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3 December 1987

The Remarkable Convergence of Fashion on Small Enterprise
and the Informal Sector: What are the Implications for Policy?

I - Introduction

I would like to propose a research project that would, hopefully, be the part of a larger agenda of research on small scale enterprise (SSE) as related to issues of private-sector development and employment policy. The purpose of this research would be to build on the existing literature with the aim of formulating a set of policy recommendations that are relevant to current conditions and more grounded in today's reality.

The growing interest in the SSE sector today reflects the convergence of five quite different streams of literature and policy concern:

(1) the relatively recent interest of neo-classical development economists in SSE as representing a combination of labor and capital that is "right" for third-world countries, or at least better than the large-scale capital-intensive model of industrialization espoused by development economists themselves in an earlier period;

(2) the recent literature on agricultural development and its growth linkages, which argues that agricultural growth, if broadly based, creates a market for locally-produced non-agricultural goods because of the increased demands for these goods from the rural poor whose incomes are rising--just the kind of market situation in which rural SSE can flourish;

(3) the informal-sector literature (IS), which draws a distinction between (a) a formal sector where firms are large, legal, employ more workers, have unionized labor or provide their workers with higher wages,

government-mandated fringe benefits, and job protection; and (b) an informal sector, where firms (i) are small, (ii) are "illegal," in that they are not registered and do not pay taxes and hence have no access to subsidies, licenses, or formal credit, (iii) do not observe the labor legislation with respect to wages, benefits, and other worker protections, and (iv) where firm-owners and workers alike are poorer than in the formal sector;

(4) the new literature of flexible specialization (FS) or "decentralization of production," based on studies of current transformations in the industrial structure of first-world countries, which focuses on the seeming breakdown of the "mass production model" and its replacement by a more decentralized, specialized, and flexible model of small-scale production; and

(5) the literature on political and administrative decentralization in third-world countries which, though not focussing on the structure of production or the SSE sector, is useful in helping us to think out some of the policy implications of the findings about SSE from all four literatures noted above.

The above five currents of research and thinking, though overlapping with each other in many ways, represent quite different ways of looking at issues of development and equity:

1. The view of SSE as representing the "right" combination of labor and capital is rooted firmly in mainstream economics and, particularly, in the development-economics tradition of viewing industry as the engine of third-world growth.
2. The agricultural growth-linkages literature comes out of the more recent redirection of interest toward agriculture as the engine of development.

3. Much of the informal-sector literature is based on neo-Marxist thinking about the nature of capitalist development in the third world, extending the emphasis on divisions between class, and center and periphery, to the division between large and small, and legal and illegal, firms.

4. The flexible-specialization research has been carried out by social scientists interested originally in issues of labor in the formal manufacturing sector of the first world. Because they see an increasing blurring of the lines usually drawn between employer and employee in the mass-production sector of the first world, they focus on the emergence of different constellations of labor, firm owners, and institutions in particular regions. Started in part by economists and political scientists interested in labor issues and in changes in the concepts of labor and management brought about by the transformation of the mass-production model, this line of inquiry has also attracted geographers and planners, whose training makes them quite comfortable with concepts of development defined in area-based terms.

5. The decentralization literature, finally, comes from the field of public administration and political science, with an interest in how to make government more effective in supplying services and stimulating development, and in how to make the organization of government activity more consistent with the goals of political democracy and participation.

Four of these five quite separate strands of thought end up with a policy focus on the same sector--small firms. The convergence is striking, especially given that this sector was seen, up to five years ago, as marginal, unmodern, and doomed to perish with successful growth. The explanation for this change in thinking about SSE would in itself be an illuminating study, though some of the reasons for the convergence are

obvious. More to our purpose here, however, is the question of how these different ways of analyzing the SSE sector can assist our thinking about medium-term growth strategies in the third world, and about the problems of low income and unemployment that have become increasingly apparent as a result of reduced growth and the implementation of austerity programs throughout the third world.

Though the independent arrival at the door of the SSE sector by four separate sets of researchers represents an impressive juncture in the history of thinking about third-world development, it somehow has not yielded a set of policy recommendations that is equally impressive. Or, at the least, the policy recommendations that have emerged from these literatures do not represent anything like the earlier consensus by development planners on large-scale capital-intensive industrialization as the right path to development. Part of the strength of this previous consensus, it should be pointed out, lay in the unusual agreement it generated on both the left and the right, and from both the north and the south. Today, though we are wiser about the problems of that earlier model, we do not have anything approaching a consensus on an alternative. And yet the convergence of these various streams on the SSE sector today may constitute the basis for a new paradigm or, at least, for an informed set of policy recommendations--because the streams come from both left and right, and from north and south.

In the following sections, I review the five literatures in terms of (1) how they help us think about SSE policies and programs, and (2) the kinds of research questions that still need to be explored in order to arrive at a set of workable policy and program recommendations. The recommendations, moreover, should be politically viable in current third-

world contexts, where broad political consensus will be necessary if development policies and programs are to be carried out in the stable and supportive environment that is basic to their successful implementation. The purpose of my discussion of the five streams is not to review the literature, or to take it apart, but to create the building blocks of a more policy-oriented agenda for research. It goes without saying that this exercise could not have taken place without the major contributions to our understanding of the SSE sector that these literatures have made.

II - Small-scale Enterprise and the "Right" Factor Proportions

The neo-classical literature on SSE has made a major contribution to our thinking about this sector by justifying its importance in mainstream economic terms. The empirical research reported in this literature has shown that SSE accounts for a more significant share of output and employment than anyone ever dreamed of in the 1950s and 1960s, and that it has held its own as development has proceeded and, indeed, has sometimes been a leading player in the recent cases of dynamic and sophisticated growth in the manufacturing sector. Small firms, once seen as backward and irrelevant to the emerging modern capitalist system, are now portrayed in the new SSE literature as adept at combining factors in the "right" proportions and competing more healthily than the large oligopolistic, and "modern" firms that are coddled by a system of government subsidies and protection. This evolution in the history of thinking about SSE is somewhat parallel to the history of thinking about small-scale or peasant agriculture, with about a decade's delay. Just as small farmers were discovered to be rational and efficient in studies of the late 1960s and early 1970s, so it is that small firms have now been discovered to be in some ways as rational and efficient as large ones.

