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DEVELOPMENT THROUGH ENTREPRENEURSHIP, LACK OF SOCIAL CAPITAL AND THE IMPACT OF INDUSTRIAL DISTRICTS

Bachelor’s Thesis

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I declare I have written the thesis independently.
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ABSTRACT

Regardless of the attempts to accelerate the development and growth of the Global South, the international community’s involvement has not caused any outstanding results. Aid has been criticised for creating dependency and getting stuck in the hands of corrupted bureaucrats. Therefore the focus has shifted to a neoliberal bottom-up policy, where people are encouraged to create their own prosperity by starting businesses and taking up entrepreneurial activities. Tools, such as the much celebrated microfinance, have been created for this purpose of promoting small and medium businesses as a track towards growth. However, accumulating evidence does not provide extensive support for these policies and results of the studies are controversial. This paper suggests that the main reason for the observed ineffectiveness of such an approach is the omission of the meso-level; lack of trust and social capital in poor communities may lie behind the inefficiency of these measures. The theory of industrial districts might suggest a solution for dysfunctional markets and stagnating growth and thereby improve the effectiveness of aforementioned bottom-up solutions. Through increasing trust and promoting competition and cooperation, the small and medium enterprises can be scaled up and become more profitable, eventually creating employment opportunities for other people as well as a path towards sustainable development.

Keywords: economic development, MSMEs, microfinance, trust, social capital, industrial districts, industrial clusters
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INTRODUCTION

Despite the great efforts made, the international community was incapable of reaching the United Nations’ Millennium Development Goals, one of them being the reduction of poverty by half. In 2015, when the project ended, 836 million people were still living in extreme poverty. This accounts for 14% of people in developing countries (Millennium Development Goals Report 2015). Institutions and international organisations, from the United Nations to small non-governmental, non-profit organisations, have been fighting poverty for decades. Much of poverty reduction interventions happen in the form of development aid.

However, the proof of aid’s efficiency is conflicted. Easterly (2006, 40) has reviewed evidence of poor countries moving between economic classifications: 11 out of 28 poorest countries in 1985 were not in the poorest quintile back in 1950 – they regressed into poverty. The growth of those in the poorest bottom quartile is the same in 1950-1975 as the long-term growth rate of the American economy (Easterly 2006, 40). When growth declined, there was a surge in aid. It is possible, but highly unlikely, that the fall was caused by aid. Easterly (2006, 43) thinks that the fall caused the surge in aid, but the aid could not help increase growth. It also seems that countries with hardly any aid as a percentage of income, such as Korea, Singapore, Hong Kong, Taiwan, China, India, and Vietnam have managed to lift themselves out of poverty with exports, whereas in African countries the economic situations are similar to their independence levels despite the vast supply of aid (Easterly 2009, 5). In the 1990’s, 15 % of a typical African country’s income came from foreign donors (Easterly 2006, 43).

Scholars, such as Easterly and Moyo, who are sceptical about the effectiveness of development aid, are especially critical of government to government aid. Due to corruption and bureaucracy, the aid is not fully used for the benefit of the common people. According to Easterly, the aid system has never been able to resolve the trade-off between supporting an illegitimate government and helping the population, as donors are rarely held
accountable for the inefficiency (2009, 6). Aid may be useful in a crisis for preventing humanitarian suffering, but has limited capabilities to support sustainable economic growth and development.

Dambisa Moyo (2009, 33) argues that the concept of development has caused a paternalist top-to-bottom structure of aid. African countries are perceived as children, who need help and guidance in order to develop into maturity. This attitude dates back to the white man’s burden, when colonies and their “backward people” were helped to become “civilised” (Ibid.). Eventually, the aim became more economy centred as the former colonies gained their independence and economic aid was labelled development aid. In its current form, aid started in the post-war Bretton Woods Conference when the IMF and World Bank were founded, but aid has its roots in the cold war era and decolonisation, when Western powers gave financial support to poor countries in order to prevent them from seeking solutions to the economic situation from communism.

This aid was linked to political and strategic goals from its very inception. Aid can be used to reward good policy decisions and a shift to more democratic governance, to pressure countries to pursue these policies by denying aid or to promote trade with the donor country. Burnside and Dollar examined the effectiveness of development aid and their research concluded that development aid does work, but only with good policies (1997, 1). The IMF and World Bank naturally suggest these would be the liberal policies and Burnside and Dollar (1997, 1) actually do list fiscal surplus, inflation, and trade openness as factors contributing to the effectiveness of aid on growth. Therefore, in order to guarantee the effectiveness of aid funding, development institutions IMF and World Bank are now employing policy conditionality to their loans and donations.

Because of the persisting ambiguity related to aid effectiveness, and in order to ensure that interventions have an impact on those in the most vulnerable position, entrepreneurship is promoted as a bottom-up, grassroots-level solution. Critics of government-to-government aid, such as Dambisa Moyo (2009), have suggested that micro-lending, entrepreneurship and job creation are better and more sustainable solutions than the funding of governments. As people provide for themselves, they will not become passive or dependent on help, but are instead empowered by the ability to exercise control over their own lives and earn their income.

This approach of giving a push for growth and poverty alleviation through
entrepreneurship has in practice spawned a huge industry of microfinance institutions. In December 31st, 2013, there were 3,098 microfinance institutions (MFIs) around the globe, reaching 211,119,547 borrowers (State of the Campaign Report, 2015). Microfinance is often used to fund micro-, small and medium enterprises (MSMEs) by giving out small loans, which banks do not offer to people whose creditworthiness is difficult to evaluate or who are seen as risky borrowers.

These micro, small and medium-sized enterprises established by poor people supposedly grow and eventually provide an opportunity to employ other people. The approach has credible supporters, such as the OECD, which promotes MSMEs as a way to increase growth through increasing exports (OECD 2004). In EU aid programmes, the focus of private sector development is on micro-, small and medium enterprises and the business environment (European Commission, Accountability Report 2015).

However, there is growing evidence suggesting that microfinance and MSMEs may not be the solution to poverty either – at least not by themselves. Developing countries are generally unable to guarantee the enforcement of contracts and establish property rights, creating a lack of trust in communities. Fafchamps and Minten (1999) call these countries flea market economies and suggest that lack of trust creates high transaction costs for trade, which is another obstacle hindering growth and expansion of businesses. In contrast, presence of trust can also translate into social capital or “networks together with shared norms, values and understandings that facilitate co-operation within or among groups” (Keeley, 2007, 103). High social capital contributes to growth through lowering crime, creating more functional labour markets and increasing innovation.

As Fukuyama argues (2002, 24), “the problem with the Washington consensus was not that it was misdirected, but rather that it was incomplete. One of the ways in which it was incomplete was its failure to take account of social capital”. He continues by explaining that the liberal policies were implemented even though the countries lacked a strong, and effective state and its related institutions, for example those necessary for contract enforcement. Additionally, some of the countries do not have a competent cultural setting for creating the type of social capital necessary for the economy to become productive, innovative and sustainable.

This paper introduces the problems of microfinance and small and medium enterprises and argues that the lack of trust and social capital has an impact on the local
market, causing stagnating growth and not allowing these enterprises to expand. As a solution, this paper applies the theory of industrial districts. In urban environments, similar companies tend to cluster, creating economies of agglomeration and regional economies of scale. There are several advantages that arise from similar businesses residing in close proximity regarding both competition and cooperation and this paper examines how the concept of industrial districts may benefit developing economies and improve the efficiency of microfinance and entrepreneurship.

The research in this paper is conducted by means of deductive qualitative analysis based on secondary sources of the relevant academic literature. This paper analyses the logical and empirical weaknesses in development approaches and deductively suggest a new combination of approaches. These new approaches would require empirical testing, which unfortunately is outside the scope the current Bachelor’s Thesis.

