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THE ROLE OF SMEs FOR DEVELOPMENT: A LITERATURE REVIEW

Paper submitted to ERSA 2004 CONGRESS:

"Regions and Fiscal Federalism"

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ABSTRACT

The role played by SMEs in any society is undoubtedly important, for instance, in Portugal around 98% of the industrial fabric is composed by SMEs. Nowadays, entrepreneurship and firm creation is mostly related to small and micro firms, which lead us to look at them as an important development agent in any society.

Most of times, firms are seen as a black box on what concerns to development however the measures taken by them, entrepreneurial strategies, and entrepreneurship actions, have influence in the development theatre. At the same, not only the SMEs as a group of firms (industrial sector) must be taken into consideration, but also many factors inside the firm, such as the quality of management, human resources, or innovation factors.

This work intends to present the state-of-art on the subjects relating SMEs and development, trying to find out how the SMEs are related to development, which factors are taken into consideration when the role of these firms are analysed, for instance, innovation factors, human resources, or the firm revenues.

It is widely accepted that SMEs are an important development agent, but sometimes they are analysed not like an agent by themselves, but as a group of firms creating (the group) another agent. This group might be a cluster, an industrial district or a *filière*, however it is important to look to the firm by itself. The entrepreneur might take individual actions different from those followed by the group. So the small or micro firm also has an important role for development, the main idea for this work is to find out some important initial literature on SMEs and development, trying to get a perception of the role played, not only on what concerns to enterprises creation, but also on the strategies adopted by these type of enterprises to overcome the bottleneck of regional development.

Keywords: Development, SMEs, Entrepreneurship

1. Introduction

The importance of Small and Medium Enterprises (SMEs) and Micro Firms in both national and international context is undoubtedly of higher relevance. In a large number of countries the percentage of micro and small firms is extremely high, e.g. 98% in Portugal. These firms are important not only on what concerns to its representation for economic analyses but also for the countries economies and the implications that it brings to the society. These firms have an important role on many aspects, such as employment, taxes or innovation that, most of times, is regarded as something on the responsibility of large firms or research centres. In *“The Theory of Economic Development”* Shumpeter (1934) emphasizes the role of entrepreneur, as a prime cause of economic development, being this development achieved through innovation. Taking into consideration this thesis one can say that if the entrepreneur has an important role for development, this role is achieved through the “institution” that he/she represents: the Firm.

Nowadays most of the World Economies are facing some economic problems, it is said that we are in a recession period, however a few years ago Audretsch (2000) was saying: *“the last decade has seen a re-emergence of competitiveness, innovation activity and job generation in the United States. Not only was the economic turnaround largely unanticipated by many scholars and members of the community policy, but what was even more surprising than the resurgence itself was the primary source – small firms.”* If this was the reality some years ago it must be valid for the new crisis that the world is facing today.

In the theatre of development the role played by SMEs and micro firms is very important, not only because they are defined as the engine of economic growth, but mainly because they are the largest percentage of firms in the economic activity. *“Industry and its impact on economic and social development and the environment has been at the centre of the debate on sustainable development since the term ‘sustainable development’ was brought into common use by the Brundtland Commission in 1987. There is now a consensus among policy makers that in order to achieve sustainable development, Governments and non-state actors need to make greater efforts to integrate economic, social and environmental goals into industry policy and decision making”* (United Nations, 1998). Six years after this conclusion, it seems that the word industry must be understood not only as the manufacturer sector, but the economic

activity that includes industry and services. Once again we are talking mostly about SMEs.

Related with SMEs, nowadays we find a very common word that is Entrepreneurship. “*As means of generating jobs and raising incomes, increasing rates of enterprise creation is an almost universal concern among local authorities. Along with efforts to attract investment, stimulating entrepreneurship is one of the two pillars of most local and regional development strategies*” (OECD^a, 2003).

Most of times entrepreneurship is related with new firms creation, which in a way is true. However the concept and practice of entrepreneurship should not stay only for this step of the process. Entrepreneurship must be practised not only on the firm creation, and once again we will find this concept related to small and micro firms, but also it must be a continuous practice on any enterprise management. One of the “dos for small firms¹” presented by Beaver (2002) is “*grow if you want to survive*”. If entrepreneurship is one of the pillars to local and regional development through enterprises creation, the same must happen when the firm is growing, creating more jobs, increasing productivity, raising incomes, among others. So entrepreneurship in SMEs must be seen on the enterprise *start-up*, as well as on the enterprise growth. This growth may be the source for more entrepreneurship through *spill-overs* to the firm, and because it can originate some *spin-offs*, that will contribute for the region development.

