading of local producers. Before we discuss the downside of value chain promotion, this section deals with the important stimulus that value chain promotion can provide to more realistic demand-driven interventions.

### **The upside of value chain promotion**

Traditional development approaches often upgraded local producers and then battled to find markets for their improved or new products. In contrast, value chain promotion is based on the insight that successful interventions start by looking at what the potential demand for the new or upgraded products is and how entry to final markets can be achieved through the gatekeepers. The value chain perspective draws attention to the sequence of activities from product conception to final consumers, stressing the importance and interrelatedness of activities within and beyond the actual production, notably design, logistics and marketing (Gereffi and Kaplinsky, 2001; Kaplinsky, Morris and Readman, 2002). Value chain maps visualize how different firms carry out the various main activities destined for particular market segments, and it shows the types of product, price, quantity, and numbers of buyers and sellers involved in specific chains. Such maps allow local producers, as well as policy-makers, to quickly improve their understanding of:

- who bargains with whom for what,
- where in the chain value added is concentrated,

- what are the opportunities and constraints for growth within existing chains,
- what are the chances and limitations for upgrading into higher value added chains and
- how to achieve most intervention leverage by addressing main bottlenecks in chains.

The value chain tool has proven a very useful analytical device to assist both producers and policy-makers in rationalizing their decision-making process about how and when to upgrade. An important upside of value chain promotion is that it brings the consumer and buyer perspective into the decision-making process around upgrading interventions. It makes producers more aware of their relative position within the bigger (value chain) picture. Therefore, it can help producers in better identifying their core competence or niche, and more sharply orienting themselves to strengthening this core competence and to developing strategic alliances with key stakeholders in relevant value chains, instead of 'workshopping' with everybody on everything. Moreover, the value chain tool can be used to collect views from global buyers on the relative competitiveness of producers in various locations (Schmitz and Knorrninga, 2000). Such comparative assessments of competitiveness in the eyes of the buyers can act as a strong lever to 'shake up the entrepreneurs and make them hungry for outside assistance' (Schmitz, 2005: 19).

These comparative assessments can also be used by policy-makers to 'find a focus for their policies, programs or projects' (Schmitz, 2005: 19). More generally, the value chain perspective helps policy-makers and business support agencies to develop more targeted interventions, and achieve more leverage by addressing main bottlenecks that affect a multitude of producers (like providing a testing facility, which firms increasingly need as an entry requirement but cannot individually afford to set up). While traditional business support often drives producers deeper into overcrowded sectors by pushing them to do better what they do already, value chain promotion provides ammunition to investigate *how* overcrowded specific market segments might be, and whether opportunities exist to enter more attractive value chains (Schmitz, 2005: 21). As a rule, traders and buyers know more about distant markets and consumer behaviour than industrial policy-makers and publicly funded BDS providers (see, for example, UNDP *et al.*, 1988). Value chain analysis gives policy-makers and BDS providers a better understanding of how local producers are linked to global markets, and how they can be supported more effectively. In this



way value chain promotion and demand-driven BDS can reinforce each other. Embedded BDS, that is, service delivery to producers through buyers, may be one extreme but promising example of this interaction (AFE, 2004; Anderson, 2000; Lauridsen, 2004). So far, embedded BDS delivery seems limited to smaller and traditional producers such as in handicrafts, where buyers are often domestic intermediaries. Global buyers in main consumer goods seem – understandably – hesitant to act as for a source of assistance, but more experiments are needed (Schmitz, 2005).

Among researchers and policy-makers often two different types of value chain promotion are distinguished: interventions to assist producers in achieving initial entry into global value chains, and interventions to stimulate further upgrading of producers that operate as suppliers in global value chains. These require different interventions. To achieve initial entry into global value chains, one needs to get (a group of) local producers on the ‘radar screen’ of one or more global buyers (usually through regional intermediaries and or scouts that are always on the look-out for new attractive production spaces). Next to upgrading local capabilities and standards to a ‘threshold level’, preparing the local ground, which includes infrastructure and other broader LED phenomena, selective networking is often crucial to secure some trial orders. Once initial entry has been achieved, the global buyers, and especially their regional intermediaries, usually start playing an important role in product and process upgrading.<sup>1</sup> It is especially in this initial phase where incipient suppliers go through a process of fast-paced process and product upgrading (Schmitz and Knorrninga, 2000), also leading to increased employment and foreign exchange earnings. Obviously, achieving significant levels of local employment and foreign exchange earnings through such processing plants is not a mean feat. For example, from an LED perspective it might well be important in bolstering local effective demand. Nevertheless, an increasing number of authors in the value chain literature appear to be doubtful about the extent to which such processing plants are a likely first step in a more endogenous LED strategy.

