

## Workshop 3 – Dealing with Industrial Change and Restructuring

Referring to SMEs in Europe, “the challenge for governments is to provide a business environment that supports the competitiveness of this large heterogeneous business population and that promotes a vibrant entrepreneurial culture”<sup>1</sup>. Such development strategies must recognise and understand the reality of the needs of SMEs and of industry in general.

At any point of a nation’s development, the mix of industrial and growth policies must reflect the nation’s stage of competitive development at that time. It is fair to say that the SEE Region in general is at the early to intermediate stages of industrial development – often referred to by the World Economic Forum and Dr. Michael Porter as the factor-driven (e.g. low-wage, easy access to resources) and investment-driven (e.g. FDI) stages. These are the stages where government has most influence, as it seeks to push, pull and cajole industry into leading a nation’s competitive development. At these stages, tools such as currency policy, fiscal policy, subsidies, capital and resource provision and temporary protectionist policies play a large part in that development. Government will also look to improve educational facilities, infrastructure and put in place the process of accumulating technological and scientific wealth. In time to come, however, as the economy grows, government will take a more backseat role as industry itself becomes more sophisticated and assumes the lead role in innovation, as they forge stronger alliances globally and with educational and research institutions. Often, the real challenge to government is to relinquish their direct power and influence over industry, and concentrate on being a facilitator.

### Porter’s Diamond<sup>2</sup>

Porter has identified four key determinants for industrial growth:

1. Factor Conditions – the nations position in factors of production, such as skilled labour force or infrastructure able to compete on a global basis in a given industry
2. Demand Conditions – the nature of (home) demand for the industries products or services
3. Related and Supporting Industries – the presence (or absence) of internationally competitive supplier industries and related industries
4. Firm Strategy, Structure and Rivalry – the conditions in the nation governing how companies are created, organised and managed, and the nature of domestic rivalry.

Referred to as Porter’s Diamond, the determinants are individual and inter-related, and therefore individually and as a system, create the context in which a region’s enterprises are born and compete:

- the availability of resources and skills necessary for competitive advantage (in industry);
- the information that shapes what opportunities are perceived and the directions in which resources and skills are deployed

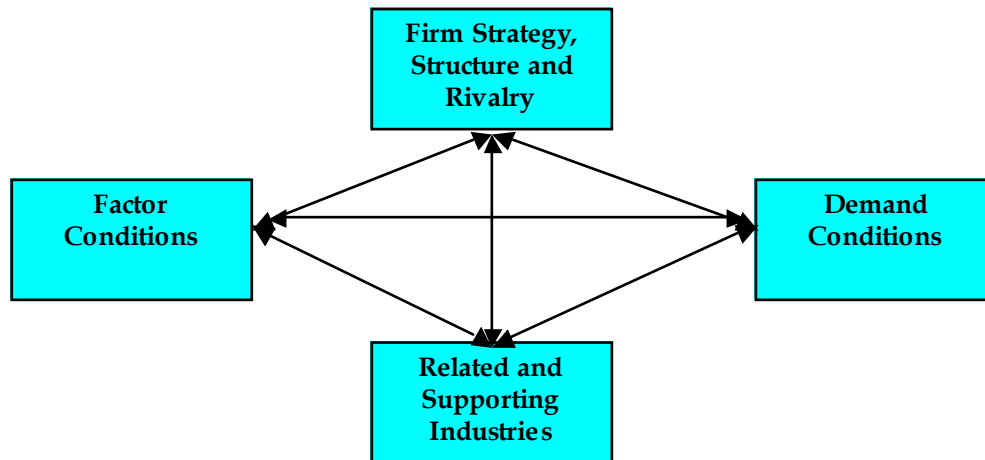
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<sup>1</sup> OECD 2003

<sup>2</sup> The Competitive Advantage of Nations, Michael Porter 1990.

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- the goals of the owners, managers, and employees that are involved in or carry out competition, and
- most importantly, the pressures on enterprises to invest and innovate.



There are two additional variables which complete the theory, but which are excluded from the four main determinants. These additional variables impact upon the general environment in which the four inter-related determinants need to be effective. Unlike the four determinants themselves, these do not directly contribute to regional competitive advantage, but may improve (or detract) from the potential for the advantage (where it exists or might be created) to be exploited.

These variables are:

1. Chance - events that occur outside the influence of regional governments and local enterprises (and often National Government) where there is no power to control or influence. Examples include uncertainty in oil markets, acts of war, climatic conditions, major technological changes, acts of foreign governments.
2. Government - the role in the treatment (development) of international competitiveness in its influence upon each of the four determinants. The role and actions of Government is of major importance in a transition economy. Early in the development process Government has the driving influence upon focussed advanced Factor creation, in addition to more subtle, but no less critical, influence on the other three determinants in the Diamond.