The flip side of the new neoclassical celebration of SSE as using the "right" factor proportions is a companion set of policy recommendations about labor that is politically problematic. What has caused SSE to use labor and capital in the "right" proportions, according to this thinking, is that SSE faced the "right" prices for these two factors--high prices for capital and low wages for labor. This contrasts with the larger formal-sector firms, which have faced artificially low prices for capital

(subsidized credit and overvalued exchange rates), and artificially high prices for labor (union- or government-mandated wages, and increased wage costs resulting from government-mandated charges for fringe benefits). The "unemployment problem," according to this logic, can be solved by letting wages fall from their artificial highs--abolishing minimum wages or letting them languish with inflation, reducing the power of labor unions, reducing the fringe-benefit add-on to the wage bill. Getting labor prices right certainly makes sense in terms of the neo-classical model and in view of what has been learned in the last thirty years about excessive price distortion. But when set forth in policy terms in particular country environments, it translates into a distinctly "anti-labor" position, and therefore has a difficult going politically. This prevents the recommendation from gaining widespread acceptance among politicians and ministers of state, let alone among workers.

The implicit employment-policy package of the SSE literature reflects to a certain extent what is actually happening in many countries today, with or without policy interventions. Many large firms are "de-formalizing" by subcontracting out more of their work and labor contracts to small and often illegal firms, in order to reduce their wage and tax bills, and to avoid obligations to provide worker security--a phenomenon analyzed extensively by the flexible-specialization and informal-sector literature. Although the current neo-classical prescriptions on labor may hence be consistent with what is actually happening in some areas "naturally," these recommendations are nevertheless inadequate as a basis for policy. First, they are seen by workers as anti-labor, and thus cannot form the basis of a politically broad-based development policy. Second, they are based on an understanding of "successful" policy history that is now being proven to be in some ways inaccurate, a point I return to below.

The policy recommendations coming out of the neo-classical SSE literature--or, for that matter, from the larger body of policy recommendations about "getting the prices right"--are not necessarily being proposed by anyone as "employment policy" or "social policy." Rather, these recommendations simply tend to drift into the vacuum created by the absence today of a viable package of policy recommendations in the employment or social area--a vacuum that exists not only in the advice-proffering world but in the political arena of many third-world countries themselves. The explanation for this vacuum lies partly in the inability of the left in many countries to formulate such an agenda, and partly in the lack of interest in creating such an agenda in the mainstream advice-giving world. The result of this vacuum is that third-world governments, more and more pressed by the political difficulties resulting from a long period of austerity and increased unemployment and poverty, are willy-nilly adopting "social" measures that are ill-thought out, counter to what we have learned about what works and what does not, and that may accomplish little therefore in buying political acquiescence from the disaffected sectors. The current moment is a propitious one, then, for policy-oriented research addressed to these questions, given that governments feel more pressed to "do something" about unemployment and low incomes, and are casting about for advice on how to do it. A research program that generated such advice could make an important contribution toward the political consensus and stability that is required for a viable program of growth within the constraints of today's international economic environment.

With respect to our understanding of policy history, I turn to the recent literature on the East Asian miracle-growth countries, much of which has been funded by the Bank. That literature has been discovering that an

intelligently administered system of "wrong" prices was an integral part of the East Asian growth successes, in contrast to our earlier understanding of those policy regimes as "free-market" and non-interventionist. A key "wrong" price in this system according to the revisionist view, has been that of credit, which was provided in large amounts at subsidized rates to certain targeted industries in the manufacturing sector. At the same time, policy advisors have been pointing to subsidized credit in other countries--particularly those of Latin America--for explaining failure and economic crisis, rather than success. We now have two separate and opposite stories, in other words, about the role of subsidies in economic development, and we need further research that seeks to reconcile them. In addition, though the East Asian studies confirm the "right-prices" interpretation in that wages in these countries were relatively low, the new studies also reveal a high level of state involvement in the provision of cheap wage goods (housing, food, job security, etc.)--a policy that is not so characteristic of the countries with "artificially" higher unit wage costs. The East Asian cases, in sum, have cast a new light on the issue of the "wrong" prices for labor and capital, confusing our picture of "wrong prices" as culprits in explaining the economic malaise of the third world today.

The world of policy advice has had a hard time incorporating this new information on wrong prices and growth successes. Despite the new evidence, the old view has stuck because, in a sense, it is so functional. It yields clear-cut policy advice in a formulaic way and tells you exactly what to do. The East Asian findings, in contrast, muddy the waters. They teach the field again, perhaps in a more intelligent and discriminating way than was already known in the 1950s and 1960s, that some kinds of subsidies and administered prices may not be that bad after all for growth. But we still

do not know how to translate that finding into finely-tuned policy advice. When are the wrong prices "right," and when are they just plain wrong? How does one create a policymaking cadre that understands this distinction, and is politically strong enough and interested enough in putting it into practice? The East Asian researchers have not yet arrived at these questions; just contemplating them, in fact, makes one long for the simplicity and security of the "getting-prices-right" way of proffering advice. The revisionist research on East Asia, then, needs to be followed with studies that ask why the wrong prices produced failure in some sectors and countries, and success in others. A research agenda that included comparative studies on this question would help move the field toward more accurate policy advice.

The neo-classical policy conclusions about labor are inadequate for a second reason. Two quite separate fields of inquiry have produced a growing body of literature that reveals the importance of non-market factors in contributing to the determination of wages, prices, and other decisions made by job-seekers and job-offerers. Though these literatures do not deny the presence of market forces in determining labor supply and demand, they nevertheless demonstrate the presence of variables that work completely outside, or contrary to, the way we think about employment in the neo-classical model of supply and demand equilibration.

One of these literatures is represented by labor economists who have studied wage determination in the formal sector of the first world and, more recently, in the "communities" of small-scale flexibly-specialized firms. These studies show that wages are very much influenced by, on the one hand, labor markets and job ladders internal to the firm. These "internal labor markets," among other things, inhibit labor mobility between firms, such

mobility being a crucial feature to the working of the neo-classical model. On the other hand, these studies show labor decisions as being influenced by social norms about sharing existing work widely in a particular community, also outside our traditional conceptions of the workings of markets in the neo-classical model.

Also relevant to the neo-classical model's assumption of mobility of labor in response to wage changes, this literature shows that labor markets are segmented within the formal sector and even within large formal-sector firms. This dual labor market is made up of a higher-paid segment of permanent workers alongside a lower-paid segment of temporary workers, there being little movement of labor between these two segments despite marked wage differentials. The segmentation serves the large firm's need to respond quickly to rapid increases and declines in demand for its product, in that a core of permanent workers (and machinery) is surrounded by a group of temporary workers (and subcontractors) that can be mobilized and demobilized rapidly.