The structure of this paper is the following: first, the liberal theory of development will be introduced and its problems will be highlighted. The second part discusses the new approach to development by looking into microfinance schemes and MSMEs and reviewing the evidence related to the success of these interventions. The third part analyses the problems caused by the lack of trust and social capital in the developing economies. The fourth part suggests that by applying the theory of industrial districts, these problems could be overcome and the effectiveness of MFIs and MSMEs could be improved. The fifth, and last part, concludes and makes policy recommendations.

In sum, this paper argues that the main reason for the observed ineffectiveness of microfinance and micro-, small and medium enterprises in promoting development and growth is the omission of the meso-level. More precisely, the lack of trust and social capital in poor communities may have caused the inefficiency of the aforementioned measures. The theory of industrial districts might suggest a solution for dysfunctional markets and stagnating growth and thereby improve the effectiveness of such bottom-up solutions. Through increasing trust and promoting competition and cooperation, the small and medium enterprises can be scaled up and become more profitable, eventually creating employment opportunities for other people as well as a path towards sustainable development.
1. ECONOMICS OF DEVELOPMENT

1.1. Competing economic theories on growth and development

The path to prosperity is often approached from two different directions. The Bretton Woods organisations since the 1980’s have approached development from the liberal side. Liberals generally understand the role of the state in the same way, even though there are several schools of thought. The aim of the liberals is to keep the state small. Its main task lies in enforcing property rights and providing only the necessary infrastructure and security services, which markets are incapable of supplying. The rest is left to the competitive markets, both domestic and international, filled with profit-seeking companies without the government meddling in their business and trade. The policy recommendations included in the Washington Consensus consist of aspects such as privatisation of public services and companies, independent central bank, free foreign direct investments and capital markets, no barriers to trade and balanced budgets in terms of fiscal policy.

From the times of Adam Smith and the beginning of classical economics, it has been assumed that when left to themselves, individuals become entrepreneurial and start to barter and trade. Human beings are understood by nature to be pursuing their own self-interest and with the power of the invisible hand, their self-interest works for the common good. Naturally, this liberal assumption of the human nature has been questioned. Liberal economic theory contains a few fundamental assumptions on how free trade will benefit the global economy. In order to lay the groundwork for the arguments presented in this paper, it is necessary to briefly summarize the logic of the liberal economic theory and compare it with the non-liberal one. Starting from the macro-level, the first assumption of the liberal theory is that trade is beneficial; not equally, but has an overall positive impact due to the global surplus. This surplus means that because of specialisation of labour, the world as a whole can expand its production. The second assumption is that of global division of labour and comparative advantage; every economy specialises in producing products it has comparative
advantage in and the tasks are therefore naturally divided globally. In practice, this means that labour intensive economies produce labour intensive goods, such as garments and textiles, whereas capital intensive economies produce capital intensive goods, such as high-tech electronics.

On the micro-level the second assumption means that some types of economic growth would help the economically disadvantaged more than others. As Bhagwati (2004, 55) explains, an outward trade orientation helped the Far Eastern economies to export labour intensive goods, increasing employment and reducing poverty. In India, on the other hand, the emphasis was capital-intensive projects, which explains why the impact on poverty was minimal. Had labour intensive goods been exported in bigger quantities, the demand for labour would have increased and helped the poorer individuals (Bhagwati 2004, 57).

The non-liberals or interventionists, who similarly to the liberals cannot be treated as one school of thought, have some counterarguments to the liberal assumptions, due to which they are opposed to the concepts of free trade and foreign direct investment. The role of the state is to intervene in the economy by regulating the markets and exercising Keynesian fiscal policy during economic hardship to stimulate growth.

The main idea of the interventionist approach is that because of learning curves and economies of scale, the countries that industrialised first have the first-mover advantage. This means that they have had time to grow and develop their businesses for such a long time, that developing countries will never be able to compete with their products in the international market. Therefore, these countries should not exercise liberal policies as a way to increase prosperity. Ha-Joon Chang (2002, 2) argues that the now developed countries did not get where they are now through the policies and the institutions which they recommend to developing countries today. Most of them actively used 'bad' trade and industrial policies, such as infant industry protection and export subsidies.

Paul Collier (2007, 81) reflects on why some developing economies did not become competitive during the time of a huge wage gap which helped other economies rise. He arrives at the conclusion that developing countries had harmful trade restrictions of their own and also had restrictions imposed on them. In addition, there were spatial economies of scale in more developed ones, such as South East Asia (Collier 2007, 84). These countries had both the low wages and scale economies and therefore the less developed ones could not keep up. Collier concludes that a similar development of these countries is possible when the wage
gap to the East Asian countries grows large enough (2007, 86).

It is fair to ask whether either of these approaches has worked for the benefit of development. There are examples of both strategies failing and succeeding. Chile was for a long time a classic example showing that the neoliberal policies work (Ostry et al. 2016). The case of the East Asian newly industrialised counties has been subject to ideological debate. Liberals have claimed that the countries emerged because of free markets, but recently it has been agreed that it was due to protectionist policies such as export subsidies (Chang 2002, 49). Thereby non-liberals suggest that these emerging economies are an example that their policies work. In the case of Latin America, neither one of the approaches has worked (Rozenwurcel 2006, 1). In 2016, the economists at IMF admitted that praise for neoliberal approach was exaggerated and deregulated foreign capital markets increase the possibility of a financial crisis and deepen inequality (Ostry et al. 2016, 1).

Paul Collier (2007, 87) argues that when it comes to the recipients of aid and countries relying heavily on oil exports for income, the system of minimal state does not work. Resources and revenues from raw materials, alongside with the received aid funding, need to be transformed into public services in order to reduce poverty and enhance economic development. On the other hand, aid is public money. The economies relying on oil exports and other natural resources will not industrialise without private investments, which contribute to growth and stimulate the economy.

1.2. Meso-level economics

When it comes to developing economies, only during the last few years has there been an intense discussion on the meso-level of the economy, even though increasing attention to the issue has been given since the 1980’s. Meso-level includes the study of contracts, institutions, formal and informal networks and markets, everything that falls between the global, national and international macro-level and the firms and individuals on the micro-level. Xiao Cheng and Andrew Sheng write on World Economic Forum’s website (2012) that “by presupposing perfect competition, complete information, and zero transaction costs, neoclassical economics assumes away the need for institutions like courts, parties, and religions to deal with the economic problems that people, firms, and countries face”. As
Dopfer, Foster and Potts (2004, 263) write, one cannot directly “*sum micro into macro*”, but there are processes and forces in the meso-level that affect the aggregate macro-level results.

The omission of meso-level in economics can create problems for economic policy-making, as several important processes take place on the meso-level. Markos Mamalakis (1996, 183) has attributed the problems of Latin America, where, as mentioned before, neither the liberal and the non-liberal policies have seem to work, to the neglect of the meso-economic dimensions. Mamalakis argues that this has caused “*an incomplete, if not faulty, diagnosis of the problems*” (1996, 183) related to economic stagnation, poverty, and inequality as well as contributed to the creation of policies which have perpetuated, even aggravated, poverty and inequality. Similar issues can be assumed to exist still today when poverty alleviation and economic development are only analysed from the perspective of the macro- and micro-level. The meso-level has an enormous impact on how communities and markets function and affects how micro-level economic activities translate into macroeconomic growth.

This chapter has shown how economic development is pursued from liberal and interventionist backgrounds. It is clear, that both theories have been successful in some cases and in other cases they have failed. Both the liberal and non-liberal approaches have some advantages. Most importantly, economic policies and reforms should not be prescribed blindly without assessing the situation in each state and trying to find out what solution would work best in each case. As Collier (2007, 87) pointed out, developing countries have a need for both public and private money in order to begin to flourish. Regardless of the policy approach taken, the meso-level is an integral part in determining the success of the policies. It is clear that economies of scale play a large role in competition and productivity. Also the role of spatial economies of scale has been highlighted in the debate, something that this paper returns to in the last chapter when discussing the importance of industrial districts. The next chapter elaborates on the problems that may arise when a liberal approach to development is taken and the meso-level of the economy is omitted, in the context of microfinance strategies.
2. BOTTOM-UP SOLUTIONS FOR INCREASING GROWTH

In order to combine all three levels (micro-, meso- and macro-) and examine the relationships between them, this part of the paper will look into some of the micro-level, bottom-up solutions to poverty and underdevelopment. The promotion of entrepreneurship, growth and expansion of micro-, small and medium enterprises and the increased microfinance targeted to poor people supposedly enhance growth and development on the national level and relieve the poverty of individuals. Unfortunately, the debate on the effectiveness of these solutions remains inconclusive. Some of the debate is even overshadowed by confirmation bias, as huge industries have developed to promote microfinance regardless of new evidence of its ineffectiveness in reducing poverty. In the case of entrepreneurship in developing countries, the existing research is quite limited.

