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## **Program to boost the competitiveness of businesses in Local Production Systems in the state of São Paulo. Lessons learned.**

### **Case A: The design phase**

After four years of preparation and negotiation, the first of four cluster-based development programs was approved by the Board of the IADB in November 2007. The loan was signed in June 2008. It had been a long drawn out process, which tried to incorporate all the lessons learned by the Bank in similar programs.

The following are excerpts from the Loan Proposal document of the IADB from 2007.

#### **I. Frame of reference**

##### **A. Economic context in Brazil and the state of São Paulo**

The state of São Paulo, located in southeastern Brazil, covers only 3% of the country's territory but is home to 22% of the population (39 million residents) and generates 34% of the country's GDP (US\$159 billion in 2004). In the 1990s, the state's economic growth resembled that of the country, with average growth of 3.4% from 1993 to 2000. Brazil's economic slowdown at the onset of this decade was acutely felt in the state, with São Paulo taking a harder hit than the rest of the national average. From 1999 to 2003 the São Paulo economy grew 25% to 30% more slowly than the national economy. In 2004, the growth in domestic consumption and the rise in exports helped to reverse this trend. São Paulo's GDP rose 7.6% in 2004, compared with 5.2% for the country as a whole.

[...]

**The production system in São Paulo.** São Paulo has a broad, diversified, complex production system. Industrial production in the state accounts for about 45% of the country's total. Particularly strong are the state's civil construction, garment, automotive, metallurgy, food, pharmaceutical, and chemical sectors. São Paulo also has a significant and relatively sophisticated service sector, and the

This case was prepared by Inés Sagrario on 2012 based on IADB official published documents about a real experience in the State of São Paulo (Brazil), as the basis for class discussion rather than to illustrate the effective or ineffective handling of an administrative situation. Some situations, characters and companies have been disguised to preserve confidentiality.

state is home to a large part of the country's financial system (70% of all banks and 50% of all deposits). Agricultural production in São Paulo accounts for about 20% of the country's total. The importance of the São Paulo economy in Brazil is also reflected in foreign trade flows, with the state accounting for 32% of all exports and 42% of all imports in 2004. In the past 10 years the state has undergone a major transformation as a result of the structural reforms and opening of the economy, which had a major impact on its manufacturing sector. Nowhere was the restructuring process as far-reaching as in the São Paulo metropolitan area, which in previous decades had been the hub of Brazil's industrialization efforts. The city's industries worked to adapt to its newfound competition or relocated to other parts of the country offering cheaper labor or tax breaks, as was the case with the automotive industry. The relocations helped raise the state's unemployment rate and placed pressure on other cities.

Policies supporting the productive sector in São Paulo had traditionally focused on promoting and bolstering the import-substitution model, and the automotive sector had been at the heart of this process since the mid-1900s. The emphasis on heavy industry favored scale- and capital-intensive industries, which built huge plants and established themselves in the vast consumption hub, the São Paulo metropolitan area. First- and second-tier suppliers also set up operations near the large plants, in a process that led to an extreme concentration of economic activity in the city of São Paulo and environs. This created a substantial imbalance not only at the national level, but also within the state of São Paulo between the capital city and the rest of the state.

This imbalanced development, however, led to the creation of hundreds of thousands of micro, small and medium-sized enterprises (MSMEs). MSMEs account for more than 99% of all businesses in the state (approximately 1.3 million units), 67% of all jobs, and 20% of GDP. These companies organize themselves into value chains linked to large industrial companies, as well as into territorial clusters of businesses in the same sector (known in Brazil as Arranjos Produtivos Locais [local production clusters], or APLs). Traditional mature-technology sectors are prevalent in areas of the state outside the capital, and it is in these areas where APLs are most common.

## **B. Challenges to productive development in the state of São Paulo**

To alleviate the imbalances created by past development strategies, the State of São Paulo decided to pursue more balanced development in areas outside the state capital, while promoting the competitiveness of sectors with job and revenue potential. Along these lines, it is focusing its efforts on making the APLs outside the state capital more competitive.