Though the labor-economics literature has had a significant impact on the way we think about labor markets in first-world countries, it does not seem to have touched the thinking about wage and employment issues in the third world. This may be because the proposed or implicit employment recommendations that emerge from the neo-classical SSE analysis are really a byproduct of the concern about "wrong prices" and of the research on SSE. This contrasts with the first-world labor-economics findings, which arise out of the empirical study of labor markets. In a sense, the third-world advice we are giving on labor is a kind of logical conclusion of our economic theory, rather than of our empirical research. A research agenda on SSE and employment, then, needs to include labor-market studies that will help us arrive at a set of more informed policy recommendations.

The second body of research to which I alluded above is a growing set of studies on labor markets in the third world that parallels the first-world research in its findings of stratified labor markets and important non-market determinants of wages, and the supply of jobs and workers. But this body of literature also has not influenced the policy world, perhaps because it relates to agriculture. I refer to the literature on interlinked contracts between agricultural workers and their landowner-employers dealing with matters of land, credit, and labor. These institutional relationships between peasant and landowner (or merchant) are now generally recognized as explaining puzzling wage differentials in the agricultural labor sector-- differentials which should not exist in the neo-classical model and which help explain why workers do not always move from one job to the other in response to wage differentials.

The "interlinked contracts" research, some of it funded by the Bank, has been recognized as making a serious contribution to our understanding of wage determination and adoption of modern practices in agriculture in the third world. Nevertheless, this recognition of a different model of wage determination and employment does not seem to have translated into a set of policy recommendations about employment and labor. Nor has this more complex understanding of labor markets been reflected in our current policy advice about employment, wages, and markets in the manufacturing sector or the public sector of third-world countries. Thus, though the "interlinking" findings in some ways contradict the current policy advice and the model on which it is based, they have not led to a revision of that advice or the theory--just as in the recent research on the East Asian cases. This is partly because the findings and the theory they create do not translate into as simple a set of policy recommendations as does the pure neo-classical

model, and partly because research intended to yield policy advice about these non-market findings has not been carried out or supported by the institutions most involved in providing advice.

The employment-policy recommendations now emanating from SSE research are inadequate, finally, because they are, in a sense, a policy that is deduced from a theory. Though they make sense to all of us as economists, they do not give us the tools with which to build a politically realistic employment policy, around which governments can obtain broad-based support. Though the current labor-policy recommendations may make sense in terms of a larger consensus among third-world governments and international institutions on the need to get prices closer to "right," the seeming sense of this latter consensus does not work when translated without modification into an "employment policy" that is perceived as "anti-labor" by a large part of the population.

Interestingly, the task of coming up with a politically viable social policy, acceptable to both labor and capital, may be less difficult today than it was in the 1950s and 1960s. To the extent that the decentralization and de-formalization of production documented by the flexible-specialization researchers is now occurring in third-world countries, the labor policies we associate with the mass-production model may make less sense and have a smaller constituency today than they did in that previous period. Research on the SSE sector can play an important role in helping us to arrive at a more current, as well as politically viable, set of recommendations about employment policy than we now have. But the recommendations need to be derived from the empirical study of reality--i.e., how labor markets actually function in third-world countries today.

The neo-classical SSE model has been translated by some practitioners into a more popularized form in which small firms, particularly the smallest, are portrayed as the epitome of an atomistic and healthy competition. Though this view is not necessarily that of the researchers in the SSE field, it does typify the more popular version of this model--as characterized, for example, by the work of Hernando de Soto of the Institute of Liberty and Democracy in Peru, and a certain subset of the nongovernment organizations interested in providing assistance to this sector. Though one cannot hold researchers responsible for the popularized versions of their work, what is important about this particular popularization is that it is having an important impact on the way people think about policy. This is partly because of the policy vacuum noted above, and partly because the policy recommendations of this popular view are consistent with the getting-prices-right model, thereby gaining a certain legitimacy by association.

The main policy implication of the popular view of SSE is that this sector needs to "get the government off its back" and hence the emphasis on de-regulation and "freeing up" the sector to do what it's good at--healthily fierce competition. Though this popular view of neo-classical SSE has helped create a climate of increasing political sympathy for reducing the difficulties encountered by informal firms in attempting to become legal, the policy recommendations are on their own incomplete, based as they are on a partially inaccurate model of how small firms operate.

As DeSoto's studies themselves show, relations between firms in the SSE and underground sector are characterized by a striking degree of cooperation, as distinct from competition. When inputs are in short supply, which they often are for small firms, they share inputs with each other. When one firm has a large contract to produce and its neighbor firm has

none, the one firm shares its contract with the other, by subcontracting to the other, or even hiring its owner as temporary employee; at a subsequent moment, the sharing will be reversed. When one firm has no work, its owner will be offered work by the owner of the neighboring firm, and vice-versa. When labor has to be laid off, community norms about taking care of people often determine which laborers will be laid off, whether wages are reduced, and/or whether full-time workers are reduced to part-time in order to make some work available to everybody.

The SSE literature has not paid much attention to this strong current of small-firm cooperation, perhaps because it is not consistent with the view of these firms as atomistic competitors, and perhaps because the cooperation does not take the form, more familiar to us, of cooperatives and worker-managed enterprises. When these latter forms of organization have been promoted by governments or nongovernment organizations, they have tended not to work well. All the more reason not to heed the signs of lively cooperation in the SSE sector when thinking about policy.

Ironically, we have learned more about this inter-firm cooperation and the norms in which it is often embedded from the studies of flexible specialization in the first world than from the SSE and informal-sector literature on the third world, with some exceptions. Though there is some work on cooperative behavior coming out of the informal-sector literature, the behavior is perceived as part of a larger system whereby the formal sector exploits the informal sector. The cooperative behavior, therefore, is not perceived as providing an opportunity for improving things, or as a basis on which one might think about building policy. Because the flexible-specialization literature has discovered these cooperative relations in the course of trying to understand sectors in which small firms predominate and

do well, it has been more disposed toward viewing this cooperation as part of a larger model of economic growth and social betterment. A research agenda on the SSE sector, then, should attempt to pull the flexible-specialization research toward the third world--a direction in which it seems to have started to move through a small research program at the ILO in Geneva--and to encourage this literature to focus its sights on some policy-oriented research questions.