2.1. Entrepreneurship

After the rise of so-called enterprise culture during the era of Thatcher and Reagan, entrepreneurs were almost seen as mythical heroes in the West. Today, they are viewed as start-up-minded, innovative individuals who improve the well-being of the whole society with solutions they came up with in hubs and think tanks. Naturally, there are numerous success stories told of poor entrepreneurs, making their way from rags to riches. These narratives are largely present especially in the promotion of microfinance and are used as anecdotal evidence on the success of the lending programs.

Regardless of these success stories, for many poor entrepreneurs in a developing country, who produce simple handicrafts or sell home-grown agricultural products from a stall, the reality is quite different. The way entrepreneurship is portrayed and understood affects the research of the link between entrepreneurship, economic growth and development.
Let alone the image in the mind of a donor of an entrepreneurship project. Therefore, some critical inspection must be applied to the concept of entrepreneurship and its promotion. Naudé (2013, 5) has categorised the explanations of the concept of entrepreneurship in the growing literature into three; behavioural, occupational and synthesis definitions. The synthesis definition aims to combine the first two definitions and ends up viewing entrepreneurship as a “complicated and multifaceted phenomenon” and analysing it as a process, a resource or a state-of-being (Naudé 2013, 7). Entrepreneurship utilizes new opportunities in the market and mobilizes resources from one level of productivity to another, superior level through the creation of businesses (Toma, Grigore, Marinescu 2014, 438; Naudé 2013, 7). Looking into the components of the synthesis definition more closely, it appears that the behavioural and occupational definitions can sometimes fall short of capturing the situation of the poor entrepreneur.

The behavioural school has its roots in Schumpeter’s idea of creative destruction, which means that entrepreneurs are seen as people who come up with innovations and new ways of doing things, demolishing old patterns of thinking and doing and replacing them with better solutions. It can be argued that since the economically underprivileged have had no opportunity to try out their ideas due to the lack of finance, they are more likely to come up with new innovations once given the opportunity to start a business (Banerjee and Duflo 2011, 138). However, this definition seems to be more applicable to the industrial economies than the emerging ones. Therefore, those who observe entrepreneurship from this perspective do not see its role being very important in the early stages of development.

Some behavioural definitions put more emphasis on the opportunistic nature of entrepreneurs, who can detect imbalances in markets and observe a demand that has not been satisfied yet and then create a business that supplies for this niche. Muhammad Yunus, the pioneer of microfinance emphasises this opportunist characteristic and sees the poor as “natural entrepreneurs”, making creatively the most out of very little (Cosic 2017). The third behavioural school of thought underlines the role of an economic risk-taker, since small enterprises are often started with money from the pockets of the entrepreneur. These latter two definitions may be more accurate ones in order to conceptualise and comprehend entrepreneurship in developing countries.

Occupational definitions see entrepreneurship as an option to wage employment. This contrasts with the situation in poor rural areas. Poor people do not necessarily prefer to
be entrepreneurs, do not observe a niche or do not have an innovation they wish to bring to market – their only motivation to become an entrepreneur is the fact that there is no formal employment and they do not have the occupational option this definition suggests. Banerjee and Duflo analyse this in their book Poor Economics (2011, 151) and suggest that many of the poor entrepreneurs are in fact unenthusiastic and reluctant to run their businesses. As a result, improving their business and making it more profitable is not a priority, their survival is. Banerjee and Duflo conclude their study by stating that the evidence has made them to “seriously [...] doubt the idea that the average small business owner is a natural “entrepreneur” in the way we generally understand the term, meaning someone whose business has the potential to grow and who is able to take risks, work hard and keep trying to make it happen even in the face of multiple hardships” (Banerjee and Duflo 2011, 151).

The complexity of entrepreneurship as a concept suggests that the literature concerning entrepreneurship and growth should be approached with caution – entrepreneurs have many motivations and purposes for their businesses, especially when comparing the situation between emerging and advanced economies. For the disadvantaged, entrepreneurship is not always a deliberate choice: often the reason for business creation is the fact that there are no formal employment opportunities. The economic activities poor people eventually take up are not necessarily based on a great business idea or innovation – rather the business is born within the framework of their modest skills and access to very basic resources and possibly to no external finance.

2.2. Micro-, small and medium enterprises

MSMEs are a very heterogeneous group. Businesses vary from informal microenterprises to the formal medium enterprise, which can have up to 250 employees, (OECD 2004, 10). The economic activities undertaken by the enterprise can be anything from a simple juice stall to a high-tech corporation. The diversity of MSMEs already suggests that simple conclusions about their impact on growth and development are impossible to make. In the emerging markets, there are 365- 445 million micro-, small and medium enterprises. Out of these, 25-30 million are formal SMEs; 55-70 million are formal microenterprises; and 285-345 million are informal enterprises. Formal SMEs contribute up to 45 percent of total employment and up to 33 percent of GDP in emerging economies. These numbers are
significantly higher when informal SMEs are included (World Bank Brief, September 2015). In their study of eighteen countries, Banerjee and Duflo (2011, 139) found that 50% of urban poor and on average 20% of rural poor are non-agricultural entrepreneurs.

Because of the constantly growing global workforce, an estimated 600 million new jobs will be needed in the next 15 years, mainly in Asia and Sub-Saharan Africa. Therefore, the promotion of micro-, small and medium enterprises is an integral part of the policy of institutions such as the OECD and the EU. Some economies subsidise small companies to accelerate growth. In emerging markets, most formal jobs are with SMEs, which also create 80% of new employment opportunities (World Bank Brief, September 2015). In addition, especially in the case of developing countries, MSMEs also contribute largely to the informal economy, meaning that they do not necessarily always pay taxes and companies have problems following the rules that apply to larger companies, such as regulations regarding working hours and conditions. Some of them even take part in illicit or at least unethical activities, such as brewing of high-ethanol alcohol or funding cockfighting businesses and exploit child labour (Sherratt 2016, 126).

As mentioned above, there is no consensus about the impact of MSMEs on the economy. Generally, the support of SMEs is based on the assumed increase in competition and thereby in efficiency, innovation and productivity. Some proponents of SMEs suggest that these companies are generally more productive than large firms, but their growth is held back due to the lack of finance. The third argument is that SMEs are generally more labour intensive and thereby increase employment relatively more and help alleviate poverty by creating jobs and employing people (Beck, Demirgüc-Kunt and Levine 2005, 2).

Concerning productivity, a very basic concept of economies of scale seems to be forgotten. Large companies are capable of reaching higher productivity more easily. Larger companies are also more likely able to bear the cost of investing in research and development, thereby leading to more innovations. Critics of the exaggerated SME promotion claim that size itself does not tell anything about the company’s capability to create growth, compared to the company’s use of and access to resources, available technology, policy environment and institutions, which determine the optimal size of the company and its production level (Beck, Demirgüc-Kunt and Levine 2005, 2).

In addition to these contrasting theoretical arguments, statistical research does not support the conclusion that MSMEs increase growth and development. The study
conducted by Beck, Demirgúc-Kunt and Levine (2005,1) argues that while a large SME sector is a typical feature of successful economies and correlates with high GDP, there is not enough data to support the conclusions that SMEs cause growth. In addition to this, the researchers found no indication of SMEs alleviating poverty or decreasing income inequality. Wiggins (1995) suggested that a large SME sector is actually a symptom of economic uncertainty.