### **The downside of value chain promotion**

The barriers to entry for developing country producers to being integrated into global value chains are high, since most value chains are subject both to a variety of codified standards and to direct inspection by buyers. Getting on the ‘radar screen’ of the global buyers is a difficult and expensive process, and substantial investments are necessary to acquire product and process certification. Leaving aside the processing

plants in 'export processing zones', usually only the already somewhat larger and more dynamic local producers in more diversified developing countries with a sizable domestic market, or located in the 'China-plusregion', are able to successfully enter global value chains. Therefore, it is an approach to further strengthen, streamline and bolster the achievements of 'local champion' companies, rather than an approach to develop new firms or achieve direct poverty alleviation in poorer regions.<sup>2</sup>

Producers in developing countries are usually integrated into quasi-hierarchical value chains, where the rules of the game are defined by buyers from industrialized countries. A key issue is the extent to which these asymmetrical relationships with buyers provide local producers with opportunities for learning and upgrading. Recent studies (among others, Gereffi, 1999; Schmitz and Knorringa, 2000) argue that global buyers often play a significant role in process and product upgrading, especially for their more favoured suppliers. The controversial issue is whether firms are also able to achieve functional upgrading, and to determine the role buyers play in furthering, neglecting or obstructing functional upgrading by their suppliers. While Gereffi's study on garments recognizes that there are many obstacles to functional upgrading, he emphasizes the dynamic learning curves that producers in value chains are exposed to: moving from mere assembly to monitoring the entire production process, to design and sale of their own branded merchandise. In contrast, Schmitz and Knorringa (2000) found that in the footwear industry global buyers tended to see attempts at functional upgrading as encroaching on their core competencies and actively discouraged such attempts. One way around this problem is that especially somewhat larger producers in, for example, the Brazilian footwear and furniture industry actually participate in several value chains at the same time, and leverage the different capabilities acquired in the various value chains (Navas-Aleman, 2006). For example, in the domestic market they may operate in market-based relationships with wholesalers and retailers, selling their own designs, while using the process and product upgrading acquired in the quasi-hierarchical relationship with the global buyer. Another example that provides a nuance to the gloomy picture of captive world-class producers without a parallel development of design, branding and marketing capabilities, is the recent experience in the Vietnamese footwear industry. Here sub-national associations are carefully supporting producers to functionally upgrade in new production units without antagonizing the global buyers (Knorringa and van Staveren, 2006). More generally, Schmitz and Knorringa (2000)

have argued that while participation in quasi-hierarchical chains leads to fast-paced process and product upgrading, market-based relationships with a variety of smaller buyers offer better opportunities for a slower but more balanced development of process, product *and* functional upgrading capabilities.

Nevertheless, by far most developing country producers in global value chains operate in quasi-hierarchical chains and are under constant pressure to improve quality and reduce prices, and they face substantial obstacles when it comes to functional upgrading, that is, moving into the higher value-added activities in the value chain. As local producers are constrained to processing activities under tight control by outside inspectors the local spin-offs are usually much more modest than initially anticipated. It turns out to be extremely difficult to forge a multitude of local horizontal, forward and backward linkages with such processing plants. Moreover, entrepreneurs and managers in such production plants often feel more 'attached' to their vertical value chain linkages, with outside actors, than to their horizontal local cluster linkages, which further limits the potential for local spin-offs. More generally, the conditions for locational upgrading efforts change profoundly once a local cluster has been spotted by global buyers. There is a strong incentive for local efforts before, while the focus of local producers shifts from local coordination to international interaction after. However, a crisis in the relationship with the global buyer may well lead to a new period in which local relationships become crucial again in achieving more broad-based functional upgrading at cluster level (Bazan and Schmitz, 1997).<sup>3</sup>

Notwithstanding the selective success stories of (clusters of) firms that have entered global value chains, and a widespread enthusiasm among industrial policy-makers, in recent years some analysts have become increasingly hesitant to advise policy-makers to try to follow this route (Kaplinsky, Morris and Readman, 2002; Knorringa, 2002). For example Kaplinsky, Morris and Readman (2002: 1175) wonder whether we are not guilty of a fallacy of composition in advising firms and regions to upgrade in order to enter global value chains as processors, as rents in processing are extremely low and too many new producers are fighting for the remaining crumbs in a market increasingly dominated by producers from the China-plus region.

In this context Kaplinsky has put forward the concept of immiserising growth,<sup>4</sup> where 'growing... participation in industrial activities – reflected in the level of industrial activity, the growth in physical trade and the increase in industrial employment – may in fact become associated with

declining overall standards of living' (Kaplinsky, 1998: 4). This negative macro effect is not because of an inefficient allocation of resources, but because of the pressures arising from economic globalization. Revenues from processing are very limited as compared to the revenues from, for example, designing and branding, and all competing potential suppliers are also busy upgrading, which leads to a situation of 'running to stand still'.