A final comment on the neo-classical SSE model: the very success of this research in legitimizing SSE as a sector deserving serious attention has, in its more popular version, resulted in a zeal for SSE among many practitioners and advisers in the development world. Though this zeal is a welcome counterweight to the earlier zeal for the capital-intensive, large-firm model of development, it can also trivialize that sector. In order for the thinking about SSE to be taken seriously, as a form of policy advice about private-sector development and growth in general, it needs to be seen as integral to the larger picture of small and large firms. The growing body of studies on subcontracting--coming out of the IS, FS, and SSE literatures--is an important example of research oriented toward this larger picture. The larger focus, moreover, is perhaps the only one that can help generate some useful ideas about employment policy and social policy.

III - SSE and Growth Linkages from Agriculture

The growth-linkage literature, with recent stress on equitably-based agricultural growth as the basis for an SSE sector in rural areas, has directed policy attention to the role governments can play in providing a facilitating environment that will make the linkage occur--infrastructure and decentralized institutions of support to SSE in towns with agricultural hinterlands. But like the employment-policy recommendations implicit in the neo-classical SSE literature, the posited linkage is more logical than empirical. Little research has been done on SSE firms that have actually emerged in the wake of successful agricultural growth, in order to determine the kinds of policy and structural environment in which these linkages are more likely to occur.

Actually, some case studies have found that the linkage between robust agricultural growth and local SSE did not take place, contrary to the theory. A study of the non-agricultural investments made by peasants who increased their incomes considerably in the wake of the successful Muda irrigation project in Malaysia found that these farmers invested their surplus in businesses in the capital city or even outside the country, rather than locally (Hart). An empirical test of the linkage theory carried out in an area of Nicaragua that had experienced a long period of robust growth in cotton, found almost no SSE sector in the areas of that boom (INCAE); farmers and transporters continued to service their equipment and vehicles, and buy their inputs, in the capital city. Finally, a study of the investment of peasant-farmer surplus in a region experiencing agricultural growth in West Africa found that farmers with increased incomes invested them not in local SSE but in clientelistic relations with urban

bureaucrats and others who could increase their access to licenses, permissions, favorable judgements from the courts, and jobs for their children (Berry).

The studies cited above do not necessarily controvert the growth-linkage literature, but they do show that agricultural growth is not sufficient for the linkages to SSE to take place, no matter how equitable the growth is. If we are to come up with useful policy recommendations in this area, then, we need to understand better why local SSE emerged in some cases in the wake of agricultural growth, and why in other cases it did not. A research agenda that carries the growth-linkage literature closer to policy relevance then, should include studies of the environments that characterized the cases of successful growth linkage.

IV - The Informal Sector

The literature of the informal sector (IS) has made a major contribution to our understanding of the workings of SSE. Long before the neo-classical literature had released its minions of researchers on the SSE sector, informal-sector researchers were studying small firms and the labor force in this sector--though from a different perspective. IS theory, moreover, has been remarkably responsive to the findings emerging from its empirical research, and the literature reveals a constant struggle to modify the theory to fit the findings. The IS literature, for example, initially portrayed the IS as quite separate from the formal sector, as marginal to it or, at least, as a haven of petty producers who had mysteriously survived the advance of capitalism. Through its constant empirical soundings, however, the IS researchers found that firms in the informal sector were often intimately linked to formal-sector firms in the production process, and hence the theory was modified correspondingly.

Likewise, until quite recently, the IS literature portrayed the "inhabitants" of the informal sector as uniformly poor--or as poorer, on the average, than people working in the formal sector. Informal-sector empirical research itself, however, found that not only did income vary across workers and self-employed in the informal sector more than in the formal sector, but that the owners of small informal-sector enterprises were distinctly in the upper third or half of the income distribution, and hence in no way a part of the "poor." Along with this finding came the inevitable discovery that firm-owners in the informal sector exploited their workers as much, if not more, than those in the formal sector. Because of this empirical research, then, IS theorists found it more and more difficult to

characterize the IS as the space in the economy occupied by the poor. Though the theory has been struggling to accommodate this finding, it has not yet done so successfully; and some of the more popular versions of IS thinking and practice do not recognize it at all.

It was IS empirical researchers, finally, who themselves discovered the various ways in which the line between informal and formal becomes more and more difficult to distinguish. IS researchers have found, for example, that many "IS" households pursue a strategy of placing one of their members in a formal-sector job, so as to gain access for the family to health and social security benefits, and thereby feeling less concerned about having the rest of the members work in the informal sector. Similarly, according to the empirical findings of the IS literature, formal-sector workers often voluntarily get themselves "fired" in order to use their severance pay to start a small business. Similarly, IS empirical research discovered that some firms are informal with respect to some aspects of their existence (part of their labor force, some taxes, some licenses), and formal with respect to others. If anything, the relentless empirical tradition of this literature may contribute to the ultimate demise of the formal-informal distinction, since the research has uncovered so much of the intermixing of the two that it is difficult to come up with a definition of the IS that is useful, at least with respect to policy research.

Though IS researchers have been more concerned about poverty, unemployment, and exploitation than has the SSE literature, the IS literature has been somewhat silent about policy. It has not generated policy recommendations about labor and unemployment--let alone a set of recommendations that is more constructive, or more socially acceptable to the laboring sectors, than that suggested by the neo-classical SSE

literature. Why would such a socially-conscious literature have not contributed to an agenda for social policy?

One possible explanation of the above question is that the theory in which the IS research is embedded views the state as an important actor in the exploitation of labor by capitalist firms. The formal sector, according to current IS theory, needs a lower-wage informal sector in order to allow sufficient profits to be generated by formal firms. That is, the existence of an informal sector in third-world countries, with large numbers of low paid and underemployed job-seekers, has a "reserve army" effect on wages in the formal sector, keeping these wages from rising to the point where formal-sector firms would lose the cheap-labor advantage they have over first-world firms. Moreover, according to the theory, the informal sector produces the "wage goods" consumed by formal-sector workers (prepared food, shoes, clothing, etc.). In so doing, IS workers pay themselves and their family members a less-than-market wage, or none at all. In exploiting themselves this way, they lower the cost of wage goods for formal-sector workers and, hence, their "cost of reproduction." In this way, the informal sector allows formal-sector firms to keep their workers' wages down.

In this view, the policies of the state support the system, by favoring formal-sector firms in the granting of subsidies, licenses, tariff rebates, other waivers, and credit, and by making it difficult for IS firms to enter the system. Since state policy is seen here as an expression of the system, rather than as independent of it, it is a contradiction in terms to expect the state to change policy in a way that would improve the conditions of employment in the informal sector, or to fold the informal sector into the formal sector by extending the same privileges and protections to the former.