The unsuccessfulness of MSMEs in both generating a stable income from the entrepreneur and contributing to economic growth on a larger scale boils down to a few factors. First, the enterprises established by the impoverished tend to be extremely small and have no paid staff. For instance, in Morocco, the number of employed staff was zero and in urban Mexico the number was on average 0.57 (Banerjee and Duflo 2011, 142). In addition, these businesses are often short-lived and many of them do not grow at all during their lifespan. In Indonesia, two thirds of MSMEs started by poor people survived for five years. During this time, those businesses which had one employee in the beginning did not grow to have more employees (Banerjee and Duflo 2011, 142). The enterprises also lack assets like machinery and vehicles. Most commonly the MSMEs only have equipment such as tables, scales and pushcarts. In Hyderabad, India, only 20 percent of enterprises have a space for their business (Banerjee and Duflo 2011, 142).

The economic activities that poor households are able to take up are not often met with real demand for their outputs. As Banerjee and Duflo state, poor entrepreneurs are energetic, resourceful and can make a lot out of very little. “But most of this energy is spent on businesses that are too small and utterly undifferentiated from the many others around them. As a result, their operators have no chance to earn a reasonable living”(Banerjee and Duflo 2011, 145). Starting a successful business requires some knowledge, education and a favourable market. Take, for example, the projects financed with microfinance in order to empower women. Because the entry into the project is made relatively easy for women, the economic activities are often some type of handicrafts, which are created with modest tools from cheap and thereby poor quality raw materials. The quality may vary and the women may not even have basic measurement skills, which would help them standardise sizes of their products. This creates barriers for the sale of the product outside the low-income consumer base.

The income generated by these enterprises is most often very small or even
negative – especially when the supply of free family labour is taken into account. Many of the businesses are run because someone in the family is believed to have some time on hand and any additional income is needed. In many cases, this person is the woman of the household, who does not seem to have much of a choice if an opportunity to start a business comes up (Banerjee and Duflo 2011, 152). Running a business or producing handicrafts takes up a big portion of the woman’s time, which is already limited due to the disproportionate responsibility of the upbringing of children and taking care of domestic chores. Therefore, they may not enjoy running the business a lot and are not enthusiastic to expand it, given the opportunity. Women fear it would only add to their workload or their children may have to be taken out of school to care for younger children and the household. This naturally affects the potential income generated for the owner by the microenterprise and has an impact on how profitable the company can become and how it can thereby contribute to growth.

For those who are in fact interested in expanding their business and increasing profitability, the trouble lies in limited resources. According to the OECD, micro, small and medium enterprises identify financing, particularly medium and long-term finance, as their largest hurdle in order to grow and invest (OECD 2004, 22). The World Bank reports that fifty percent of formal SMEs do not have access to formal credit. When it comes to micro and informal enterprises, this financing gap is even larger. Overall, approximately 70 percent of all MSMEs in emerging markets lack access to credit (World Bank Brief, Sep 2015).

As with any company, ability to access external financing is necessary for increasing competitiveness. SMEs need access in order to invest in new technologies, skills and innovation (OECD 2004, 25). Financial needs are not, however, restricted to just loans – companies are equally dependent on the ability to save safely and transfer money efficiently. Without financial services, many need to store their cash savings in their houses and have trouble getting employed because of the lack of a bank account, where pay checks would be directly deposited. Microfinance institutions (MFIs) and related NGO’s have emerged to provide financial services to rural regions, where poor and unbankable people have no access to formal banking services, and they are constantly expanding their markets.
2.3. Microfinance

Microfinance has been celebrated as the panacea to poverty. The year 2005 was declared the UN Year of Microfinance and the following year microfinance pioneers Muhammad Yunus and his Grameen Bank received the Noble Prize for Peace. Since its introduction in the 1970’s, microfinancing has grown into a huge industry set on three pillars – eradication of poverty, women’s empowerment and free enterprise (Karim 2011, xxi), which all contribute to its appeal, both on the left and the right side of the political spectrum. In the West, the concept has easily gained support, as it is based on the ideas of self-help, individualism and entrepreneurship, all central to the liberal worldview.

Five years after the peak in international recognition and celebration of microfinance, criticism started to become more prevalent. Researchers became disturbed by the lack of robust evidence to support the alleged effects of microfinance and news media reported about indebted Bangladeshi women harassed by ruthless debt-collectors. Accumulating microfinance debts were connected to incidents of organ trade in India, as people could not otherwise manage to pay back their loans (Burke 2011; Buncombe 2010; Melik 2010).

In 2009, randomised control trials gave new reliable evidence on microfinance (Banerjee, Duflo, Glennerster and Kinnan 2009). The results fuelled the debate even more, as they found no significant increase in consumption, no increase in total household income and no improvement in women’s empowerment. Six new randomised control trials were completed a few years later, arriving to the same conclusion and giving an average zero for the impact of microfinance in poverty reduction (Banerjee, Karlan and Zinman 2015). David Ellerman (2007, 149) criticises the impact evaluations and suggests that it is not very scientific to compare the impact of microfinance to doing nothing. Any inflow of wealth to a district is likely to create increase in economic activity. Instead, comparisons should be made to other type of programs and projects, “treatments” to poverty. This taken into account, it is even more concerning that the overall effect of microfinance is minimal.

First of all, not all microfinance is practiced to fund businesses, regardless of the persisting image. As Milford Bateman writes in his book “Why doesn’t microfinance work?” (2010, 28) the public justification for microfinance is the assumption that it is used to fund income-generating activities. In reality, the use of a microloan is often reduced to
consumption smoothing, allowing people to make larger household purchases, get medical help in case of illness or help them through a period of food insecurity. Several studies have shown that the main use of microfinance is other than the funding of business activities – in Uganda and Tanzania, only 15% of microloans are used to establish businesses, in India between one third and one fifth of microfinance is used for business activities (Bateman 2010, 29). The promotion of microfinance still remains based on the idea that it helps fund businesses and thereby increases growth.

Microfinance is supposed to work so, that poor entrepreneur take a loan, invest in their business, gain growing revenues and pay back the loan. This is beneficial for the whole economy, as the poor entrepreneurs should be able to have higher returns to investments based on the principle of diminishing returns to capital. This also means that money naturally flows from rich depositors to poor entrepreneurs and investments move from richer countries to poor ones and within each country from the richer regions to poorer (Armendáriz and Morduch 2010, 6). The marginal returns to their businesses are also often quite high, even though their average overall returns remain low or even negative (Banerjee and Duflo 2011, 142).

However, in practice this is not happening because lending to poor people is riskier and costlier, which explains why formal financial institutions have not been lending them money before. First of all, there is inadequate information. As the poor do not generally have any record of their income, other transactions and possible other loans, it is difficult and expensive for the banks to estimate their reliability. This creates an opportunity for the impoverished debtor to take advantage of the information asymmetry. Therefore, the cost of lending rises due to increased need for monitoring during the loan period. This adds to the costs of lending, which is already high, since poor people tend to borrow small amounts, increasing the transaction costs for every loan (Armendáriz and Morduch 2010, 8). For the borrower, this generally means high interest rates.

Secondly, poor people do not generally have any valuable assets to offer as collateral to the bank. Another way to secure their loans is to offer smaller amounts with higher interest rates, which is also often the case with microfinance, although the interest rates vary greatly. The lack of assets explains the use of peer monitoring and information gathering instead of requiring collateral in ensuring the repayments. So-called social collateral is used in popular group-lending schemes. Much of group lending is based on interpersonal trust.
People need to personally know the person to ensure that they are creditworthy and will not default, leaving the rest of the group to cover for their repayments. The reliance on trust may lead to a situation where the borrowers would rather have someone they know join than a creditworthy stranger. Naturally, the poor may not be any better in assessing the risks of the loans than the bank officials.