The ideas presented by now are undoubtedly discussed on the literature, however much more than a firm creation and development can be done in order to achieve local, economic, or social development. Recently, Bessa (2004) presented a study of the less favoured regions of Portugal in order to achieve some solutions to boost local development. In this study are presented some political implications, such as fiscal and financial incentives, or social policies measures. At the same time is necessary to distinguish and to pay attention to the initial fostering versus assistance to established businesses measures.

In order to get good results on what concerns to local development, this challenge cannot be won only through Government measures or by each enterprise alone. It is common to talk about a cluster or a *filière* or in a simple way in a group of firms. These firms must be seen by two different perspectives; first all the firms are competing among them; secondly all of them should be working for local development.

¹ The dos and the don'ts for small firms

On this work is intended to present the main ideas on these fields that can be found on the literature followed by some critical comments in order to find out interesting points to deal with on future researches.

2. SMEs as a Development Agent?

i. Sustainable Development

The term Sustainable Development was brought into common use in 1987 by the World Commission for Environment and Development, or in other words by the Brundtland Commission. Accordingly to Spangenberg (2004), sustainable development is based on the integration of four dimensions: the economic, the environmental, the social and the institutional and is perhaps the most challenging policy concept ever developed. This Commission named four key problem areas related to sustainable development: (Spangenberg, 2004 quoting WCED, 1987; Kopfmüller *et al.*, 2001)

- The environmental challenge, the degradation of the natural basis of human life;
- The first social challenge, the increasingly unequal distribution of income and assets;
- The second social challenge, the high number of people living in poverty;
- The institutional challenge, the resulting threats to peace and security.

Derived from these problems were established three core imperatives:

- The environmental imperative, safeguarding the environment globally and for a long term perspective;
- The social imperative, strengthening cohesion by realising justice between people, countries, genders, social groups etc.;
- The institutional imperative, securing participation in political decision making and as a precondition for peaceful conflict settlement.

“An economic imperative is not mentioned, nor is one of the challenges an economic one (if distributional issues are not – in a more classical sense – regarded as economic issues). Instead, the economy is perceived as a Janus headed: its current way of working is a driving force behind most of the problems, but it could also be a force for the better, contributing to the solutions of problems by creating enough wealth to solve them. Although a vibrant economy is no end in itself, it is considered essential for the long

term satisfaction of material needs by providing jobs, income, social security and consumption opportunities” (Spangenberg, 2004).

It seems clear that the economic dimension assumes an important role in sustainable development. It can be said that this dimension is above all other concerns, and/or is the support for sustainable development. But how to improve this dimension? An essential element for this dimension is growth. For instance, nowadays with the “crisis” that the Economy is facing it is common to find in any newspaper, including the non-economic ones, news about national growth (or not) on the first page.

The Organization for Economic Co-operation and Development presents in the study *“The source of economic growth”* (OECD^b, 2003) the causes of the differences in growth performance of countries and regions, and identify factors, institutions and policies that could enhance long-term growth prospects. In this study it can be found the basic determinants of growth, which are:

- The accumulation of physical capital;
- The accumulation of human capital;
- Research & Development.

All of these determinants are from one or another way related with industry or enterprises, for instance, the accumulation of human capital *“leads to better organization, as it helps the firm learn how to produce more efficiently”* (OECD^b, 2003). *“Attending that economic growth sources are related to enterprises, it can be assumed that enterprises role, no matters the size, is extremely important. If these «agents» drive us to economic growth, they also drive us to economic development, that accordingly to the steps: Economic Growth → Economic Development → Sustainable Development, it might be said that enterprises have an extremely important role in the «development theatre»”* (Duarte, 2003).

Up to now there were mentioned the concepts of enterprises that are one of the pillars, probably the most important, of economic growth, which plays an important role on the economic dimension that can largely contribute for sustainable development.

ii. Small and Medium Firms

Taking into consideration the enterprises and the main goal of this work, the relation between development and SMEs one cannot forget that enterprises can be small

or medium-sized, but they can also be large firms. Caloghirou *et al.* (2004) presented a work contrasting the relative impact of industry and firm specific factors on the profitability of Greek manufacturing enterprises in both SMEs² and large-sized firms. The results “*reveal that the impact of individual industry and firm variables on profitability are different between SMEs and large firms. At the industry level, the findings indicate a positive, albeit weak impact of concentration on the performance of small and medium-sized firms. In the case of large enterprises, only industry growth was found positive and significant. Results at the firm level indicate that financial and marketing competencies, together with transformation capability are the factors significantly affecting the performance of SMEs*”. Even with some apparently weak points for the SMEs side, these firms have an important “mission” in the economic sector. For example, even “*finding a weak, but nevertheless significant, effect of industry concentration on the profitability of SMEs implies that the small firms operating in concentrated industries tend to occupy ‘isolated’ market niches that enable them to earn high profits despite the monopoly power of market leaders... In contrast, the negative and insignificant impact of industry growth on SMEs’ profitability is surprising*” (Caloghirou *et al.*, 2004). Another conclusion drawn from this study is that small firms base their competitive advantage on marketing rather than technology, which allows developing a differentiation strategy for these firms.

