

THE WORLD BANK/DFID/MIT/IPEA

Beyond Informality

Understanding how law enforcers and economic-development agents promote small and medium firms' economic growth under the law*.

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EXECUTIVE SUMMARY

In most developing countries, small and medium firms in the informal sector have grown steadily over the last decade as a consequence of regulation and increasing international competition. In Brazil, 58% of the manufacturing employment growth from 1995 to 2005 happened in cities with fewer than 100,000 inhabitants; cities where most small and medium firms are informal. In these places, the great challenge for policymakers and economic-development practitioners today is how to reconcile economic growth with legal standards. On the one hand, government and non-government practitioners claim that small firms' economic growth is important to increase employment and reduce poverty despite firms' non-compliance with the labor, tax and environmental legislation. On the other hand, law enforcers usually face a dilemma of making small and medium firms comply with the law and bear the risk of being accused of hindering the local development, when these firms are not able to face the burden of meeting law standards.

There is no simple solution to this dilemma. In one solution, the government proposes to change the law to exempt small firms from complying with labor and environmental standards. On the other, the government keeps inspectors away from harassing small and medium firms owners. However, I believe that the solution to this dilemma lies halfway between these two extremes. Law enforcers can make small and medium firms comply with the law when they enforce the law together with the support of economic-development officials who help firms face the costs associated with formalization.

This research is based on three industrial clusters in Brazil's countryside where firms were notoriously informal for decades. This equilibrium marked by high informality started to change as a result of four different and complementary factors that reinforced each other. *First*, despite firms owners lobbying for subsidies and exemptions from the law, I found that economic-development agents might help the enforcement of the law when they only provide subsidies to those firms that are willing to take serious steps to upgrade and comply with the law. *Second*, economic-development agents strategically decide to focus on a few problems to solve, making the problems manageable to

be tackled by their agencies (SEBRAE, local and state secretariats of government). *Third*, law agents worked intentionally or unintentionally together with other institutions (SEBRAE, state secretariats, etc) to enforce the law partially and gradually. In none of the cases I studied, law enforcers acted to enforce the tax, labor and environmental legislation simultaneously. And *fourth*, local business association were important to help firms make the changes to comply with the law by providing real services that helped firms to upgrade and by negotiating with law enforcers a grace period and a deadline for firms' compliance.

My case studies suggest that once law agents try to enforce the law gradually and economic-development agents provide selective incentives for firms to register labor force, control pollution or collect taxes; this might unleash a process in which firms might increasingly act in accordance with the law. This does not mean that the public sector should always enforce the law gradually or provide subsidies whenever law enforcers want to make firms comply with the law. Still, this might be a better option than exempting firms from complying with standards.

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ABBREVIATIONS AND ACRONYMS

ASCIT	Entrepreneur’s commercial and industrial association of Toritama
ACIJ	Entrepreneur’s commercial and industrial association of Jaraguá
CPRH	Water and Environmental Agency of Pernambuco
FEAM	State Environmental Foundation of Minas Gerais
FIEMG	Industrial Business Association – Minas Gerais
IEL	Euvaldo Lodi Institute – Minas Gerais
SEBRAE	Brazilian Bureau to Support Micro and Small Firms Development
SECTMA	Secretariat for Technology and Environment (Pernambuco)

SINDIVEST Garments Firms' Association (Pernambuco)

SINDINOVA Entrepreneur's industrial association in Nova Serrana

MP *Ministério Público*

Beyond Informality: Understanding how law enforcers and economic-development agents promote small and medium firms' economic growth under the law*.

Mansueto Almeida (November, 2007)

1. INTRODUCTION

There is a major concern on how the public sector can enforce the law among small and medium enterprises (SME) without jeopardizing firms' competitiveness. On the one hand, it is a well-known fact that small firms owners in developing countries face constraints (lack of capital, lack of access to value-added markets, etc.) that prevent these firms from complying with labor, environmental and tax legislation (Blackman 2000; Dasgupta 2000). On the other hand, we can point out many examples of firms located in clusters that, once upgraded improved environmental and labor standards, becoming more competitive (Nadvi 1999; Tandler 2002; Polaski 2006). However, it is still quite blurred under what circumstances the public sector can make SME comply with labor, tax or environmental legislation without harming firms' survival and competitiveness.

In this paper, I intend to show small and medium firms' compliance with the law by focusing on three industrial clusters located in small cities (fewer than 100,000 inhabitants) in Brazil's countryside. SME in these three clusters had not operated under the law for years, but this situation changed when development agencies adopted policies that enabled firms to act in accordance with the law. As I will show in this paper, the process that ultimately led SME to observe the law occurred gradually and the resulting compliance was limited to some aspects of the law: some firms improved labor standards but continued to pollute, while others adopted cleaner technologies without obeying the labor legislation. I believe that even though the compliance was partial, this was a positive outcome as firms became aware of the possibility of observing the law and likewise still be competitive.