To summarize, the inefficiency of MSMEs in creating growth and economic development is partially explained with lack of external financing. But even when the finance is granted, these businesses seem to remain unsuccessful and there are no significant changes in income, investment and household consumption. Most of microfinance is not even used to fund enterprises, but is used for consumption smoothing instead. There may be several possible explanations to why the results of these programs are minimal. This paper will now examine in further detail one of them, namely the lack of trust and social capital in the society, which results in inefficient contract enforcement, high transaction costs and dysfunctional markets. By doing this, this paper aims to explain why many enterprises started with microfinance are not successful.

A study by Beck, Demirgüc and Levine (2005, 1) manages to find robust evidence that the overall business environment influences economic growth, regardless of the size of the firm. This business environment is measured by the relative ease of entering and exiting the market, as well as the strength of property rights and contract enforcement. Recent work finds that under-developed financial and legal institutions do not only hurt SMEs but under-developed institutions hinder the growth of all firms to their efficient sizes, whatever it may be (Beck et al., 2003). This issue of inefficient institutions also creates a problem for the enforcement of contracts and thereby affects the level of trust in the society, which the next chapter will elaborate on.
3. THE PROBLEM WITH MARKETS: LACK OF TRUST AND SOCIAL CAPITAL

3.1. Contract enforcement and property rights

One of the most important tasks of the state is to make sure contracts and property rights are enforced. This is generally accepted by political scientists as an integral part of the role of the state regardless of ideological background. Unfortunately, many of the developing states are incapable of this because of corruption or general dysfunctionality of the government. Often the same countries are unable to allocate more resources to the improvement of legal and court systems and to efficient law enforcement. Consequently, many developing countries have a high crime rate and bribery of officers is customary. Douglas North (1990, 54) has argued that the most important reason for historical stagnation and contemporary underdevelopment is “the inability of societies to develop effective, low-cost enforcement of contracts”.

Knack (2001, 1) argues that both historical and recent evidence show that the difference between long-term economic success and failure is for a large part a result of the incentives of wealth-maximising individuals. In some countries, the structure of incentives directs people toward producing new wealth, while in other countries wealth gain is easier by abstracting it from others. The capacity of enforcing contracts and protecting property rights determine the benefits that arise with either making or taking wealth. However, also social norms and interpersonal trust pay a role (Knack 2001, 2). If the citizens do not have trust in institutions, such as courts and law enforcement and lack trust in each other or especially in strangers, there is an increased possibility of people engaging in opportunistic behaviour.

Fafchamps and Minten (1999, 6) have listed factors for why people do not turn to the state when they encounter thievery or breach of contract. First of all, there is the cost of legal action, including lawyers’ fees, bribes to agents of authority and also the opportunity
cost of the plaintiff’s time. Getting involved in a legal dispute is costly and time-consuming and a poor entrepreneur can easily find other allocations for their wealth and effort. Secondly, they need to consider the expected time delay before compensation is received, which in turn depends on the speed with which legal institutions handle their case load. Thirdly, getting involved in a legal dispute depends on the certainty surrounding expected compensation, which is a function of the ease with which perpetrators can be brought to justice, the ambiguity of the case, the availability of evidence, the neutrality of judges and police officers, and the sloppiness of the law and jurisprudence; and lastly, the fear of revenge taken by the other party, which itself depends on if the other party will and can be imprisoned.

3.2. Alternative methods of contract enforcement

Sources of trust (Knack 2001, 5) can be divided into first-party, second-party and third-party sources. The first party is the agent who takes up the order, for example a product delivery, from the principal, the client. Trust in the agent is established by awareness of the internal sanctions the agent may impose on him/herself, such as a feeling of guilt, should the agent fail to deliver the order. In religious communities, the threat of afterlife sanctions, such as reincarnation as a lesser being, may be enough to enforce contracts. Even though liberal economics define human beings as self-interested, the impact of good will and altruism in contract enforcement needs to be acknowledged. These sources of trust naturally require good knowledge of the person who is acting as the agent.

The principal can motivate the agent to respect a contract and deliver the order by making continuous agreements, which means that breaking the promise would result in significant loss of income compared to what could be gained by breaking the single, first contract. In developing countries, trade often takes the form of barter and the roles of principal and agent are reversed in another contract. Therefore, for example, the delivery of bad quality products may result in receiving bad quality goods through another contract. Knack (2001, 5) compares these situations to an exchange of hostages which ensures the mutual respect of contracts.

The third party sources of trust and mechanisms of contract enforcement include social institutions, private organisations, and governments. Often, there is not much sense in getting involved in a legal battle and therefore traders would rather avoid relying on the
state’s help and take matters into their own hands. When a country’s contract enforcement fails, people need to find other ways to ensure what was ordered gets delivered. Often the solution to a breach of contract and cheating is the strong-armed enforcement of contracts. It can make more sense to farmers to buy a gun to protect their yield than to invest in new farming equipment. This naturally increases the inefficiency and cost of farming.

Fafchamps and Minten (1999, 9) mention several alternative mechanisms of contract enforcement used by people in developing countries. Communities can enforce a joint punishment through shame, ostracism and the avoidance of trade with the agent guilty of a breach of contract. This method of social contract enforcement is familiar from the microfinance literature as well. Lamia Karim (2011, xvii) points out that the much praised social collateral used in group microlending works because of the cultural construction of family honour. Women are the bearers of honour and their shame brings shame to the whole family and the whole village community may take part in violence and shaming the defaulted woman.

Even though communities can avoid further trade with the unreliable agent, Fafchamps and Minten do mention that information about unreliable trading partners does not diffuse easily. Often contracts are only based on a long term relationship between the two agents and their enforcement is therefore easier as both parties benefit from the existence of this kind of relationship. Fafchamps and Minten (1999, 3) say that trust is established with repeated interaction, not by recommendations from others. In these types of communities where personal repeated interaction is required, the word of bad partners does not spread, making group punishments weaker and fewer. In microfinance, this often means that group lending schemes only take their friends and people they know to join, regardless of their ability to pay, instead of people they do not know personally even if they can demonstrate their creditworthiness.

However, in the case of agricultural work, family members are trusted less as trading partners for some reason (Fafchamps and Minten 1999, 20). This is presumably because it is hard to discipline relatives who are suppliers or clients and therefore breach of contract is higher amongst relatives in agricultural trade. Generally, one might also feel pressured to accept higher flexibility when it comes to schedule of delivery and quality of products or even the price of goods. These factors may result in lower profits for the business when there is a lot of trading within a family.
Most of these alternative enforcement mechanisms are heavily dependent on kinship, ethnic, or other social ties. In general, the more homogeneous a society, the more trust a principal will place in an agent (Knack 2001, 7). Zak and Knack (1998) find that trust is more prevalent in societies with less income inequality and with less racial, linguistic and religious polarisation. If we look at the situation in developing countries, the societies are very heterogeneous (Knack 2001, 8). The African continent, which hosts the majority of underdeveloped countries, also hosts most ethnically diverse states. Strong trust within an ethnicity in a society with high ethnical diversity may restrict transactions and lead to segmented markets. This would reduce gains that could be achieved with specialisation and with economies of scale (Knack 2001, 16). The following part suggests what happens in the economy of these diverse countries when trade and employment are only concentrated within one tribe, village and family, and contracts can only be enforced through violence or by building interpersonal relationships.

3.3. Transaction costs in the flea market economies

In a perfect market and in a situation of perfect competition, customers have perfect information about all the products and can therefore make educated and rational decisions. Unfortunately, this is hardly ever the case even in the West. George Akerlof (1970) got a Nobel Prize for his concept of the Market of Lemons, which originated from the sales of used cars. Akerlof’s logic is that the buyer cannot really know the quality of the product he/she is about to purchase, so the willingness to pay for a used car is lower than for a new one. The seller knows this and therefore has the temptation to sell a bad quality product, as it is difficult to get a fair compensation for a good product anyway, since the buyer expects to receive “lemons”. This accurately depicts the atmosphere of trading in developing countries, where contract enforcement is weak, unlike in the West where quality is controlled by external parties as well.