The size of these firms seems to be an important factor on their success, because it allows some flexibility, which is difficult to find on the large firms. “*Through their flexibility and their potential for employment creation, SMEs can play a major role in regional development*” (Inforegio, 2000). “*As argued by many, SMEs are more flexible, speedier and adaptable than larger organizations. Constrained by size-related disadvantages, small firms typically rely on flexibility and timely responsiveness to customer needs to create and serve profitable market niches. The positive relation found in this study between the capacity to transform and profitability appears to render support to the widely held notion that quick response to market signals is vital for the survival of small firms*” (Caloghirou *et al.*, 2004).

Undoubtedly small firms have an important role for many economies, its weight in the industrial fabric of most industrialised countries is above 80% (see Vidal, 1999). But what is a small firm?

² The cut-off point for SME and Large firm in the quoted work was 250 employees.

“Small Firms are much easier to describe than to define and to this day there is no generally agreed operational or numerical definition of what constitutes a small business... In order to meet the perceived imperative of facilitating comparison between sectors and Member States, the European Commission recently adopted a common definition of SMEs which emphasises the numbers of employees as follows: (1) Micro-enterprises: employing less than 10 people; (2) Small enterprises: those with 10-99 people; Medium enterprises; those with 100-499 people” (Beaver, 2002). It seems important to be aware for the “problem” of the various definitions for SMEs because one must be reading something about a small or medium firm when in fact the author is writing about a micro or a large firm. Along this work the references to these type of firms is done having into consideration the definition presented by the European Commission (EU). However in some quoted works this might not be the adopted criteria. In this case the adopted criteria will be indicated when it will be possible.

Even playing an important role in some Economies, SMEs not always have a representative share of economic activity as presented by Audretsch (2000) and this role can be theoretically explained by the static and the dynamic role of SMEs. *“One of the most striking findings emerging in static view of industrial organization is that small firms generally operate at a level of output that is too small to sufficiently exhaust scale economies, even when the standard definition of a small firm employing fewer than 500 employees is applied. A large number of studies found that because the minimum efficient scale (MES) of output, or the lowest level of output where the minimum average cost is attained, large-scale production is typically required to exhaust scale economies in manufacturing. Any enterprise or establishment that was smaller than requires by the MES was branded as being sub optimal or inefficient, in that it produced at average costs in excess of more efficient larger firm”* Audretsch (2000). Given that these factors, and others such as higher wages are paid in large firms or higher productivity leads to public policy shift from small to larger firms. In this case the attentions are turned to the large firms, and this might lead the society to think that is worthless to think about a small business because this is not profitable.

On the other hand there is the dynamic role of SMEs that, as Audretsch presents, seems to be more consistent nowadays than the static. *“An important implication of the dynamic process of firm selection and industry evolution is that new firms are more likely to be operating at a sub-optimal scale of output if the underlying technological conditions are such that there is a greater chance of making an*

innovation, that is the entrepreneurial regime. If new firms successfully learn or adapt, or just plain lucky, they grow into viably sized enterprises. If not, they stagnated and may ultimately exit from industry. This suggests that entry and the startup of new firms may not be greatly deterred in the presence of scale economies. As long as entrepreneurs perceive that there is some prospect for growth and ultimately survival, such entry will occur.” From this point of view, small firms might enter in the market in order to provide a fairer income distribution, among the firms operating in a certain business, to bring innovation using their knowledge either with a new idea or from the past experiences. Audretsch referring is work *Innovation and Industry Evolution* suggests that small firms, at least in some situations are not smaller clones of the larger incumbents, but rather agents of change through innovative activity. Nowadays most of the references on the role of SMEs are considering these firms trough their dynamic role.

iii. Micro, Small and Medium-sized Firms and (Economic) Development

After a review on SMEs definition, and some theories about this type of firm, let us take a look on some roles played by these firms. *“The well-known futurist, John Naisbit long predicted the growing importance of the concept: ‘small is beatiful’. Acs as an economist observes small business in the US and Europe and finds an increasing trend in their importance since the nineteen-eighties. Liargovas suggests that small firms are considered the ‘back-bone’ of local economies in Europe. In the Asian financial crisis, small and medium scaled enterprises³ were depicted as ‘an army of ants’ for Taiwan to fight the crisis”* (Hu, 2003).