Interestingly enough, the neo-Marxist and neo-classical theories seem to converge today in their skeptical view of the state's role in the economic development of the third world in the last thirty years. The nature of each set of critiques, of course, is quite different. The neo-Marxists see the state's heavy subsidization of formal-sector industrialization, leaving in its wake a large informal sector, as a predictable pattern of capitalist development in the third world, dependent for its success on the exploitation of labor. The neo-classicists, in contrast, view the pattern of heavy state subsidies as bad economic policy, which can be corrected by bringing policy closer into line with the canons of economic wisdom. By getting the prices of labor and capital right, they say, the problem of unemployment will resolve itself and the informal sector-formal sector disparities will disappear on their own.

In a sense, it is easy for the neo-classicists to argue that the problem is one of bad previous policies. Since the past policies of subsidized industrialization also came out of the neo-classical world, or some variation on it, policy advisors can justify their strong faith in the wisdom of their currently proposed policy changes on the grounds that they know a lot more than they did thirty years ago, and that this learning can be the engine of policy reform. The neo-Marxists cannot recommend policy change with such ease because of the different lens they apply to the analysis of the policies of the past. For them, the past policies were predictable rather than bad or good, being consistent with the dynamic of twentieth century capitalism in the third world.

This brief summary of the IS literature and its theoretical framework does not fairly represent the sophistication of that literature, or the remarkably dynamic relation between its theory and its empirical research

over the last fifteen years. My purpose here is not to analyze or criticize this literature, but to draw attention to the strange absence of these researchers from the debate on policy, and to attempt an explanation of the difficulty that IS researchers have had in contributing to the debate. More important, I review the IS literature in order to point to the need for a more policy-oriented research, which builds on the strong empirical contributions made by this literature to our understanding of unemployment and poverty, and which draws into the policy arena the strong social concerns that are missing from it today.

Though the IS literature itself has not been policy-oriented, popular versions of its theoretical assumptions and findings have played an important role in creating an "alternative" policy arena that does not overlap much with the world of policy advisors and mainstream development research that one finds, for example, at the World Bank. I refer to the world of smaller donors who are interested first and foremost in issues of poverty alleviation and the generation of income and employment directly through projects and programs--the European donors, the Inter-American Foundation, other foundations, the SSE programs of the Inter-American Development Bank and the U.S. Agency for International Development, and the large group of nongovernment organizations through which these donors channel much of their funding. The latter agencies or divisions within agencies represent, together with the researchers they fund, a kind of "policy-arena-in-exile," with much less power currently than that held by the Bretton Woods institutions.

What unites the IS academics with this more practice-oriented world is not necessarily a common theoretical explanation for poverty but, rather, a common concern for the persistence of poverty, and a strong skepticism

about the ability or willingness of the state to do much about it. Out of this amalgam of IS literature and poverty-oriented practitioners has come two allegations about poverty and the informal sector which, though not necessarily inaccurate, have (1) tended to lead "the alternatives" down a somewhat marginalizing path in terms of policy concerns, and have (2) prevented them from paying attention to some important policy-oriented research questions that have arisen from their own work.

The two propositions central to the "alternative" view are that (1) the informal sector is an expression of poverty, a view that gains more credence with the recent increases in "residual" informal-sector employment in the wake of reduced GNP growth and austerity programs; and (2) state initiatives to alleviate poverty cannot be counted on because the state is incapable of effectively channeling resources and assistance to the poor, or because such initiatives are incompatible with the state's role in maintaining elite power.

The view that the informal sector is an expression of poverty creates the following problems for policy-oriented research and agenda-setting in the "alternative" world. First, it prevents donors and researchers from being interested in comparative studies of dynamism vs. stagnation in the informal sector.¹ It may be a contradiction in terms, that is, to define the informal sector as the place made for poverty and at the same time be interested in research that studies instances in that place where poverty has been overcome. The iron link in the IS theory between formal-sector success and informal-sector poverty may play a role in preventing such research questions from being of interest.

¹One remarkable exception is a recent study of two "de-formalized" sectors in Spain, shoes and electronics, which the author chose for study precisely because one experienced stagnation and reduced incomes, as the theory would (Footnote 1 Continued on Next Page)

In order to generate informed and useful policy advice on the informal sector and SSE growth, the development field needs studies that help distinguish between the conditions under which self-employed persons do well in the informal sector and those under which they do poorly. The economic crisis of the 1980s exacerbated our tendency to view the informal sector as synonymous only with poverty and economic malaise, because of the increased amount of "involuntary" self-employment that seems to have occurred in response to reduced opportunities in the formal sector. For purposes of thinking about policy, then, it is important to separate out that part of the informal sector that represents malaise, and that part that shows dynamism and health--and to try to understand what causes the difference.

The current economic crisis has not only reinforced the view that the informal sector is synonymous with malaise. The dramatic policy changes caused by the crisis have also given rise to an unusual opportunity to study the effect of certain policy changes on SSE. The austerity programs and import controls forced on governments by the economic crisis have, in some cases, opened up significant opportunities for small firms in the informal sector--by weakening the competitive edge of large modern firms through the reduction of state subsidies and preferences to capital-using and import-using firms in the formal sector. Some firms in the informal sector have flourished as a result of this windfall reverse of the state subsidy system; others have suffered equally with the large firms, because of the contraction of demand for their goods and services, a demand that came in part from the large firms themselves. Research is needed to explain why, in

(Footnote 1 Continued from Previous Page)

lead one to expect, while the other became more dynamic with de-formalization, and experienced increased incomes (Benton).

this drastically changed policy environment, certain sectors in the IS have done well and others have done poorly, because such an understanding will provide important material for the formulation of policy advice.

In a sense, the large crisis-induced changes in third-world policy are analogous to the policy changes caused by World War II in third-world countries, particularly Latin America. As a result of the disruption of trade relationships caused by that War, many third-world countries suddenly faced a set of foreign-exchange, tariff, and import-control constraints that, if they were not imposed by outside circumstances, might have looked like a strategy of import-substituting industrialization. Indeed, it was only when historians later looked at this period in their studies of the origins of industrial growth in some third-world countries, that they pointed to the War and its stringencies as responsible for creating a policy environment suitable for early industrialization. In the 1950s and 1960s, the architects of import-substituting-industrialization policy drew upon these studies to inform and to justify their thinking about the vast changes in policy that would be required to justify the third world's going against the canons of international comparative advantage, in the quest to become something other than dependent, primary-commodity exporters to the first world.