In the context of markets, the lack of trust creates several complications, when agents cannot trust their trading partners, suppliers and clients. In 1999, Fafchamps and Minten completed their research on the markets in Malagasy, Madagascar. They examined the impact of trust – or more precisely – the lack of it, on the markets of several agricultural products. What they found, was that the level of theft was rather low due to the low exposure
to thievery. Sellers of grain go to great lengths to avoid exposing their products to robbery and breach of contract. Avoiding exposure means that direct cost of theft and contractual breach are low, but transaction costs are high.

Traders use different preventive methods. They often inspect received goods themselves instead of relying on employees or trusting their trading partner’s word. Protection money is given for transportation and most risky routes are avoided. Overnight storage is avoided to lessen risks. This can mean that people do not buy goods for stock and need to buy several small amounts, which results in multiplied transaction costs. Some traders may rather sell their goods with a discount at the end of the day in order to avoid bringing goods back with them. If overnight storage is necessary, people often sleep in their stores (Fafchamps and Minten 1999, 2).

There is a lot of unemployment in most developing countries, but due to the fear of employee theft, traders avoid hiring new workers. In case new people are hired, the employee often comes from within the family. There is an expectation that unfamiliar employees may steal and family in general is trusted more. Naturally, this means that the most qualified candidate may not be accepted for the job and family ties are preferred over skills and knowledge, creating a bias also to the labour market.

Fafchamps and Minten (1999, 4) labelled these type of economies Flea Market Economies. In societies like this, there is no forward contracting, no brand recognition and no returns to scale. It becomes clear, how the lack of trust paralyses the markets, creates additional costs and increases suspicion. This explains, why companies, especially the small ones that cannot afford legal battles, thievery and cheating, must rely on the aforementioned tactics to avoid exposure. This diverts a lot of energy and resources away from the actual business. Even labour intensive small enterprises may have to refrain from employing more staff to avoid exposure to employee theft, or they might have to employ unqualified and unskilled workers from within their family. It is clear, how these factors contribute to the inefficiency and unproductiveness of the MSMEs.
3.4. Social capital

In addition to contract enforcement, there is another theoretical concept – social capital - which explains where and how trust emerges, making contract enforcement less costly and problematic. Social capital is crucial for both economic development and liberal democracy. The level of social capital tends to increase states are able to ensure the rule of law, contract enforcement and property rights. Social capital affects the way in which people organise themselves for economic activities but it also supports the creation of institutions and the rule of law and thereby contributes to democracy. Societies in which people cooperate across large organisations are more likely to develop strong, efficient state institutions and the existence of these types of institutions also fosters the creation of social capital, so there is a reciprocal relationship (Fukuyama 2002, 27).

There is no single theory of social capital, but several competing ones that aim to explain the phenomenon. Additionally, there is no generally accepted way of measuring social capital, which leaves the concept slightly vague. It is, however, very popular in the discourse on economic development. In recent years social capital has been discussed alongside neoliberalism and it has been on the neoliberal agenda. Most development literature engaging with social capital considers it a resource (Knorringa and Staveren 2006, 6). It is a meso-level variable, and understood as one of the input factors of a production process creating outputs.

Social capital refers to the networks, shared norms, values and understandings that facilitate co-operation within and between groups (Keeley 2007, 103). The concept can be divided into three categories: bonds, bridges and linkages. To return to the idea of trust, in the homogenous societies where trust was strong between people who are alike, bonds are strong and many. Bonding is a traditional form of social capital and is prevalent in societies where the state does not provide basic services and the family is the safety net during hardship. However, the bridges are the ones that connect the different kind of, heterogeneous people with each other. This is a more modern form of social capital. Linkages describe the connections to individuals higher up or lower down on the social ladder.

Returning to the notion that homogenous groups generally have a higher level of trust, this would indicate that there is a high level of social capital that consists of bonds. However, from the perspective of markets, this kind of social capital is not very fruitful. What
the community would need is to bridge with other groups to form social capital between heterogeneous groups and individuals (Fukuyama 2002, 25). Fukuyama (2002, 27) argues that not all systems of norms and values, and thereby not all cultures, have similar positive impact on economic growth. If the norms and values promote the creation of bonds instead of bridges, the culture is less likely to foster growth and development. Fukuyama brings out the example from Latin America, where the business sector is organised based on kinship and conglomerates are formed based on family relations across different, non-related businesses and not based on advantage resulting from synergy.

Social relations and social capital are not always necessarily positive and neither are their economic effects. Social structures also include asymmetrical power relations which need linkages to connect groups and individuals on different levels. Without linkages, actors are included and excluded based on some discriminating criteria and inequality increases. Asymmetrical power relations can naturally result also in relationships that use authority and control that can in the very extreme lead to the oppression of a group by another (Knorringa and Staveren 2006, 3). This kind of relations can contribute to creation of wealth, but it is distributed unevenly in the society.

There are studies that analyse the link between microfinance and social capital. The debate aims to determine whether microfinance creates social capital and in which cases. Fukuyama argues that microfinance is a good example of successful building and exploitation of social capital (2002, 33). Feidenberg et al. (2014, 1) have studied the role of social capital in the context of group-lending. Results were better when the group consisted only of new borrowers and borrowers who had a similar level of empowerment to begin with. Repeated interaction among the borrowers seemed to have a positive effect on their relationship and social capital continued to accrue.

When it comes to the exploitation of social capital in the context of microfinance, there can also be negative impacts. Molyneux argues that microfinance diminishes the existing level of positive social capital by creating a socially corrosive competitive individualism (Molyneux 2002, 181). Lamia Karim (2011, xvii) presented the idea that the cultural values of honour and shame that are embodied in women are exploited in order to guarantee repayment. In the context of microfinance, the building of trust does happen in the debt framework. Many banks and lending programs have group building and solidarity activities – lending groups are given names, they grow a plant together or have a
group vow. This is done to ensure repayment by creating loyalty to the group and the peer monitoring can definitely create a negative atmosphere in the group. Most importantly, this kind of creation of social capital does not really enhance relations crucial for business activities. The focus should be turned to improving the business and networking with buyers and other stakeholders. It seems that microfinance is able to create important bonds among female borrowers, but may not increase the development of linkages to beneficial stakeholder groups.

The generation of social capital must happen through the changing of norms and values to encourage the type of interactions that create more bridges. Fukuyama (2002, 33) points out that building social capital is more realistic at the micro-level of a village, bureaucracy, firm, or department, where there are many cases of organisations successfully creating social capital, compared to the macro-level where it is created through policy. It seems that there is not much that policies (which often are rather invisible for the citizens) can do to re-build trust and change deeply rooted patterns of thinking. In these cases it is important to concentrate on creating a strong state and a rule of law (Fukuyama 2002, 32).

Paul Collier (1998) summarises that the link between social capital and economic benefits is through trust, which leads to collective action. Therefore, social capital sometimes works as a substitute for both the market and the state, as it provides social sanctions against opportunism and exploitation of common pool resources. Fafchamps and Minten (1999) suggest that social capital works as a cost-effective substitute for laws and legal systems for small businesses. Thus, the creation of social capital can compensate for the inefficient legal system.
4. INDUSTRIAL CLUSTERS

Industrial clusters are one of the drivers of the creation of social capital and these two concepts are vitally intertwined. In cultures where social capital largely consists of bonds, clustering can compensate for the lack of bridges, as it creates similar advantages for the economic activity as social capital does and also promotes the generation of social capital through spillover effects.

4.1. Theory and terminology

Historically, industrial development happens in industrial districts. The idea of industrial districts was first presented in the 1920’s by Alfred Marshall. Development economists call these areas industrial clusters and sometimes one can see the term economies of agglomeration used. These terms are not synonymous, but all do, however, describe a concentration of businesses, suppliers, customers and workers in geographic proximity. Agglomeration means a larger centralisation of people, businesses and transportation networks etc. whereas clustering happens within agglomerations. Clusters are more specific concentrations of businesses that produce similar or related goods and associated institutions (Karlsson et al. 2014). In this paper, these terms will be used interchangeably.