All over the world SMEs have a very representative weight for economies and for local development. Helmsing (2003) presented the new generation of actors policies and instruments for Africa, on what concerns to local economic development. Here he presents a distinction between three main categories of local economic development initiatives (cf. Blakely, 1994 accordingly to Helmsing, 2003):

- Community economic development;
- Enterprises development;
- Locality development.

³ This definition for SME is presented as an independently owned business and under 200 employees.

As we have previously seen, the economic dimension is very important on what concerns to sustainable development. Once again we can find the economic dimension on the categories defined for local economic development, and the words micro and small enterprise are common on the description of the three categories presented on Helmsing article. On the **community economic development** micro and small firms are presented as contribute for *housing improvement and settlement upgrading*, for *basic service delivery*, and as a way to *stimulate community economy*. On **enterprises development** the clustering and specialisation of firms, in special micro and small firms, may contribute to the emergence of *agglomeration economies*. This agglomeration might bring to local producers knowledge *spillovers*, *spin-off* activity advantages, and the creation of new *start-ups*. As we have seen, having the SMEs a greater flexibility and ability to change and to respond to the society new needs, and considering its dynamic role, these firms seems to be perfect and an important piece for the local economic development *puzzle*. Finally on **locality development** corresponds to management of the entire local territory, it includes all the local planning, infrastructure development and the creation and expansion of socio-economic overhead capital. On these components micro and small firms also have an important weight, since they can provide the specific needs demanded for this development. Diniz *et al.* (2004) presented a study on the local economic integration on some Portuguese towns. It can be found on this study some conclusions such as:

- *“In terms of non-farm business sales, the integration on the local economy is weak in Silves and Lixa and very weak in Tavira. On the contrary, it is moderate in Esposende and strong in Mirandela and Vila Real;*
- *The non-farm business purchases local integration is weak in every town but Tavira, where it is very weak and in Esposende where it shows values pointing to a moderate integration;*
- *The employment measured in terms of WTE and the correspondent salary payments by both farm and non-farm businesses have a high local integration level.”*

On this work it can be found some interesting conclusions on what regards to local economic integration at different levels. This might be interesting in order to better understand the social networks existent on these localities.

As it was already said on this work (quoted from United Nations, 1998) it is consensual that besides local environment, industry must be the main “concern” on policy making regarding sustainable development. Going a bit deeper on this subject we will find that *“small and medium-sized enterprises are increasingly seen as an important focus for the attention of policy makers. Most economic structures are largely composed of SMEs, and despite the presence of large firms most employment is concentrated in this group”* (Hoffman *et al.*, 1998). In this article, the authors present a literature review on innovation and small firms in the UK. On the conclusions one can find the idea that there are some gaps on works of innovation and SMEs, but it highlights a focus on the question of innovation management – *“how SMEs develop strategy and incorporate innovation into their thinking on this, how they mobilise and access resources and how monitor and control their disposition in innovative projects.”*

In a certain sense it seems that SMEs are not contributing to innovation, and taking into consideration Shumpeter (1934) work where he emphasized the role of the entrepreneur on the development scenario through innovation, one could say that after all SMEs are not so important on what concerns sustainable development. However innovation might be seen from different perspectives. Innovation in terms of R&D and technology, at least on the work presented by Hoffman *et al.*, does not seem to present a high correlation, but from the studied carried out by Caloghirou *et al.* (2004) the competitive advantage for SMEs is marketing rather than technology, therefore differentiation assumes an important role. At the same time taking into consideration the dynamic role of SMEs, these firms might grow, and then they could be responsible for innovation investments.

But the discussion about innovative performance is based in a mix of factors. Kaufman and Tödting (2002) presented three main factors:

- The technological level;
- The market relations;
- The strategies of competition.

*“This heterogeneity is one of the reasons why there are contradictory results comparing the levels of innovativeness between SMEs and large firms. Some studies have found evidence that SMEs are generally more innovative (Pavitt *et al.*, 1987; Acs and Audretsch, 1990) whereas according to other studies large firms appeared to be*

more innovative (Community Innovation Survey, 1997/98; Craggs and Jones, 1998; Kaufmann and Tödting, 1999)” Kaufman and Tödting (2002).