I am in no way arguing in favor of a policy of import-substituting industrialization, or that the policy response to the current economic crisis is like World War II in simulating a policy environment ripe for growth. Though the War and the crisis may be similar in creating internal shortages that open up space for local or small firms that otherwise could not compete, the more important similarity for today's policy research agenda is that the crisis, like the War, represents a unique opportunity to

understand how policy changes can contribute to the flourishing of certain firms. The seemingly ever-mounting poverty resulting from austerity, and its equivalence in people's minds with the informal sector, prevents "the alternatives" from seeing these cases of SSE health as interesting and from providing financial and intellectual support for studying them.

There is no question that the social costs of austerity have been high, and that concern about these costs has not been central in the mainstream world of policy advice. And to the extent that self-employment has increased markedly in the informal sector, this increase certainly reflects those costs. In ignoring the highly diversified nature of the informal sector, however, we miss an opportunity to understand better how to think about policies and programs that will stimulate growth in a way that avoids the mistakes of the past while, at the same time, takes social concerns more explicitly into account.

Even if it is true that the informal sector is roughly equivalent to poverty, thinking about it this way places the "alternative" thinkers and practitioners in a box that limits their ability, perhaps, to think strategically about poverty alleviation. Because self-employment and illegal microenterprises are characteristic features of the informal sector, that is, the alternative worldview translates in practice into programs to assist the economic activities of the self-employed and microenterprises-- particularly the provision of credit, as well as assistance in organizing income-earning activities into groups for purposes of buying, selling, obtaining credit, or production. As experience with these programs has shown, on the one hand, many microenterprise owners turn out not to be poor at all; it has proven to be difficult, on the other hand, to launch the truly poor into economic activities, whether grouped or not, that increase

their incomes significantly. Though many might justifiably dispute the accuracy or completeness of these judgments, I am more concerned here with the way in which this chain of logic, together with the results of practice, prevents the alternative world from formulating research and policy agendas of a wider scope, and of a potentially broader impact on the issues of unemployment and low incomes.

The box that the alternative world is in, and should be encouraged to break out of, has the following four sides: (1) the informal sector and self-employment are equivalent with poverty; (2) only programs working exclusively with the poor will help increase their incomes; (3) but, as is being learned from the projects and the informal-sector research, many IS self-employed are not poor so we exclude them from our intended list of beneficiaries even though they might prove to be the "winners" in the kinds of microenterprise programs we restrict ourselves to; and (4) we therefore will concentrate our income-generating efforts on the truly poor, even though it is difficult to be successful in raising incomes on a large scale through this kind of assistance. The lid of the box is the view that nothing the state does for the poor can work--a view, by the way, that inadvertently places these socially-concerned practitioners in the same camp as those who argue that state poverty programs should be ended because they involve an excessively large role of the government in the economy, a point I return to in a moment. Though this particular convergence might not be to the liking of these otherwise opposed camps, it also explains why the free-market advocates and the social reformers have come to share a common interest today in assisting small firms in the informal sector.

Even though the "alternative" approach may produce good results in some projects, the box keeps the alternative world from engaging in a

broader debate about, and sponsoring evaluation research on, the kinds of policies, programs, and development models that might have the greatest impact on unemployment and poverty--including existing and past government efforts at targeting and poverty alleviation, public-sector transfer programs, social services, employment-intensive growth policies, formal-sector employment policy, public-sector employment policy, as well as programs to assist SSEs. Again, those with the most concern for poverty turn out to be absent from the debate about what to do, which in itself reduces the vitality and meaning of the debate. Though the absence of the "alternative" view from the mainstream policy-advising world today can be attributed in part to the fact that it has been side-lined by those with power, there is no question that the box "the alternatives" are in has also kept them away from the debate voluntarily.

The alternative camp tends to refrain from the mainstream policy debate, in sum, partly because it believes that the state cannot or will not do much about unemployment and poverty--in policy areas affecting formal-sector labor, public-sector labor, social transfers, social services, and equity-oriented growth strategies, programs, and policies. This keeps the alternative camp from being interested in research issues that could lead to a better understanding of policy for these areas--particularly, comparative studies on what has worked and what has not in the area of poverty alleviation. In staying away from these larger questions, ironically, the alternatives end up inadvertently in the same camp as those who believe that growth will of itself take care of poverty--or of those who want to reduce the role of the public sector and therefore are not interested in comparative studies of its effectiveness. For different reasons, then, we are lacking a policy-oriented research that could prove useful in providing the facts and the theories for a more enlightened approach to policy advice.

Part of the reason for the narrowed scope of the "alternatives'" involvement in policy questions is the fact that nongovernment organizations (NGOs) have played an important role in defining the alternative view. To many researchers and donors in the alternative world, the NGOs represent the only institutional focus of concern about poverty today. They are among the few development-oriented institutions in the first world that (1) have an agenda for poverty and (2), regardless of how effective it is, can execute it in the form of projects, a form of intervention that donors are best set up to fund. Clearly, the smaller donors' view of poverty and how to fight it has been influenced by the informal-sector literature as well, which nevertheless would probably view an NGO-centered strategy as paternalistic. But the smaller donors, like any institution needing to make quick decisions in a world of imperfect information and imperfect solutions, have formed a view that is consistent for them by taking eclectically from both the IS literature and the NGO worldview. In their search for projects, ideas, and experience in the poverty area, then, it is no surprise that the alternative donors have turned to the NGOs.

The NGO presence on the implementation side, in turn, has contributed toward keeping the alternative world in its "box" and maintaining the chasm that separates the two worlds. NGOs are, by nature, small organizations that usually do best with small projects; they tend to prefer to work on their own, independently of the state, and to have a certain distrust of the state; they tend to design their programs and see their role not in terms of a broader approach to poverty reduction, but more as "good works" carried out by staffs who are truly committed to the poor. Given these characteristics of the NGO world, which also account for its many instances of fine work in providing services to the poor, it is not surprising that

the NGO view of poverty alleviation holds little room for the state, and that NGO programs usually reach a fairly limited number of people. This NGO view, understandable as it is for NGOs themselves, has played an important role in forming the view of poverty and the state held by the smaller donors.

The strong NGO presence in the alternative world has precluded a research interest in poverty interventions by the state. Similarly, the NGO influence in that world has precluded interest in an important set of questions, some of which would actually look into the strengths that some NGOs themselves have shown for having wider impacts on poverty. Research of my own and others, that is, suggests that some of the unusual cases of NGO programs with wide impacts were those in which the NGO was working complementarily with the state--either formally, in the joint production of services, or informally, through leaders that were closely linked to the centers of state power and therefore had easy access for their clients to the services and subsidies of the state. These findings acquire significance in light of a growing humility on the part of third-world leaders and technocrats with respect to their ability to carry out broad programs effectively, and a corresponding interest by some of these actors in learning lessons from the NGO experience, or in linking up to NGO programs. The current interest in decentralization of government and local organizations is another way of thinking about such a link, no matter how loose, between the state and organizations like NGOs that emerge out of civic society.