Many such APLs consist of companies in traditional sectors, such as clothing and footwear, whose growth was sheltered by tariff protection and a large domestic market. But with Brazil's increased integration into the world economy over the past decade, some of these sectors need to adapt their strategies to become more

competitive and continue generating jobs and revenue. Moreover, MSMEs belonging to these APLs face typical problems for companies their size, which involve the following issues in market operations and public-sector support:

a. **Coordination issues.** Businesses in the APLs naturally enjoy some benefits based on geographic proximity to one another. Yet in São Paulo not all the advantages that could be gained from enhancing coordination both among themselves and between them and the promotion bodies active in each APL are being tapped. Improved coordination among local agents would help overcome problems related to scale, access to information, or barriers to major markets, especially export markets. Due to the small scale of production at many of these businesses, individual actions by them are largely ineffective in addressing these issues.

b. **Problems with matching business support services supply and demand.** The state does have consulting, technical support, and technological development services that could help solve some of the problems described above. Supply, however, often fails to reflect companies' specific needs and lacks coordination. In addition, many firms do not know how to access these support services. This gap between supply of and demand for business support services hinders the full development of companies in the state.

### **C. The country's and state's productive development strategies**

As part of the 2004-2007 Multiyear Plan to energize the productive sector, the federal government announced its new Policy for Industry, Technology, and Foreign Trade in March 2004. This policy is designed to help develop the productive sector and make it more efficient by spreading technologies with the potential to foster economic growth and competitiveness at the international level. The linchpin of the policy is coordination of all such interventions through a focus on APLs. The most immediate challenge for the policy is identifying and coordinating the many activities and programs currently being handled by various public-sector agents, including those related to APLs. This task has been the responsibility of the Conselho Nacional de Desenvolvimento Industrial [National Council for Industrial Development] and the newly formed Agência Brasileira de Desenvolvimento Industrial [Brazilian Agency for Industrial Development] (ABDI) since early 2005. The federal government's proposals for activities to support APLs are largely based on interventions that some Brazilian states have been carrying out for several years.

The São Paulo state government, the Serviço Brasileiro de Apoio às Micro e Pequenas Empresas [Brazilian Microenterprise and Small Business Support Service] in São Paulo (SEBRAE-SP), and the Federação das Indústrias do Estado de São Paulo [Federation of Industries of the State of São Paulo] (FIESP) have been working with APLs in the state for several years. A study was conducted in 2002 to identify and map the state's production clusters. The study used quantitative and qualitative criteria to identify existing concentrations of businesses

in a given sector within defined geographical areas. Based on this study, some stakeholders in the state—especially civil society organizations and semipublic agencies, such as SEBRAE-SP and FIESP—began providing services to strengthen APLs. The state government, SEBRAE-SP, and FIESP thus developed their own methodologies, which they gradually aligned. A common component of these methodologies is to spend several months raising awareness, conducting diagnostic assessments, and planning in each APL before proceeding with more powerful interventions to make it more competitive.

More recently, to begin the process of adapting the new national industrial policy to the local level, the 2004-2007 Multiyear Plan of the State of São Paulo set a priority of strengthening the APLs and, in particular, linking and coordinating the actions of the various bodies that will deal with the APLs. The Secretaria de Desenvolvimento [Department of Development] (SD) is leading this effort and has asked the Bank to finance this operation for the purpose of coordinating interventions to promote economic development in the state by supporting the state's APLs.

[...]

### **E. Program strategy**

The program strategy is to help APLs become more competitive by intervening to mitigate the effects of information and coordination failures that limit productivity gains at companies belonging to APLs. These interventions, led by the SD, will be coordinated with other entities in the state, SEBRAE-SP, and FIESP, which have already been supporting the development of APLs and SMEs.

The program strategy is heavily focused on supporting APLs through four clearly defined steps: (i) raising awareness among the companies and public- and private-sector entities that make up the APLs and mobilizing them, so that they are aware of their problems and the opportunities that teamwork can offer them; (ii) preparing a joint strategic plan to improve the APLs' competitive position through a series of activities; (iii) carrying out the activities set forth in the strategic plan; and (iv) monitoring and evaluating these activities. While the bulk of program resources will be allocated to step (iii) above (for direct activities), the program's final outcomes will hinge on the success of the first two steps. The program's four components parallel these four steps exactly.