One of the possible reasons for the *non-contribution* of SMEs for innovation, therefore development, brings to the discussion the question «why does it happen?» A possible answer may lie on a work of Pissarides (1999). “*A number of theories have been used to explain why small firms find it difficult to grow and survive: liquidity, managerial constraints, and transaction costs. However, not much empirical work has been carried out to test the evidence of these barriers to growth. What is clear is that in the case of central and eastern Europe, the weight of the liquidity constraints is so great that even in the more advanced countries the financial system can be blamed for the disappointing growth of SMEs sector.*” If these barriers are important for the firm survival, obviously they will be determinant in the non-investment on R&D and technology. The lack of funds for SMEs could be a strong reason for the weak role of these firms on innovation. Having into consideration that the work presented by Caloghirou *et al.* (2004) and Hoffman *et al.* (1998) were developed in Greece and UK respectively, Pissarides (1999) quoting Brunetti *et al.* (1997) also says: “*The CEE region, however, is the only one where lack of financing comes into the top three most important obstacles.*”

However the lack of funds is not the only reason for the weak innovation strategy followed by SMEs, Kaufman and Tödting (2002) got some results for the region of Upper Austria that lead to the conclusion that some of the innovation support to SMEs is mistargeted, disregarding certain indicated or latent deficiencies of SMEs: direct financial support concentrates on research and development, neglecting the commercialization of innovations. Bearing in mind the work of Caloghirou *et al.* (2004) and the conclusions of Kaufman and Tödting (2002) it seems that the key competence of SMEs is being forgotten by the policy makers. This subject will be better analysed ahead on this work.

The innovation potential of SMEs, that, as we have seen, is not consensual if it is above or under the large firms potential, and this can be explained by factors that are specific to each activity sector (Acs and Audretsch, 1993) namely, as scale economies, concentration, technological environment and distribution of firms accordingly to their class size.

Nevertheless, local development agents do not give up the idea of implementing SMEs in its regions. Laukkanen and Niittykangas (2003) presented a paper discussing

the preconditions and strategies of local development and turnaround in difficult surroundings such as peripheral rural communities. The communities studied “*are small, with economies based on agriculture, forestry and services (private and public) as main sources of employment. With exceptions, there are a few SMEs especially in manufacturing.*”...“*An overall finding of the study is that the RMDs (Rural Municipality Directors) consider private initiative and economic activity, i.e. entrepreneurship broadly defined, as the current key driver of local economies... Despite traditional resource- and individual-oriented views of local entrepreneurship development, some, at least for this region⁴, unusual proactive practices were found in the studied municipalities*” (Laukkanen and Niittykangas, 2003). The practices found were: Attracting locating firms to the community and more recently a project on existing firms, especially activating their growth by bottleneck-removing and internationalization projects, and a subproject directed at small firms creation. On another municipality they fostered *spin-offs* of small firms in cooperation with a local firm and authorities. And in the other region presented on the study, a “difficult region” (so-called ‘forest communism’) the development model was based on locating small-scale subcontracting opportunities, applying the incubator concept.

With more or less propensity to innovation, SMEs are welcome in most of regions, particularly on those that are facing “development problems”. Not only in Europe but a little bit all over the world SMEs are an important support for growth, development.

3. Entrepreneurship

“Elliot Stern (1996) has recently pointed out that the new understanding of economic development policies challenges traditional ways of evaluating them. These policies are ‘a move away from major infrastructures projects and cutbacks on subsidies to firms and to public authorities’, and stress a major concern for ‘intangible factors’ such as entrepreneurship capacity building and encouraging innovation (Doeringer, Terkls & Topakian, 1987, calls these ‘invisible factors’)” (Stame, 1999).

These ‘intangible factors’, in fact, have been in the centre of debate. “*Paste research addressing issues such as management, organization development and*

⁴ This study’s context are typical rural municipalities in North-Savo, North-Eastern Finland.

innovation has for a long time focused on mature, predominantly large enterprises. small and medium-sized firms have typically been ignored. More recently, however, the research on entrepreneurship and small businesses has started attracting the interest of scholars and policy makers and the importance of small and medium-sized enterprises is increasingly acknowledged in Academia as well as in the public debate” (Ulhøi, 2004). Nowadays is difficult to talk about small businesses without mentioning the word entrepreneurship. Dollinger (2003) presents some definitions of entrepreneurship. These definitions are different from one to another author; however, Dollinger presented some common elements in these definitions:

- Creativity and innovation;
- Resource gathering and the founding of an economic organization;
- The chance of gain (or increase) under risk and uncertainty.

At the same time, Dollinger presents two conditions in order for entrepreneurship to flourish:

- There must be freedom: freedom to establish an economic venture and to be creative and innovative;
- There must be prosperity: favourable economic conditions that give an entrepreneurial organization the opportunity to gain and grow.

These conditions go in the same direction of the conditions presented by Ulhøi, (2004) in which the idea of entrepreneurship lying in the characteristics of an individual is wrong. Among other factors it is important to take into consideration the social network surrounding the entrepreneur, and to recognize the role and importance of social capital. At the same time entrepreneurship needs the presence of opportunities (i.e. *spin-offs* of small firms in a region) as well as enterprising individuals who wish to take advantage of them. There is a Portuguese proverb that says that “the occasion creates the thief”. Applying this proverb to the concept of entrepreneurship, the opportunity might create the entrepreneur therefore the new (or expansion of the) business.