Especially in those labour-intensive sectors where developing countries have in recent decades become successful exporters, this trend is likely to lead to immiserising growth unless the firm or country in question can outpace competitors in process or product upgrading, or, even better but also more difficult, in functional upgrading. While individual firms or a specific country may use this as a successful development strategy, the tenet of the concept of immiserising growth is that this survival of the fittest can not constitute the basis for a broader and more inclusive development strategy that also benefits weaker economic actors and regions.

Kaplinsky concludes that: 'in previous eras, participation in industrial segments of the value chain provided the source for sustainable income growth. But, increasingly, in a globalising economy these industrial niches have become highly competitive, raising the spectre of immiserising growth' (Kaplinsky, 1998: 31). He argues that firms or countries need to identify and exploit specific rents from competitive advantages, but that the main lesson from recent history is that all rents are transitory and that new suppliers in GVCs basically carry out 'rent-poor' activities. Again, escaping from this immiserising-growth trap is something that might be achieved by some individual firms or countries, but the general trend is expected to be one of:

declining real wages and declining real incomes in those countries specialising in rent-poor products....The challenges thus confronting producers everywhere is to upgrade by appropriating whatever categories of rents are within their grasp, but to do so more rapidly than competitors in the knowledge that a rate of innovation lower than the average will result in immiserising growth. (Kaplinsky 1998: 34)

This compelling and gloomy picture raises the question of how many niches in the global market can successfully be supplied by developing country suppliers to global value chains in a way that also provides a stimulus for local development. Even though global buyers will probably remain wary of becoming completely dependent on sourcing from the

China-plus region, producers from other regions will most likely also need to be able to target rather substantial and sophisticated market niches in their domestic (or regional) market to remain competitive. These domestic or regional market niches may well require producers to be well versed in design and branding activities, next to supplying to global buyers through quasi-hierarchical relationships. For more peripheral localities, with lots of low-potential SMEs but without some clear local champion firms with export potential, entry into (attractive) global value chains is likely to remain a remote option.

## Conclusions

A country that addresses productive sector development, and in particular SME promotion, exclusively through LED and value chain promotion has effectively discarded the ambition to move upwards in the global economic hierarchy. The limits to the locally focused LED approach are not only related to the dependent integration of local producers into GVCs and the finding that the options for functional upgrading, that is, higher value added, are seriously limited once local producers have been integrated into a global value chain. The limits are also due to the intrinsic limitations of local approaches, which are the consequence of limited capabilities and resources of local policy-makers. LED and value chain promotion are incremental upgrading approaches. They are devoid of a vision for national development based on a consistent catch-up effort that involves not only upgrading within existing economic sub-sectors but also moving into new sub-sectors.

Latecomer countries need strategic interventions to build competitive sectors with a strong growth effect. This implies defining a new role for local government. It must not only create an enabling environment, but also pursue meso-level activities to shape a knowledge-based competitive advantage. This requires targeted support by higher levels of government, both in terms of funding and regarding conceptual guidance. The promotion of high-potential clusters would be one element of a strategic approach, which would be based on sectoral targeting. Recently, authors such as Dani Rodrik have pointed at issues such as persistent market failure, which stand in the way of purely market-driven development processes, and which condemn poor countries to remain stuck with a weak productive base (Rodrik, 2004; Rodrik and Hausmann, 2006). Esser *et al.* have argued since the early 1990s that 'systemic competitiveness' is the result of a collective effort of various

societal actors (Esser *et al.*, 1996; Meyer-Stamer, 2005). This does not imply a call for traditional ‘picking winners’ policy but rather network-based governance patterns to shape economic upgrading efforts.

Strategic upgrading efforts are not an alternative to LED and to localized efforts to integrate producers into value chains. All these approaches have important roles to play, and ultimately they complement each other. The point is that all of them need to be in place. Relying on a partial approach only is unlikely to pull countries out of poverty.

## Notes

1. Upgrading, in value chain literature, is usually broken down into: process upgrading (doing things better); product upgrading (producing better goods); and functional upgrading (engaging in additional and higher value-added activities) (Humphrey and Schmitz, 2000).
2. There also exists an increasingly rich literature on using the value chain tool in the context of poverty alleviation, by finding ways to strengthen the bargaining position of survival and micro businesses, and, for example, industrial home workers, in particular value chains and/ or to connecting to more attractive value chains (Dawson, 2003; McCormick and Schmitz, 2002). In this chapter we focus only on more formal small, medium and large firms that have a potential for international competitiveness.
3. In the case of the Sinos Valley, an American buyer that moved its sourcing to China (Bazan and Schmitz, 1997).
4. The phrase was initially coined by Bhagwati in 1958, and further developed in Bhagwati, 1987.

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