Industrial clusters can be defined with the following main attributes: geographical proximity, sectoral specialisation, predominance of small- and medium-sized firms, close collaboration and interconnectedness, competition that is based on innovation instead of lowering wages, a socio-cultural identity which facilitates trust between firms and between employers and skilled workers, active self-help organisations, and active regional and municipal government which strengthens the innovative capacity of local industry (Hashino and Otsuka 2013, 119). Oyelaran-Oyeyinka and McCormick (2007, 2) point out,
that the cluster theory assumes that all firms are equal in status and power they wield in the cluster. This may underplay the confrontation, friction or domination that also takes place in the clusters alongside cooperation.

Hashino and Otsuka (2013) review an endogenous model of cluster-based industrial development proposed by Sonobe and Otsuka, based on more than 20 case studies in Asia and sub-Saharan Africa. The model has three stages: first is the initiation state, second the quantity expansion stage and third the quality improvement stage. During the initiation stage of cluster development the product quality is low, but profitability may be quite high since there are lots of low – income buyers in the developing countries’ markets who prefer the cheaper option. This profitability attracts imitators and eventually a cluster is formed. This stage of clustering drives prices down as supply increases. Companies start to improve quality in order to outperform competitors (Hashino and Otsuka 2016, 14). When clustering happens, number of firms decreases but overall employment and profitability increases. Hashino and Otsuka also mention (2016, 16) that not all clusters behave this way – some of the clusters remain static, survival clusters, like the ones in sub-Saharan Africa. For comparison, the clusters in East Asia are considered dynamic clusters as they continue to develop.

![Fig.1. An illustration of the development paths of industrial clusters in terms of changing profitability and the number of firms (Hashino and Otsuka, 2013, 21).](image)

Some industrial districts are born because of natural advantages – shipbuilding happens on the shore, mining takes place where large concentrations of minerals appear.
Sometimes clusters are established as a part of government procurement programmes. Others have economic advantages as the driving force of the formation. Industrial districts may create external economics of scale, but there are other benefits as well, which will be analysed in further detail in the following section of this paper.

4.2. Advantages of clustering

Dynamic industrial districts can have the benefits of external economies of scale. Namely, these benefits are (Hashino and Otsuka 2016):

1) the ease of division of labour and specialisation of labour among enterprises
2) information spillover and imitation
3) development of skilled labour market

The first point, division of labour and specialisation is extremely relevant for small enterprises in developing countries. In the inefficient market, it is not uncommon that several similar small shops, selling a limited inventory of products, are located in close proximity. Through the division of labour, these entrepreneurs would be able to specialise. One shop could provide a larger variety of fruit and vegetables and the other could concentrate on selling dairy. Specialisation also helps the enterprises to differentiate from each other in the market and thereby attract new customers.

When it comes to the spread and application of knowledge, entrepreneurs are vital as they sieve the ubiquitous knowledge to find the relevant knowledge to be exploited by their industry (Karlsson et al. 2014, 24). There have been numerous studies on knowledge spillovers and adoption of new technology. Conley and Udry (2008, 17) examined the case of the agricultural sector in Ghana, where new pineapple growing technology was adopted for use. Social learning happened between individuals of different levels of wealth and even across long distances between pineapple farmers. Surprisingly pineapple exporters, though they could benefit from providing information that would increase their inputs are not a source of information. This supports the argument made by Karlsson that entrepreneurs themselves are in the key position to sieve and spread information. Often these kind of information spillovers result in small improvements in technology, marketing and management, instead of ground-breaking innovations.

Intuitively, the disadvantages of not clustering are the opposite. The enterprises
have no information about the development of new products and production methods. The employers lack awareness of skilled workforce or at least may not have access to it. Long distances between suppliers, buyers and other relevant businesses increase transportation and transaction costs. Similarities between problems that arise from the lack of social capital and that arise from not clustering can be observed. As already stated, the inefficiency problems caused by a lack of trust are pretty much identical: high transaction costs and general inefficiency. As there is no integration outside of one’s own homogenous network of family or ethnicity there is no diffusion of information about bad trade partners and presumably about new innovations either. For the same reason, enterprises resort to the employment of unskilled labour.

4.3. Examples of cluster organisation in emerging economies

One example is a case study of a spontaneously emerged, low-tech shoe industry in Brazil reported by Fisher and Reuber (2000, 11). In the 1960’s there were 400 entrepreneurs in the area - in 1991 it had grown to include some 1500-4000 firms with altogether 150, 000 workers. The effective dissemination of information was guaranteed by the publishing of two weekly papers and four bimonthly papers on shoe manufacturing. As there were numerous entrepreneurs in the area, it was considered less risky by foreign investors since there were many investment options. Any effort put into learning about the area would not go to waste, since it was likely one would find some company worth investing in. The area was a large enough concentration for the firms to cooperate in the creation of trade shows and joint marketing in order to reach foreign buyers and investors. The area also grew specialised businesses of design, accounting and finance as well as technical consultants. American export agents negotiated the prices with foreign buyers and exercised quality control. The decline of the cluster started in the 1980’s when the atmosphere of cooperation and competition was harmed by labour difficulties and workers’ associations were divided to those serving big and small companies. Inflation in the country was high and lower production cost countries started to attract business. The eventual failure of the clusters has been attributed to the agents who did not drive the market development in the right direction and concentrated too much on improving production capabilities. This example
shows the importance of dynamic change and growth as well as collective organisation. The cluster benefited largely from organised distribution of information within the industry.

An artificially created woodworking cluster in Brazil was started to combat drought as a government procurement programme. It was so successful that it was continued afterwards even though the drought had ended. The woodwork cluster had an efficient way of ensuring product quality. Every table made had a metal blade of the carvers name and a contract number. If there were any flaws, the buyer could return it for repair. In the case that the carver was no longer in business, the collective association would take care of the repairing of the table. Since the program was extremely successful, there was political pressure to repeat it in other districts. The decision on where these projects would take place is an opportunity for political gains and therefore difficult to make. As a result, the program was replicated in many places. In this case, the creation of multiple clusters turned out to be counterintuitive for the original idea of concentrated production and the multiple new clusters were not as successful as the first. (Fisher, Reuber 2000, 15) The creation of artificial clusters is possible, but there is a risk that politics influence the process in a way that does not ensure the most optimal cluster development.

Mawardi, Choi and Perera (2011) studied a wood furniture cluster in Bukir, in Indonesia. They analysed the development factors in order to find variables that influence the cluster development and growth. For example, inefficient bureaucracy, unfair tax, and poor public infrastructure have created difficulties for Indonesian SMEs, which have been discriminated by government regulations opposed to large scale enterprises (Mawardi, Choi and Perera 2011, 2) According to Mawardi, Choi and Perera (2011, 25) the case of Bukir cluster shows that government’s policy incentives are not necessary for enhancing the cluster’s growth and development. However, the government can create policies that make it more difficult for the MSME sector. The scholars also emphasise the role of collective efficiency and social capital in this case and conclude that these factors have likely contributed to the development of the Bukir cluster. The study was able to also point out that in addition to the government’s counteractive policies, the lack of financial sources was, not surprisingly, reported as an obstacle for growth by the entrepreneurs (Mawardi, Choi and Perera 2011, 25). This example supports the idea of improving access to financial services for entrepreneurs.
4.4. Cooperative competition in clusters

In order to demonstrate how to overcome the common problems of the MSMEs and use the whole potential of industrial districts to facilitate growth, the social capital literature has been combined with the industrial district literature. This part discusses the dimensions of cooperation and competition in clusters. Often, it is assumed that out these two elements one can only be present at a time – people and companies either compete or cooperate, but in fact those who manage to combine the two are more successful.