However, the literature on the role of opportunities in the entrepreneurial process has not been peacefully accepted among scholars as presented by Eckhardt and Shane (2003). In order to take deeper the discussion on the opportunities these authors, presented the theories on entrepreneurship from which we should move away. Firstly

the person-centric approach that is not an explanation for entrepreneurship; secondly the assumption that entrepreneurship is an equilibrium phenomenon, this equilibrium imposes very strict constraints, which are inconsistent with the entrepreneurial process, for instance, there are some decisions that involve creative processes, in which the constraints are determined by the entrepreneur.

Going back to the opportunities subject Eckhardt and Shane from the prior literature considered three dimensions of opportunities:

- The locus of change that generate the opportunity;
- The source of the opportunities themselves;
- The initiator of the change.

All these opportunities are explained on Eckhardt and Shane work and will not be developed here, since the aim for this work is not a deeper discussion on entrepreneurship by itself, but, on the relation between entrepreneurship and sustainable development (through SMEs). However if these opportunities might be the engines for entrepreneurial activity they also can be engines for the so-desired sustainable development.

Besides these opportunities Wiklund and Shepherd (2004) presented that the performance of small businesses is a three factors interaction:

- The entrepreneurial orientation;
- The access to capital;
- Environmental dynamism.

So to small businesses, that are important to most economies, there are some important factors that might be taken into consideration. Some authors argue that the discussion on the individual characteristics should not be taken into consideration, because there are other more important factors. However the individual characteristics might be important in order to lead the firm to the entrepreneurial orientation, and since we are talking about small, sometimes micro businesses, this entrepreneurial orientations might come from the owner/manager of the firm, and in this case this case his or hers characteristics might play an important role. Obviously, the entrepreneurial orientation is not enough. As it can be found in the literature, capital, industrial

organization, the social network among others are also important for the “art or science” of entrepreneurship therefore are important for small businesses performance.

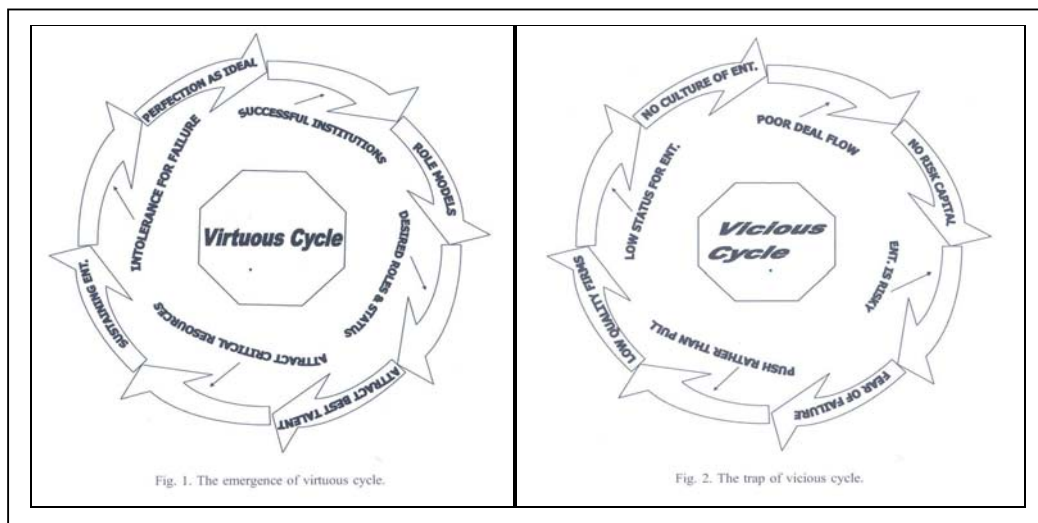
Even assuming an important role “*entrepreneurship is not merely an economic process but draws from social context which shapes and forms entrepreneurial outcomes*” (Jack and Anderson, 2002). In this work the authors present another concept that must be considered: the concept of embeddedness. The entrepreneurial activity must be sustained by the social context, particularly the local environment. The concept of embeddedness is important because for the entrepreneurs to establish their businesses they must be influenced by social factors. This idea drives us to a cycle, and starts to explain the gap on development from one region to another. If a region does not present social conditions to attract people for that region difficultly people will get embedded in the region, more likely they will move for another region. By this flow out, people will not have the capacity to find out the specific needs of the local situation, therefore, there might be some opportunities that are not being explored. Obviously this “negative” cycle will lead to a lack of entrepreneurial activity in the region, which will contribute for a slower, sometimes stagnation of, local development.