The potential influence of Government in supporting the enabling environment for SME and industrial development, and therefore the promotion of Regional Competitive Advantage across all the elements of the value chain is significant. In addition the role of Government in enhancing Factor Conditions, (particularly in linkages with education, training of the labour force, physical infrastructure, fiscal policies, etc.) as well as influencing domestic Demand Conditions is considered crucial. The SEE Region currently has a number of Factor Conditions that support its economies, some of which are sustainable but some - such as relatively low labour costs - are not sustainable over time.

### **Government Policy in Transition Economies**

Generally speaking, the key to industrial growth in transition economies is to escape from the constricting influences of factor-driven competitive advantage, where industries are typified by low-wage, low-cost and locational advantages. These will probably give short-term impetus to exports and home demand, but they are also very vulnerable to outside influences and factor cost swings. To survive, these industries are often dependant on government supports and protectionist policies. Using scarce cash and other resources in this way is not conducive to longer-term development, though there may be short-term political and social considerations. Gaining unfair advantages at home will lead to an adverse reaction from those countries whose exports are being hit, and will also be counter-productive to the industry itself, as they will lack any advantages in international markets.

Similarly, and as referred to earlier, factor advantages are not enough for sustainable industrial development. The four determinants in the diamond are inter-related in that for long-term advantage, all four must be addressed, though each will require differing levels of attention and effort at various stages of the growth cycle.

### **Industry Targeting**

Industrial targeting is the practice of choosing particular industries or sectors for more focused support, usually during the stages where the economy is growing and moving to the investment-driven stage. The choice of industry or sector usually hinges on the region possessing a sustainable or long-term competitive advantage in that area, but it can also be based on new technologies or research where focused investment can create a competitive advantage, allowing the region become a world player in the sector. Practically all nations practice targeting in some form or another, what differs between them are the policies used to promote certain industries. Government involvement in this way is of course distortionary to the market, but by giving clear signals of its intentions and confidence in a sector or industry, this can help to attract private capital and investment into the sector. It goes without saying that such government support must be consistent and indicative of longer-term goals. It must also have a clear exit strategy, as direct support of this nature cannot continue indefinitely.

### **Industrial Clusters**

One of the defining features of the global economy is that national borders matter less but location matters even more. The capacity to create wealth is not evenly distributed across global or national markets. Rather it is concentrated in geographic areas where the appropriate business environment exists and where companies can gain access to qualified manpower and expert knowledge from research institutions etc. Such geographic concentrations of competing and co-operating companies, suppliers, service producers, research institutions and associated institutions are defined as clusters. Clusters have become the "spearheads" of their host regions, creating high employment, high added value and enhancing exports.

Regions should base their choice of industries on factor condition advantages, but must also ensure that the other determinants of national advantage are present, or can potentially be developed. An initial advantage can be gained from exploiting beneficial factor conditions, but a strategy must be put in place at an early stage to develop other determinants. Vertical and horizontal growth should be prioritised and supported by increased investment in education, infrastructure, research and the other pillars of advanced economies. At this point, government policies can provide support in the next steps in clustering by facilitating their local home-grown companies expand abroad through the acquisition of technology, acquisition of skills, access to markets, provision of some development services, etc.

A cluster can contain a small or a large number of companies of different sizes and encompass different types of networking, e.g., Italian industrial districts, the French "systèmes productifs

locaux”, Silicon Valley, etc. The geographical coverage of a cluster may shift from regional to cross-border in order to follow the market or to allow co-operation amongst clusters within a particular geographic location. Regional clusters will increasingly co-operate with one another to ensure access to skills, research, best-practices, etc. An example of this can be found in the biotech cluster situated in Denmark and Sweden, which shares labour resources and research activities at universities in both countries. Another example is the tourism cluster between both parts of the island of Ireland. Securing the competitiveness and prosperity of a cluster region is no longer solely up to a single nation.

Clusters can lead to higher growth in a number of ways:

- Raise productivity by allowing access to specialised inputs and employees
- Increase innovation capacity in companies by diffusing knowledge and technology more rapidly
- Stimulate higher rates of new business formation, as employees become entrepreneurs in spin-off ventures, since barriers to entry are lower than elsewhere.
- Encourage an enhanced division of labour among companies offering greater economies of scale for individual enterprises.

The need to “involve small enterprises in inter-firm co-operation at local, national, European and International levels” is stated in the European Charter for Small Enterprises (June 2000). Other studies have pointed to the growing benefits to SMEs of cluster development. OECD initiatives include the LEED programme, International Club of Local clusters, and several series of workshops.