Before going any further, I should make it clear the differences between this research and the traditional cluster literature. Despite being based on industrial clusters, I do not intend

* I would like to thank the members of the research team (Salo Coslovsky and Roberto Pires) and the project supervisor, Judith Tandler, for their constant support and feedback for this research.

to focus on the issues raised by the cluster literature. (Pyke and Sengenberger 1992; Rabellotti 1995; Schmitz 1995; Nadvi 1999; Schmitz 1999). I am not interested in understanding under what circumstances firms cooperate, whether firms that cooperate have a better performance than those that do not, or even how firms succeed in upgrading to reach more value-added markets. Neither am I interested in understanding the links between SME located in clusters and global buyers (Humphrey and Schmitz 2000; Kaplinsky 2000; Humphrey and Schmitz 2002). *I am interested in understanding when SME start to comply with the law, even when they sell to low-priced markets in which consumers do not boycott firms for violating labor and environmental standards.* However, I might bring up the issues of upgrading and cooperating if it helps me to develop my main argument in the text.

In addition to this introduction, this paper is divided into four sections. In the next section, I lay the groundwork for the paper's main argument by showing the formal employment boom after 1999. This happened despite no major changes in the labor legislation in Brazil. In the third section, I explain how the three case studies were selected and why these cases are considered "successful" to understand when firms comply with the law. The fourth section explains the main findings behind SME's compliance with the law, which are the following: (a) selective policies implemented by economic development agencies that increased the benefits for firms to observe the law; (b) mobilization of local entrepreneurs through associations to promote SME's development; (c) the creation of a multi-institutional taskforce to solve specific bottlenecks in the clusters. In the last section, I try to put together the main findings of the paper and suggest further questions.

2. EMPLOYMENT GROWTH IN SMALL CITIES: SOME EMPIRICAL FACTS ABOUT THE BRAZILIAN LABOR MARKET.

In the last 15 years, we can identify two different phases in the dynamics of the Brazilian labor market. The first phase is marked by an increasing unemployment rate and lasted from 1990 to 1999. The second phase, which started after 1999 and continues today, is characterized by the growth in the formal employment year after year.

As to the first phase, according to PNAD¹, the unemployment rate practically doubled, increasing from less than 5% in the beginning of the 1990s to near 10% in 1999. The number of unemployed reached more than 9 million, which is a sharp increase compared to the previous two decades (1970s and 1980s) when this figure never exceeded 2 million workers (Pochmann 2001; Ramos 2007). It was during this period that many scholars, politicians and entrepreneurs pressed for reforms in the labor legislation, the “*Consolidação das Leis do Trabalho (CLT)*”, since this law is considered by many as being outdated and a major barrier to formal employment growth. The lobby for labor reform led the government to enact new laws such as the new legislation regulating the compensation for overtime (“banco de horas”), the temporary working contracts, and the conciliation committees of labor (Noronha, Negri et al. 2006). But despite these changes, there were no major amends in the CLT as to the hierarchy of this legislation over individual and class labor contracts.

The major criticisms against the CLT involves the excess of rules regulating individual employment contracts, the hierarchy of CLT over class and individual employment contracts, and the high costs of hiring under the CLT. Pastore (2007) calculates that hiring under the CLT imposes an extra cost on firms that amounts to 102% over the wage firms pay to workers. But the “*Departamento Intersindical de Estatística e Estudo Socioeconômico (DIEESE)*” claims that this figure is as low as 30.9% when some of the fringe benefits are considered as wage and not extra cost (Noronha, Negri et al. 2006). This is an unsolved debate and each one uses the figure that best fits the point he or she is trying to make. In any case, the CLT continues to be under intense attack by entrepreneurs, but the nature of this criticism changed after 1999, when the formal employment started to increase quickly and the CLT could no longer be blamed for slowing the employment growth.

As a result of the employment increase since 1999, critics started to point to informality as the major problem resulting from the CLT. Informality in Brazil reached 53% of the Brazilian labor force² in 2005, meaning that over half of the employed labor