Despite the potential convergence of these various new perspectives on NGOs, the alternative world has not shown a research interest in comparative studies of effective NGO programs with larger impacts. NGOs, in

part, feel threatened by such a perspective because they want to remain small and unlinked to the state, often with good reason. And their influence on their benefactors, the smaller donors, inhibits the development of such a research initiative, even though it would focus in part on the lessons to be learned from NGO successes.

It may be unrealistic to expect that such a research initiative would come from the "alternative" sector, given the NGO presence there, even though one would think that the social concerns of that sector and its experience with NGO projects would make it the most likely home for the asking of such questions. The World Bank might be a better place for such an initiative, because it is not so involved with the NGO world. That the initiative has not come from the Bank either is partly attributable to its relative lack of attention in recent times to issues of unemployment and low incomes, and to its somewhat premature verdict on its own poverty-oriented programs--namely, that "nothing worked."

As adopted by the alternative world, in sum, the informal-sector literature has held us back somewhat from thinking about policy and programs for increasing incomes and employment of the poor, just as the neo-classical SSE literature and its popular interpretation has left us with an inadequate theory and empirical base for thinking about employment strategy. The alternative view has inhibited those in the alternative camp in two ways: (1) it has kept them from thinking about poverty-oriented strategies in a way that goes beyond small income-earning projects in the informal sector; and (2) it has kept them from elaborating an SSE-oriented growth strategy as a way of thinking about production and employment together, because so many SSE firm owners are not poor.

Perhaps the most striking aspect of this story of informal-sector research and its contribution to the alternative view of development assistance is that today's thinking about third-world problems is so polarized--with two separate camps who do not have much to do with each other, and who do not think much of each other's opinions or research. This kind of separateness, of course, is not unusual; it can reflect strongly-held different ideological positions, and may be healthy in terms of creating supportive environments for like-minded people to do research and to talk about strategy. In this case, however, the separation has made it difficult to carry out policy-oriented research on topics that are of interest to both worlds--research that should yield policy advice on (1) how to achieve broad impact in the SSE sector, and (2) the kind of policy package that can accomplish this and at the same time be politically and socially acceptable in third-world countries today.

Luckily, there are various researchers from all these fields who feel comfortable in both worlds, who feel they have something to learn from both literatures, and who do not necessarily see the world as being divided in this particular way. It would seem that the Bank, squarely situated in the mainstream world and with a growing concern about public-sector management, institutional issues, private-sector development (including SSE and the informal sector), and post-crisis growth strategy, is in a special position to bridge the gap between these two worlds by initiating a policy-oriented research agenda that builds on some of the scholarship that is reaching toward a more integrated vision of the problems of third-world development.

V - Flexible Specialization

The literature of flexible specialization (FS) does not stand on either side of the divide between the neo-classical SSE camp and the IS alternative camp. This is partly because it studies the transformation of industrial structure in the first world, where poverty issues are viewed as more separate than in the third world from issues of production and economic growth. Flexible specialization, in brief, attributes the current changes in the industrial sector of first-world economies to the breakdown of the mass-production model of production. At its height in the mid-twentieth century, FS researchers argue, mass production was dependent on a stability of international markets that no longer exists. In today's world, with greater swings in consumer tastes and with powerful competitors emerging unpredictably from newly-industrializing countries, mass production's high fixed investment in machinery dedicated to long runs, and the rigid work rules and job classifications of its labor-management pacts, are no longer a competitive or innovative form of production.

In response to the changing conditions of the world market in the second half of the twentieth century, FS researchers say, "communities" of highly specialized and flexible small firms, often quite sophisticated, seem to be emerging. Some of these specialized groups of firms flourished even during the heyday of mass production, filling a market need that complemented mass production. Others have sprung up more recently as a result of the de-concentration or de-formalization of previously integrated mass-production firms. In general, the appearance of these smaller firms represents a response to the relative advantage given to smallness and flexibility by the growing unpredictability of market conditions, together

with the innovations in computer technology that allow for programming of production equipment, which makes it possible to change product specifications quickly in response to changes in demand.

As of the moment, the FS literature does not help us much with some of the policy-oriented questions raised here, partly because it is not oriented that way. The FS literature has not yet explored the question of why SSE is sometimes characterized by stagnation and exploitation, and other times by dynamism, improved incomes, better job security, and a more humane work environment. As documented by the FS literature in the first world moreover, the process of de-integration or de-formalization of production is less significant for understanding economic growth and labor markets in the third world because the informal sector always accounted for a significantly larger share of employment and output than in the first world. Any recent process of de-formalization in the third world, then, would be less salient with respect to the nature of labor markets and the structure of production. Nevertheless, the FS analysis of the newly de-formalized structure of the first world is still quite useful for an understanding of long-existing informal-sector activity in the third world.

The FS literature has, in a short period of time, made a major contribution to our understanding of the processes of transformation in industrial economies today, and has generated heated debates over its interpretations. I bring in the FS literature here not to enter that particular debate or to fault the literature for not doing something it did not set out to do, but to draw upon it for a perspective on the private sector and employment, and a research style, that are particularly relevant to the policy-oriented research task being discussed here.

The FS literature provides us with a basis for integrating the subject matters of private-sector development and social policy in a way that the existing third-world literature surveyed above does not, divided as it is into two camps. For example, the FS perspective tends to see the lines between labor and management, and between informal and formal, as becoming less clearly drawn. The more specialized production of the smaller firms requires workers to be responsible for a more diversified set of tasks and hence makes employers more dependent on worker judgment and dedication. Lines between labor and management also become more blurred than in the mass-production model because of cooperation between small firms. A small firmowner with a large contract will subcontract a part of it to a neighboring small-firm owner who, at the moment, has no work--and vice-versa. In this model, moreover, trade-union-like organizations may emerge less from among the laborers of one firm or group of firms than from among a group of subcontracting firms or outworkers, for purposes of negotiating the terms of their contracts with large buyers of their products.