For SMEs in particular, clusters can greatly assist smaller companies to reap the benefits from economies of scale and scope. The many examples of affluent regions containing dynamic clusters of companies have spurred local, regional and national governments to adopt cluster oriented policies in order to offer clusters optimal business conditions (research, education, venture capital etc.), tailored to their specific needs.

A number of countries in Europe are currently working with clusters, drawing maps of their strongholds and designing the policy to support their growth. But Member States have different definitions and different policy approaches to clusters and to networking in general. In some Member States policies take into account/support enterprise clusters or networks either within a national strategy to improve competitiveness or within regional programmes. Other Member States do not have such policies. A project is underway within the EU which will identify and exchange good practices, and the SEE region can use the findings in its own development strategies. More information on the project is given as an appendix to this paper.

### **Foreign Direct Investment**

FDI has been used in many countries as the catalyst for industrial growth, as an economy moves from the factor-driven to the investment-driven stage of competitiveness. There are obvious advantages and benefits in attracting FDI, not least of which are the rapid creation of employment, introduction of new skills and technologies, modern management practices, investment capital, etc. But there is a trade-off in that foreign multinationals locate their activities in other regions as part of their own global strategies, not as part of a national or regional strategy. Therefore, it is probable they will relocate elsewhere as soon as the attractions which brought them to a particular location in the first place no longer contribute to their value-chain. For that reason, FDI can only be part of an industrial development strategy. It must be seen as a partnership from which local industry gains through technology and skills transfers, upgrading

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management capacities, development of the local value-chain and service industries. Therefore, a region must also have its own SME Development policy aligned within its overall industrial development policy.

Foreign multinationals should not be attracted randomly to a region or nation. We spoke earlier about the development of industries or sectors where there is a sustainable competitive advantage. Priority should be given to those multinationals which fit within those industries and sectors. The presence of the global company can itself lead to the development of a cluster, where focused government policies can provide the stimulus to SMEs to innovate and upgrade in line with the requirements of the multinational. In time, with the right conditions, local companies will be in a position to themselves compete globally, leading their region up the ladder of international competitiveness.

## **Appendix 1: Enterprise Clusters/Networks**

The project will be two-fold. Firstly, it will consist of a stocktaking exercise of the Commission, Member States and other countries (e.g. US, Australia, New Zealand) initiatives in the field of enterprise clusters/networks in order to identify future areas for action.

Secondly, it will analyse, together with the Member States, how national policies take into account clusters and other types of networks – and specific policies to support clusters where these exist - with a view of identifying good practices.

Under the MAP 2001-2005, within the EU itself, an expert group has been set up with Member States' experts, officials of the inter-service group and OECD experts (eventually also some experts from the CEECs). Member States' representatives have been asked to provide information on the basis of a questionnaire prepared by the Commission, which will focus on national policy initiatives aimed at supporting the creation/development of clusters (or alternatively on how national policies take into account clusters/networks). In addition, Member States will also describe relevant national initiatives supporting other types of networks and present information on their clusters and networks. Information on networking relationships within existing clusters and examples of cross-border clusters could also be included where relevant.

In addition, the following policy issues will be discussed within the expert group:

- The role of regional/national and EU authorities as regards promoting and developing clusters /networks.
- The spread of awareness amongst enterprises on the potential offered by clusters/networks.
- How Member States can provide conditions to facilitate cross-border clusters/ Networks.

On the basis of the material provided by the external consultant, Member States and of the work of the expert group and of the inter-service group, the Commission will draft a report including conclusions from its past initiatives, an analysis of national policies, examples of good practices and recommendations for future actions. The report should be presented to the EPG in order to facilitate a discussion on the benefits from and the possibilities of integrating a cluster approach in EU enterprise policy.

Depending on the results of the project and of the importance/relevance of the good practices identified, a Best procedure project or other appropriate action will be proposed. The results will be disseminated widely e.g. by conducting a conference or seminar.

In general, the project seeks to analyse Commission initiatives and Member States' policies with a view of identifying future activities in this field. More specifically, the project will also contribute to achieving the following specific objectives:

- Raise awareness amongst the Member States on the potential and importance of clusters/other types of networks in making enterprises more competitive.
- Contribute to enterprise's competitiveness through the dissemination of good practices in cluster policy.
- Contribute to the creation of conditions enabling cross-border enterprise clusters/networks
- Contribute to the identification of the appropriate role for governments and the EU as regards clusters and networking of enterprises.
- Give valuable input to policymakers on where to focus resources and how to design enterprise, regional and research policy both on a national and EU-level.