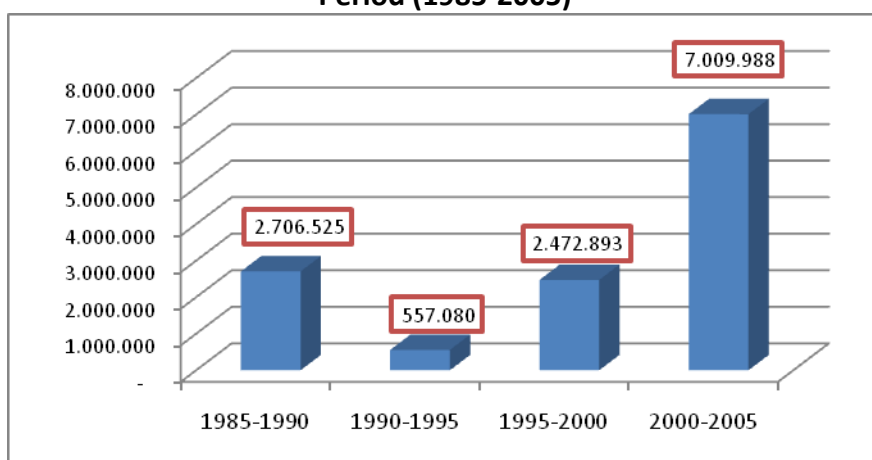
¹ PNAD stands for Pesquisa Nacional de Amostra de Domicílio (*National Household Sample Survey*). This is an annual survey of Brazilian households conducted by the Brazilian Census Bureau (IBGE – Brazilian Institute of Geography and Statistics) in non-census years.

² The rate of informality here refers to the sum of non-registered workers, self-employed and workers with no wage divided by the total labor force (“População Economicamente Ativa-PEA” – *economically active population*). These data refer to 2005 (see Ramos, 2007).

force in Brazil is not under the protection of the CLT. Based on the view that CLT increases informality, some scholars have claimed that labor informality could decrease if the labor market were deregulated and the fringe benefits negotiated freely by each workers' labor union. But today this proposal does not find echo in the political arena in Brazil for three reasons. First, despite the high rate of informality, this figure had shown an impressive stability in the 1990s and it has been decreasing since 2001 (Ávila 2006; Ramos 2007). Second, labor union representatives fear that any deregulation of the labor market might spark a race to the bottom, if firms try to squeeze labor costs to meet the wage levels of other developing countries. Therefore, labor union representatives are strongly against any change in the CLT and they have been lobbying the Congress for maintaining the workers' rights imposed by the CLT. And third, as I pointed above, the formal employment started to increase after 1999, rendering the criticism against the CLT more fragile than it had been in the previous years.

We can see below that the number of registered workers in Brazil increased by 7 million from 2000 to 2005, a number which is higher than the growth of registered workers in the previous 15 years before 2000 (see graph 1). This result is impressive taking into account that the average GDP growth rate was 2.6% per year from 2000 to 2005; which is close to the average growth rate for the previous years (2.3% from 1991 to 1999). Therefore, it is not higher economic growth that explains the fast increase in formal employment in Brazil after 1999.

Graph 1 – The Net Flow of Registered Workers by Five-Year Period (1985-2005)



Source: RAIS – Brazilian Labor Ministry

Labor economists are still struggling to understand the reasons behind this growth³ since no major change in the labor legislation occurred and the cost of labor, when measured by the real minimum wage, increased by 73% from 1995 to 2005. Most labor economists in Brazil agree that this growth is linked to the Brazilian currency devaluation in 1999 and the boom in Brazilian exports led by the world economic growth in the last five years. But these economists cannot explain why the employment increased in labor intensive sectors (footwear, textile and garments), which were under intense competition from low-wage countries, and also why most employment growth in the manufacturing sector happened in Brazil's countryside. According to the data published by the Ministry of Labor, 58% of the manufacturing employment growth (766,906 new workers registered) from 2000 to 2005 happened in cities with fewer than 100,000 habitants⁴. These cities can be divided into three different types: (1) small cities close to state capitals or to medium cities; (2) small cities whose investments were driven by large firms' investments attracted by state fiscal incentives; and (3) small cities where we can find strong local native industries constituted of small and medium enterprises. All the cases I have selected for this research fit into this third category. These cities are Toritama (PE) in the Northeast region, Nova Serrana (MG) in the Southeast, and Jaraguá (GO) in Brazil's Center-west. These cities are among the select group of 417 cities out of 5,560 municipalities in Brazil where the manufacturing employment increased by at least 1,000 workers from 1995 to 2005.

I believe that these cities are examples of the economic dynamism we find in small cities in Brazil. Therefore, rather than being exceptions, the cases to be developed in this paper are examples of a more general pattern of industrial growth that took place mainly in small cities in Brazil's countryside during the last ten years. Next, I will describe how the cases were selected and what makes each case successful as to firms' compliance with the law.

³ Interview with Carlos Alberto, professor of labor economy in Universidade de Brasilia (UnB) and consultant at the Brazilian Ministry of Labor (July, 2007).