But what matters most on the entrepreneurial capacity of a region? Georgellis and Wall (2000) developed a theoretical model in order to explain what makes a region entrepreneurial as measured by regional self-employment rates, and estimated the roles of labour market conditions, labour-force characteristics, industry composition, and fixed region specific factors. From their results, all of these factors are important to explain the differences in regional entrepreneurship in Britain, however regional factors such as regional entrepreneurial human capital play a significant role in determining why some British regions are more entrepreneurial than others. This regional entrepreneurial human capital is what remains from all market factors that determine a region’s self employment rate such as the value of paid employment, the age and the educational profile of the labour force and the structure of the regional economy. Obviously these factors are social factors translated to statistic figures, but the individual characteristics influenced or not by the social network seem to be once again present.

As we have seen up to now there are some important factors to take into consideration on what regards to the fostering of entrepreneurship. This fostering is assumed as something necessary to stimulate the region development, and why does it happen? “*Entrepreneurship is popular partly because it is perceived as an engine of*

socio-economic growth and development, providing new job opportunities and diverse goods and services to the population. (Reynolds et al., 2000). Thus, enhanced entrepreneurship in a country leads to greater national prosperity and competitiveness (Zahra, 1999)” quoted by Hitt et al. (2001)

Venkataraman (2004) explained why some regions fail in fostering entrepreneurship. For example in the United States every county, state, and region has been struggling to promote entrepreneurship. But only in some areas are flourishing. This happens everywhere; in the European Union one of the main concerns is to reduce the disparities among the regions. But once again, why does it happen? Why do some regions have entrepreneurial orientation and others do not? Venkataraman presents two cycles that can explain the different regional attitudes toward entrepreneurship: The Virtuous Cycle and the Vicious Cycle.



Source: Venkaraman (2004)

The first one might be found when a region has been conducting economic and cultural activities for long periods and has settled into a predictable and comfortable position. The success of some leaders, firms or institutions motivates the other people to be like them, even the children grow up with the idea of “being like someone”, but this someone is someone successful. This environment will be a strong contribute for the embeddedness and the entrepreneurial activity within a region. **On the other hand**, the Vicious Cycle of Venkataraman appears when variation and experimentation are shunned for long periods of time in favour of the status quo represented by successful institutions. In this case the society will live without a culture of entrepreneurship, with

the fear of failure and the quality of the existing firms is low. In order to drive the region to the Virtuous Cycle are presented on the quoted work seven intangibles of regional technological entrepreneurship. Novel ideas, role models, informal forums, region-specific opportunities, safety nets, executive leadership and access to large markets, are the intangibles for entrepreneurship.

As a final remark entrepreneurship seems to be a strong support to foster the region growth and development, however it is necessary to pay attention to the measures taken in order to foster entrepreneurship.

4. Where shall policy makers focus their attention? At the firm or industry level?

Entrepreneurship, SMEs and embeddness are important concepts to consider on what regards to local development. But what shall deserve greater concerning the firms, each one by itself, or the industry? In some regions there are firms that can be identified (the group) as a cluster or simply as an industrial district, and sometimes the measures taken by the policy makers are turned to the group instead of the firms. Recalling the work of Caloghirou *et al.* (2004) and the conclusions of Kaufman and Tödting (2002) it seems that the key competence of SMEs is being forgotten by the policy makers.

Moreover, when compared the industry and firm effects for profitability (Eriksen and Knudsen, 2003) even concluding that both firm and industry effects exist, consistent with previous research, but also that the firm effect is more important than the industry effect. This study was taken on Danish SMEs but the results are similar to studies on American large firms, which lead us to conclude that the firm effect is always more important no matter the firm size. Not only in profitability, but also on the performance the firm effect is higher than the industry effect (see, for instance, Hawawini *et al.*, 2003). At the same time *“the results indicate that firm factors have a much more pronounced impact on profitability than industry structure, both for SMEs and large enterprises”* (Caloghirou *et al.*, 2004).

Even considering a great importance to the firm level, it is very difficult to evaluate the effects of the “public investment” on each firm. *“States investing in or planning to invest in competitiveness programs that include networks want to measure the return to their investments in terms of effects on their economy. Since the programs target small- and medium-sized manufacturers and related services, the macro-effect on*

the economy is assumed to be reflected by aggregated changes in individual businesses affected by the programs” (Rosenfeld, 1996). This evaluation may not allow finding out what really happened in each firm, some may present an excellent performance, and some others may present the opposite results to those expected. If the authorities do not know exactly what happened it might lead to a “mismatched” support to SMEs; *“Firstly, there can be mismatch between the support offered and needed, i.e., the support instrument does not target the most serious problems... Secondly, there can be a mismatch of firms which are targeted and firms which need support”* (Kaufman and Tödtling, 2002).