Even though industrial districts create external economies and thereby increase the efficiency of businesses, create knowledge spillover and advance the adoption of technologies, one of the most defining features of clusters is the opportunity to reach even larger advantages through collective action with other actors in the cluster (Schimtz 1999, 469). This cooperation could take the form of either horizontal or vertical collaborations. The horizontal linkages connect enterprises with their competitors. This can be individual linkages or collective ones, such as trade associations. More concretely, these horizontal ties can result in the joint purchasing of input, joint production, joint marketing, order sharing, sharing equipment, in addition to exchanging information and know-how (Schimtz, 1999, 469).

One problem of MSMEs and emerging clusters is bad quality and the deliberate selling of bad quality products. An example of this problem of information asymmetry comes from industrialised Japan where the overall quality of silk products was bad and regardless of the attempts to improve the quality of the products across the whole industry, the traders could not get rid of some free-riders who refrained from improving the quality and thereby tarnished the image of the whole industry (Hashino, Otsuka 2013, 153). In Japan, trade associations provided training and introduced new production methods for the industry and local governments were involved in quality control. Cooperation and quality inspection by trade associations can limit the information asymmetry between buyers and sellers and also between companies. This establishes trust and thereby reduces transaction costs. Cooperatives also have the opportunity to establish brand names – as stated before; there is no brand recognition in the so-called flea market economies. Hashino and Otsuka suggest that many industrial clusters in developing countries fail to develop and become dynamic because of the lack of active trade associations and the absence of support from the local governments (Hashino, Otsuka 2013, 31).
CONCLUSIONS

This paper started by showing that there is no consensus on the effectiveness of international development aid. There is heavy criticism when it comes to government-to-government aid, but also other forms of aid are beginning to be questioned. In the first chapter, different theoretical and ideological approaches to the issue of economic development were introduced and it was shown that both approaches have both succeeded and failed in some countries. Both the liberal and non-liberal approaches have their problems and advantages, and developing countries are often in the need for both public and private money. It was shown that regardless of the policy approach taken, the meso-level of each economy should not be omitted.

The second chapter highlighted the problems that may arise when a liberal, bottom-up approach to development is taken and the meso-level of the economy is omitted. Micro-level solutions of promoting entrepreneurship, MSMEs and microfinance also face a lot of well-grounded criticism and even lack evidence of their usefulness. The problems in these micro-level solutions, small enterprises and microfinance, were introduced and analysed. Even though one major obstacle for the expansion of small companies is the lack of finance, microfinance has not been able to increase the income of entrepreneurs and the amount of investment into businesses.

In the third chapter, the literature on social capital and trust was reviewed and combined to explain the problems in microenterprise efficiency. This paper then analysed the meso-level problem of the lack of trust and social capital in communities, showing that low-trust communities have high transaction costs and dysfunctional markets. It was evident that in addition to the reluctance of some entrepreneurs, their lack of contacts bridging outside their family circles to crucial stakeholders and partners is hindering the growth and productivity of their businesses.

In the fourth chapter, the usefulness of industrial districts in promoting the creation of social capital was examined. Through several examples, showing both successes
and failures in the creation of clusters, it was concluded that industrial districts have the capability of improving the quality of products, sharing vital information among entrepreneurs and increasing productivity through the creation of spatial economies of scale. In addition, cooperative competition and trade associations can create brand recognition in markets where it does not exist.

Whether one is on the side of the liberals or of the interventionists in this debate, it is clear that the MSME sector needs support in order to fully contribute to growth and alleviate poverty. When it comes to the debate on development aid, it is vital to understand that the government cannot completely be bypassed and overlooked. It is necessary for economic policy-making and the creation of infrastructure, which contributes to the functions of micro-, small and medium enterprises and the development of industrial clusters. However, NGO’s and other entities involved in development cooperation can also contribute to the creation of clusters. Social entrepreneurship projects can be designed in a way that they into consideration the advantages of clustering and cooperative competition.

The key finding is that the bottom-up approach to development would benefit from a more explicit focus on meso-level variables. Interestingly, the role of microfinance appears to need some re-evaluation. What was assumed as an irrelevant or even harmful practice from the perspective of economic development and poverty alleviation can actually have a positive impact on social capital, which then influences the economic environment of MSME’s. Even though microfinance does create social capital, it frequently is of a type not conducive to economic development and clustering. Therefore it should be practiced in a manner that fosters the creation of bonds and linkages between borrowers and does not contribute to the creation of negative, corrosive social capital. In addition, microfinance and entrepreneurship programmes should look for ways to expand the creation of social capital outside the framework of the borrowers to include also other stakeholders of their businesses. Future research hopefully will elaborate on the role of microfinance in social capital, on other measures of creating social capital and how to build artificial industrial districts.

From this paper, some recommendations for the practitioners of microfinance could be distilled. As the research indicates, some carefulness is necessary in promoting these measures to avoid exploitation of poor – especially women. This includes ensuring that loans are used for productive enterprises rather than consumption smoothing. As well as for practitioners, this is relevant also for donors and supporters of microfinance programs.
Microfinance seems to have some positive effects as it can both raise social capital and utilise it, but in the current situation its potential is wasted as a large portion of the loans is used for households’ consumption smoothing and not to develop businesses. Whereas microfinance seemed to have minimal effects on the growth and expansion of micro-, small and medium enterprises, it may have a role in the creation of social capital, when done right. Microfinance projects should either focus on areas that have a high degree of social capital or explicitly try to promote the formation of the right kind of social capital, for example, through promoting specialisation in a village. More research on this matter is needed and especially the risks related to the corroding atmosphere in group-lending schemes should be studied further.

Homogeneity of relations poses another problem for microfinance as the majority of lenders tend to be women. A study of agricultural pineapple in Ghana (Conley and Udry 2008) showed that interactions between genders were rare, so there is a chance that some industries are only contributed to by women. Women’s empowerment has been used as an argument in support of microfinance, but there is a risk that men and their businesses become increasingly excluded from financial services. The claims that a lot of women are often overburdened and reluctant to improve their businesses support this idea of increasing the accessibility of microfinance to men. In countries and regions that do not have a cultural code that prohibits it, the dissemination of information should be encouraged between genders. Due to the differences in upbringing and socialisation process, there is a change that different genders have access to different kind of information that may be useful for entrepreneurs of the opposite sex as well.

When it comes to policy-makers, designing industrial districts and increasing the communication and transportation possibilities is vital. Paul Collier (1998, 1) recommends that governments can aide the creation of social capital by improving transportation networks and communication tools and reducing their cost. This will naturally accelerate the development of clusters as well. The impact of networks has been demonstrated by the entire globalisation process, which has largely happened thanks the lowering cost of transportation and fast development of internet, wireless communication and information technology in general, eventually reducing the need for transportation in the business context. Governments can increase social capital by improving institutions and contract enforcement and increasing networking possibilities. Naturally, the latter can be left to markets there where density of people is larger, but especially in rural areas the improvement of transportation and
communication may need government intervention. Even if there is no significant industry, also the agricultural sector benefits from possibilities of new information dissemination, as the social learning of new technologies has shown.

To conclude, industrial districts are important for economic development but it seems that the collective action and organisation that takes place in clusters and amplifies the positive influence of clustering may be even more important. Trade associations and cooperatives can mean a great deal for social capital as well as for the growth and improvement of enterprises. The importance of this finding suggests that state’s policies should encourage the creation of trade associations, which can both ensure the quality of manufacturing, make collective efforts to increase exports, share information essential for increasing productivity, but also collectively take action against the exploitation of workers in these clusters and fight against unreported employment, tax avoidance and other issues of the informal economy. Therefore this area of research is not only necessary in the developing but also in developed countries where informal economy is blooming and stagnation is persisting.

Finally, where social capital is low, clustering can both increase its creation and substitute for it as effective clustering reduces transaction costs. In ethnically diverse societies and where the rule of law is weak, the role of social capital in economic development is emphasised. Entrepreneurship, micro-, small and medium enterprises and microfinance are important components of economic development, but their promotion should be done with some reservation, especially in circumstances where contract enforcement creates difficulties and transactions happen only in homogenous groups. The impact of cultural norms in economic transactions cannot be ignored.
REFERENCES