[...]

### **F. Innovation loan rationale**

Brazil is beginning to implement a new APL-focused industrial policy. This initiative has few precedents in the world on this scale and will require a high degree of institutional innovation to accommodate this change. The Bank, meanwhile, has been supporting projects with a cluster approach, mainly through MIF projects and projects in small countries where support for clusters was merely one component.

None of these, however, have been on the scale of a country as large as Brazil, which has a sophisticated productive sector and a range of business support tools that require coordination. This program seeks to support the State of São Paulo in implementing a pilot project to support APLs in the state. The project will provide valuable lessons for São Paulo, Brazil, and the Bank on the implications of adopting APLs as the focus of competitiveness policies. This is why the operation was designed as an innovation loan, since its objectives are consistent with those of this type of instrument, especially in terms of gaining institutional experience and testing mechanisms that can later be adopted on a larger scale.

As for institutional learning, the challenge in this program consists in coordinating a joint action for the APLs in the state by the various federal, state, and local entities in both the public and private sectors that support the productive sector. The program will thereby help identify and glean lessons on the institutional arrangements and coordination strategies that are most effective for maximizing the impact of future investments to support the productive sector in São Paulo and Brazil.

The innovative activities under this program are also an integral part of a larger initiative consisting of four APL-focused operations to enhance competitiveness in another three Brazilian states as well: Bahia, Minas Gerais, and Pernambuco. These operations are in the final design stages. Since each of these states has its own level of development, institutional structures, and obstacles to competitiveness, the experiences and outcomes from these programs as a whole will give all stakeholders a balanced view of best practices for this type of intervention. The experience gained in these four projects is also expected to support and guide implementation of the federal policy for supporting APLs. The Bank will therefore monitor all four programs in order to draw common lessons.

[...]

## **II. The Program**

### **A. Program objectives and description**

The general objective (goal) of the program is to boost the competitiveness of businesses belonging to the local production clusters (APLs) in the state of São Paulo that are selected to participate in the program. The specific objective (purpose) is to increase coordination among businesses and institutions for adopting competitive practices at companies belonging to the APLs served by the program. To this end, the program has been organized into four components.

[...]

#### **1. Component 1. Awareness-raising, training, and mobilization for business owners and local entities (US\$1,871,000)**

The objective of the first component is to make local business owners and entities aware of the benefits of cooperating with each other, train them, and mobilize them to work together. Awareness-building, training, and mobilization activities are expected to generate interest in participating in the program, encourage the formation of the local governance body, and yield early outcomes through specific activities. Specifically, this component will finance the following activities: (i) diagnostic assessment of business management and dynamics; (ii) training and awareness-raising on business cooperation and on environmental and social issues; (iii) workshops for planning and implementation of short-term activities.

[...]

## **2. Component 2. Development of Competitiveness Improvement Plans (US\$1,456,000)**

The objective of the second component is to plan the activities that the APL will carry out in order to boost competitiveness, culminating in a strategic plan that lays out the competitive challenges facing the APL, common goals for meeting these challenges, and the necessary steps for fulfilling this objective. This strategic plan in São Paulo is called the Competitiveness Improvement Plan (CIP). Short-, medium-, and long-term strategic planning will be conducted for the APLs by forging a common vision, focusing efforts, and preparing local companies and entities to implement the CIPs. This component will finance: (i) a series of diagnostic assessments and studies on the sector, business management, markets, and agent performance to support the development of CIPs; (ii) workshops to present the outcomes of the diagnostic assessments and to discuss opportunities and challenges for the APLs; (iii) consulting services to help determine the objectives, lines of action, and goals to be stated in the CIPs, including consideration of social and environmental challenges; and (iv) CIP validation events to assign responsibilities and formalize commitments with participation by companies and local entities.

[...]

## **3. Component 3. Implementation of the CIPs (US\$14,555,000)**

The objective of this component is to carry out activities based on the CIPs. The activities to be financed under this component are related to the following: (i) technical assistance; (ii) training; (iii) market access; and (iv) APL-wide horizontal activities. To be eligible for program financing, activities must be directly related to the objectives set forth in the CIPs and must contribute to these objectives.