The promise that the FS story holds for workers is different from that of both the IS and SSE literatures, and gives us more to build on with respect to employment and social policy. In the FS literature, today's capitalist dynamic holds some promise for workers, especially if guided by enlightened social policy. In the IS literature, this same dynamic promises only continued exploitation of workers, without much amelioration to be expected from government policy. The SSE literature, in turn, can offer only the traditional neo-classical promise to workers--increased employment in the future resulting from a growth policy that stimulates the more labor-intensive small-scale producers. If the SSE model has anything to say about social policy, moreover, it seems to be anti-labor. The FS model, at the

least, hints at the potential of better conditions for workers--the quality of work life, income protection, supportive community institutions, and the possibility of policies that can provide better lives for workers at the same time that they facilitate the growth of small firms. The FS literature is unusual in the third-world context, in sum, because it integrates a concern for labor with an understanding of what makes for dynamic private-sector growth among small firms.

The FS perspective is like that of the current IS literature in that it emphasizes and explores the links between the formal and informal sector. But the FS literature sees both sectors as a dynamic whole, each influencing and being influenced by the other. This stands in contrast to the IS portrayal of the informal sector as a manifestation of the needs of the formal sector, without much hope in the informal sector for dynamism, improved incomes, and independence. Though the FS literature is fully cognizant of the potential for exploitation of the informal by the formal sector, it chooses to emphasize the possibility for better work lives and better community that this form of organizing production, and firms, opens up. In contrast to the IS and SSE literatures, finally, the FS literature tends to see the formal sector as "sick," rather than the informal sector--to the extent that "formal" is synonymous with mass-production firms with highly formalized labor norms, and "informal" is roughly equivalent to the small firms that are responding "dynamically" to changing market conditions.

Dividing up the world of production into informal and formal, or large and small, does not actually fit the FS literature, precisely because of its integrative perspective and its attempt to analyze a process of restructuring of production from large into groups of small, with changing links between large and small. This is the important contribution that the

FS literature can make to thinking about policy issues in the third-world context today. It does not separate out a small-scale or informal sector that is different from, and more pathetic than, the rest of the economy. Though FS may focus on certain smaller-scale firms for study, it is because of their potential for dynamism or even for serving as a new model of growth in the 1990s, rather than that they are a tail being wagged by a formal-sector dog.

Some have criticized the FS literature as being slightly too programmatic and upbeat about the flexible specialization model. Whether or not this is true, there is no question that this perspective endows SSE with a symbolic power that it never has had in the third-world context. At its most programmatic, flexible specialization views SSE as "the cutting edge," the most sophisticated in terms of a country's industrial future, the most humane in terms of the way it treats workers. In the history of thinking about third-world growth, the now-discredited model of heavy industrialization had this same symbolic power--its imagery of coming into the modern world, of independence from first-world countries, and of redistributive justice (between first and third world at that time rather than between rich and poor within countries). This way of looking at the world, in other words, has some potential for attracting the attention of leaders in search of mobilizing and consensus-building images of development--an imagery and a symbolism that neither the IS nor the SSE literature can provide.² Though the FS literature may not have much to say

²One small sign of this symbolic potential of the FS model can be seen in Tunisia. A small group of that country's prestigious engineers have become increasingly aware of the problems inherent in their country's pursuit of a large-scale capital-intensive model of industrial development, and yet are uncertain of what to put in its place. They want an alternative that would be as mesmerizing as the heavy-industrialization model while, at the same time, not require the technical and financial dependency on ex-colonial
(Footnote 2 Continued on Next Page

about SSE as harboring exploitation and poverty, in sum, one feels that it provides a policy framework for thinking about and working on these issues in a way that both the IS and the SSE literature do not.

For anyone who has studied informal-sector enterprises in the third world, one aspect of the FS literature rings remarkably true--and has not really been developed in the same way in the myriad studies of both the SSE and IS literatures. That is the way in which (1) small firms interact with each other in a cooperative rather than competitive way; (2) these interactions form a pattern of behavior that plays a role in determining wages, prices, and other "market" phenomena; (3) these agglomerations of firms often lead to the evolution of supportive local institutions that help them find markets, acquire technical expertise, and train the kind of labor they need. These norms of community--often reinforced by ethnic, religious, political, or regional solidarity--are often more important in explaining how these firms behave than the model of atomistic competition that they are supposed to epitomize.

When I encountered this kind of cooperation among firms in my own research, my economist's training made it difficult to explain. The FS literature places this behavior in an explanatory framework that makes it understandable rather than surprising. And by focusing on the supportive institutions that grew around these communities of firms in terms of economies of agglomeration,³ this perspective helps us to think about some of the forms that supportive policy might take.

(Footnote 2 Continued from Previous Page)

powers that the previous model did. They have organized a conference in Tunisia around the themes of the FS literature as a first step in thinking about such a new model for their country's future.

³Described this way because, in the mass production model, the "agglomeration" takes place inside the large firm, and is organized by it,
(Footnote 3 Continued on Next Page)

VI - Decentralization

Much of the current policy advice given to third-world governments in the public administration field stresses the virtues of decentralization of government, and the more important role that should be played by local government and other local institutions. Though some of the current interest in decentralization is faddish, some of it has grown out of the difficult experience with implementing various government programs, particularly rural development. Some of the decentralization literature has been motivated by a concern for democratic processes, and the contribution they can make toward putting governments under pressure to provide greater access for the poor to government services and subsidies.

The flexible-specilization literature, in its own way, joins the decentralization stream, but from a totally different direction. Instead of starting with the state, and asking how it might more effectively or democratically conduct its business, the FS literature starts with the observation of certain transformations and characteristics of industrial structure. It then shows how certain local institutions, or the potential for them, evolve in response to this decentralized industrial structure; or how local institutions grow out of a process of interaction between the industrial structure and common values binding the owners and employers of a particular community of firms. This perspective suggests a way of going about doing policy-oriented research on the subject of decentralization or local institutions that is distinct from the decentralization literature.

(Footnote 3 Continued from Previous Page)

whereas the process of de-concentration of production makes certain previously "internal" functions external to any particular small firm. This causes groups of small firms to behave in a way that elicits the provision of these external functions--either by themselves as a group, or by local institutions that they create or over which they exert some influence.

Instead of asking how the state can do what it does better, the FS perspective leads us to explore the local institutions, or possibilities for them, that are emerging from a particular place of production, and to ask how the state can assist that process of emergence.

In order to answer these questions, we need to identify some production "communities" that have shown such dynamism and try to understand what has made them work well--not only in the sense of what was going on in the larger economy, but in terms of the local institutions that emerged out of these groups of firms, or whose support these firms elicited in the course of their growth. This manner of asking questions should help us enter this relatively new territory of local government and institutions with a grounded approach to policy advice.