Since local development is usually supported by agents of the region (the concept of embeddedness) and these agents might become the regional entrepreneurs, policy makers should start to pay attention first on the region and then to the local economic activity. Support, of any kind, financial, governmental (taxes), tutorial, etc., should be given firstly to those firms able to create wealth for the region, namely by fostering other small businesses *spin-offs*. By fostering *start-ups* in a region at “any price” might be an apparently good measure, because it can create a large industry, but this industry could create a strong rivalry (and rivalry is not a synonym of competitiveness⁵) among its firms, and becoming more difficult the so needed and important cooperation among them.

Visser (1999) in a study about small-sized firms in the clothing industry of Lima concluded that even with a greater performance for clustered firms the cooperative interactions among clustered producers are notably absent, both in production and transacting activities. The cooperative linkage with external agent also does not exist which implies negative effects for the quality of strategic decision making and innovative capacity of the clustered firms. The advantages that might come from the cluster are related with a kind of “scale economies” achieved among the cluster. If the weakness on cooperation exists within a cluster, it might be more notable in an industrial district.

For example, the furniture industry; instead of fostering the creation of new furniture *start-ups* in a region already characterized by a “furniture industrial district”, fostering *start-ups* on related businesses belonging to the furniture *filière*, could create a stronger impact to local development. Moreover, these new firms could create *spin-offs*

⁵ Boari *et al.* (2003) present an interesting discussion about competitiveness and rivalry.

to other businesses. This collaborative entrepreneurial environment can only occur by turning the attention on development policies to the firm as an important agent, overcoming the idea of the firm as a *black-box*.

5. Future Research

The role of SMEs in sustainable development is undoubtedly considered important, for all economies. However this subject cannot be analysed apart from other concepts that from one or another way establish a “concepts network” on the sustainable development policies.

“It is convenient to make clear that development is a normative concept, synonym of improvement of life conditions.” (Diniz, 1999 quoting Seers). This statement drives us firstly to the social perspective of sustainable development, where the problems are easily identified. A solution to these problems lies in the economic context. Cheshire and Malecki (2004) say that in some progresses occurred to understand regional growth the attention has been changing from the “region” to the economic actors within regions and the determinants of their behaviour in a spatial context. So, in order to foster development through the economic context, regional growth is a key actor. The concepts of growth and development sometimes are mixed up because *“it was settled down such a strong and narrow relationship, that distinguishing one from the other becomes sometimes difficult”* (Diniz, 1999). However growth can be presented as the support to economic context, that as it was seen is a solution, or at least, a great contribute to sustainable development.

Going inside growths’ discussion one will find the industry as an important actor, and in most of the World economies, one will find inside the industry a large percentage of SMEs. Through their flexibility and their quick response to the market and consumers needs and demand these firms are vital for any economy. This “mission” becomes more significant when these firms are acting at a local level. By its dynamic role SMEs will become stronger and will create new opportunities in the region. These opportunities might be job creation, society well being (by filling market niches to satisfy consumers demand – *spillover effects*) or even fostering new firms creation by *spin-off* effects. These are some reasons why SMEs are an important focus for the attention of the policy makers.

Quoting Shumpeter (1934) on thesis of creative destruction and the role of the entrepreneurs to development through innovation, some question might arise related to the innovative potential of SMEs. On this issue there is not a single idea defending that SMEs are more or less innovative than large firms, there are studies proving both theories. Going for the negative side (to SMEs) that these firms are less innovative than large firms one of the reasons could be the lack of funds for SMEs innovation support (Pissarides, 1999). Another could be the “non-attention” paid to SMEs core competences mistargeting the support measures (Kaufman and Tödting, 2002). This allow us to conclude that finding the best way to do that, fostering small businesses (including micro enterprises) creation leads in first place to local development and after that to sustainable development.

However, fostering SMEs creation only by supporting them at a financial level might not be the best policy to take. It is very important to pay attention to the social network existent in the community. These networks and the social environment of the region, working as embeddedness to the entrepreneurial activity, will contribute to the creation of opportunities that are considered an engine to sustainable development. Eckhardt and Shane (2003) presented three dimensions of opportunities that can develop the entrepreneurial activity of a region.

Whether these opportunities are the source of entrepreneurial spirit which leads to the small businesses *start-ups* then it should be an important focus for policy makers. Instead of supporting financially the creation of new firms in a region, this financial support could be directed to the creation of a “public” large firm, in which the concept of *intrapreneurship*⁶ could be developed. By this way public investment would start to create an economic and social environment developing conditions to create the embeddedness in the community. This initial measure would be the *pole position* to develop an entrepreneurial orientation within the community that sooner or later would bring some new firms, therefore an engine to local and sustainable development.

⁶ *Intrapreneurship* in the sense of developing strategies that could allow the workers in that firm to initiate their own business (*spin-offs*) (Duarte, 2004)

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