**Technical assistance, training, and market access.** Technical assistance activities to be financed may include technical advisory support in operations, financial management, marketing and sales, labor regulations, certification, and the environment. Training will be financed for areas such as basic professional skills, financial management, sales management, human resource management, business strategy, foreign trade, and design management. Lastly, the market

access activities eligible for program financing will include such activities as participation in trade shows, matchmaker events, and international trade missions.

**Horizontal activities.** These projects must be aimed at activities that offer broad positive externalities for the entire APL and yield benefits that are largely inappropriable by individual companies, and/or activities designed to tackle problems of coordination among companies for the sake of a common objective or benefit. These projects may include proposals such as: small infrastructure (technology centers in such areas as product and equipment testing and evaluation, basic industrial technology, innovation); environmental initiatives; preparation for certification; professional training centers; marketing or purchasing centers; industrial waste treatment programs; collective mark development programs; and improvements to local or state policies and regulations. For this type of proposal for horizontal activities, the program may cofinance expenses related to consulting, training, and the procurement of machinery and equipment. The program will not support land or property purchases, nor will it finance the cost of maintaining and/or operating projects, which must be covered by local counterpart funding.

[...]

#### **4. Component 4. Monitoring, evaluation, and dissemination of lessons learned (US\$522,000)**

In view of the innovative nature of the program and the important role of learning in this type of program, a specific component is proposed for the purpose of implementing a monitoring and evaluation system for the program, as well as carrying out activities to disseminate lessons learned and program outcomes. [...]

**The program's learning strategy.** The review, discussion, and dissemination of lessons learned from the program will be shared both within the locality and among localities, through: (i) learning workshops (held after 6, 12, 18, 24, and 30 months of program execution) with the participation of business owners, public officials, staff from the support institutions, members of the local governance bodies (Steering Committees), and consultants; and (ii) semiannual meetings of the Strategic Council. These activities supplement the record of testimonials, photographs, press releases, institutional videos, and print and electronic publications related to program experiences, which will be produced to share the lessons learned.

[...]

### **III. Program Execution**

[...]

**Strategic Council.** The Strategic Council will be responsible for setting strategic guidelines for the program and supporting execution by monitoring program

performance. The members of the Strategic Council will consist of representatives of the following: the SD, who will serve as chair; the Department of the Economy and Planning; SEBRAE-SP; FIESP/CIESP [Center for Industries of the State of São Paulo]; and the manager of the PMU [Program Management Unit], who will serve as executive secretary of the Strategic Council. The executive secretary will carry out the council's decisions, safeguard the council's legality and formalization, keep records of its activities, and report on projects or other issues that the PMU deems essential to the successful execution of the program.

**PMU.** The PMU, as the sole interlocutor with the Bank, will be responsible for managing, coordinating, and overseeing the technical, administrative, and financial aspects of the program. The PMU will use the institutional, technical, and administrative capacity of the SD. It will also use the technical and administrative capacity of SEBRAE-SP for specific activities (financial supervision, contracting of consulting services for technical assistance). The minor institutional adjustments that were recommended on the basis of the SD institutional evaluation performed during the operation's design stage will be made through implementation of an institutional strengthening plan. To support the PMU in executing the program at the local level, professionals will be hired to serve as local program managers (LPMs), who will be responsible for the technical execution of APL activities under the supervision of the PMU. The LPMs will report to the PMU. Lastly, an APL Steering Committee will be formed within each APL participating in the program. These committees will be responsible for coordinating and supporting executive actions in the APLs.

**Steering Committee:** The APL Steering Committees will liaise with and represent the companies and other entities in each APL. These committees have the executive role of coordinating program initiatives and bringing them into line with one another in terms of timing, activities, powers, and responsibilities. The committees will consist of representatives of the companies participating in the program, who will be elected by the companies in the pilot group, and representatives of local institutions, such as trade associations or the local office of SEBRAE. The companies in the pilot group will constitute a majority on the Steering Committee.

[...]

The final evaluation will address, inter alia, the program's impact on companies in the APLs supported by the program, the level of business cooperation and institutional coordination in the APLs, the adoption of modern management practices in the APL-affiliated companies, and the degree of satisfaction among business owners with program services. Also, the final evaluation should draw lessons on the different tools used under each program component, identifying strengths, weaknesses, and ideal conditions for replicability.

[...]

## **IV. Viability and Risks**

### **A. Institutional viability**

For assessing institutional viability, the Institutional Capacity Assessment System (ICAS) was applied to the SD as a potential executing agency for the program, and to the Federation of Industries of the State of São Paulo (FIESP) and the Brazilian Microenterprise and Small Business Support Service in São Paulo (SEBRAE-SP) as key partner institutions for program execution. The assessment concluded that each of these entities has satisfactory institutional capacity and recommended that the SD act as the executing agency through a specialized temporary unit set up as the program management unit (PMU).

[...]

### **F. Benefits**

The direct beneficiaries of the program will be the companies<sup>1</sup>, the public- and private-sector institutions, and the APL-affiliated service providers that are supported by this operation. Program benefits stem from increased cooperation among businesses and institutions for adopting competitive management practices in the pilot groups of participating APLs. In particular, the program's activities will increase the effectiveness of public- and private-sector policies to support APLs by instituting a mechanism to reduce duplication and overlapping in interventions. The program will also reduce information failures in the business support services market by providing APL-affiliated companies with a dialogue mechanism through which they can more effectively express their service needs. Internally, the program will strengthen the local governance bodies in each APL and improve the companies' competitive and cooperative practices.

Over the medium and long terms, the program's benefits will help make companies in participating APLs more competitive, and this, with the subnational APL-based approach as a public policy instrument, will help foster greater regional equality and anchor sustainable local development. Also, by implementing a model to identify, prioritize, and carry out joint actions as part of a common strategy, the government will benefit from a significant institutional learning process. This learning process will be considerably enriched by comparing the experience from this operation with that of the other three APL-related programs that the Bank will be executing in Brazil.

### **G. Risks**

No significant risks are foreseen in meeting the program's objectives and attaining the expected outcomes. There are, however, three minor risks to program execution that have been taken into account in designing the operation, and these

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<sup>1</sup> Beneficiary companies include those that participate in the program (i.e., receive financing) as well as those that do not participate but do belong to the APL and benefit from program outcomes and impacts on the APL and the region.

risks were subsequently mitigated through specific actions. The main risk involves a lack of demand from participating companies. This risk has been mitigated in various ways: (i) the project team and counterpart team have met on several occasions with business owners from participating APLs and have verified the companies' commitment, interest, and motivation; (ii) the dissemination and promotion activities financed under component 1 will stimulate demand; and (iii) the program's services will directly address the needs of the companies, since the strategic plans to be prepared by the companies themselves will determine the activities to be financed by the program.

An additional risk is the possibility that the CIPs may be of poor quality and hurt the operation's chances of attaining the expected outcomes and benefits. This risk has been mitigated because: (i) the program will finance world-class consulting services to advise the companies in the APLs on developing these plans; and (ii) specific plans and actions to be financed by the program will be selected according to eligibility and selection criteria to maximize their impact on selected APLs. Lastly, there is a risk associated with the need for a high degree of institutional coordination and linkage among the SD, SEBRAE-SP, and FIESP to execute this operation. This risk is mitigated by the following three features of the operation's design: (i) all three entities have actively participated at each stage and in every decision about the program and its execution throughout the entire design process; (ii) the Operating Regulations clearly define the roles for each entity and, specifically, the areas in which each will act and collaborate; and (iii) the SD will enter into cooperation agreements with FIESP and SEBRAE establishing the specific activities that each entity is responsible for carrying out.

## **QUESTIONS FOR DISCUSSION**

1. What was the main focus of this program? Competitive companies, competitive clusters (APLs) or a better business environment?
2. Is this an SME development program or an industrial policy program? Does the answer to this question have implications for the design of the program? If so, what would you have done differently?
3. In your opinion, are the risks and benefits of the operation assessed correctly?

## Exhibits

### Exhibit 1 – Maps