⁴ Ramos (1997) calculates the employment growth for the total manufacturing employment (registered and non registered workers) based on the PNAD. He shows that the manufacturing employment increased from 6.6 to 8.3 million in non-metropolitan region and from 3.5 to 4.3 million in metropolitan regions from 1999 to 2005. This figure shows that the growth of the manufacturing employment in non-metropolitan regions was more than twice as high as the growth for metropolitan regions in Brazil, thus corroborating the claim that the majority of the manufacturing employment in the 2000s occurred in the countryside.

3. METHODOLOGY AND CASE STUDIES

This section is divided in two parts. In the first part I briefly describe the methodology of this research and the criteria to select the case studies. In the second part, I show some of the characteristics of the three industrial clusters I selected to this research. But before explaining how I selected the cases, I want to make clear that in this study I am assuming that the way economic-development planners promote the economic development of SME affect the work of law enforcers. Therefore, if we want to understand when SMEs start to act in accordance with the law, we must understand how economic-development agents (hereafter named ED-agents) and law enforcers work with one another in industrial clusters. The independence of these two different economic actors from each other is only apparent, since ED-agents might grant to SME especial relief from the burden to comply with the law, making it easier for law agents to enforce the law once the standards are loosened. In other cases, ED-agents might provide subsidies to help firms adopt clean technologies, helping firms to comply with the environmental standards and law agents to enforce the environmental legislation.

3.1) Methodology and selection of the case studies

I interviewed politicians, entrepreneurs, law enforcers (prosecutors, labor inspectors and tax inspectors), development agents, labor union and trade union representatives for this research. I interviewed these stakeholders in the clusters I visited and also in the capitals (Recife, Goiânia, and Belo Horizonte) of the states where the clusters are located. In addition, I also conducted some interviews in Brasília, in order to understand how the government executives at the Ministry of Labor (MTE) and at the Federal Attorney Office (*Ministério Público da União-MPU*) affect the work of law agents in the field.

The three cases of this research were selected based on three criteria. **First**, I selected cases of small and medium industrial enterprises, in labor intensive sectors, located in clusters⁵ and selling to low-priced markets. These firms are exactly the ones most vulnerable to the competition from low-wage countries and, therefore, these industrial firms are usually the ones that advocate to be exempted from the labor and environmental standards. If we can

⁵ I will use the term cluster in this paper in a very broad way. By cluster, I mean an agglomeration of firms where there is a significant number of small firms producing the same product and these firms are located close to each other. This broad definition is quite different from the one used in the literature based on the industrial districts in Italy, but it is the most appropriate one to capture the way this term is used by policymakers in Brazil and in developing countries in general.

find cases of upgrading⁶ and compliance with the law under such adverse circumstances, I believe it would be easier for donors and the public sector as well to make a case for upgrading and compliance under more benign circumstances. Therefore, my cases are based on the most fragile group of firms: SME from the garment and footwear sectors selling to low-priced markets.

Second, I selected all the cases in small cities (fewer than 100,000 inhabitants) in different regions in Brazil. I decided to do so because firms in small cities account for 58% of the growth in the manufacturing employment (registered workers) in Brazil from 1995 to 2005. In addition, we find variants of the national business environment in these cities, including different patterns of enforcement of the law and different informal rules that regulate local business. Therefore, this local-level approach might shed some light on how local actors enforce the national legislation and change the local business environment that might help or hinder firms' upgrading and compliance with the law⁷.

Third, I selected the cases in those small cities where we can perceive some progress of firms moving toward higher compliance with the law. I relied upon two different sources of information to select the cases. One was the annual database from the Brazilian Ministry of Labor, RAIS, where we can measure the number of registered workers by firm and sector⁸. The other source was interviews I conducted with the staff of the “*Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (SEBRAE)*”, which is a quasi-public agency responsible for promoting small firms' development in Brazil⁹. My interviewees in SEBRAE reported many cases of firms increasing compliance with standards, although the compliance was restricted to some aspects of the law in most cases.

⁶ I will use the term “upgrading” in this paper meaning “process upgrading”. In this case, upgrading means any change adopted by individual firms to increase their efficiency in transforming inputs into final products. For other definitions of upgrading see Humphrey and Schmitz (2002), pp. 1020.

⁷ This local-level approach is similar to the one pursued by (Locke 1995). In this book, Locke claims that one could not understand the economic dynamism of some industrial sectors and regions in Italy in the 1980s, looking only to the institutional arrangement at the national level. Locke turns to the local sociopolitical networks to explain the diverging patterns of industrial adjustment within the same sectors among different regions within Italy.

⁸ The RAIS database only provides information on the number of registered workers, which we can use as a proxy to explore firms' compliance with the labor legislation.

⁹ SEBRAE has offices in almost every state in Brazil and is the institution with the broadest expertise in promoting small firms' development in the country.

I selected three clusters where firms increased compliance with the law in the last ten years. Based on the RAIS database, I selected Nova Serrana, a footwear cluster in Minas Gerais countryside. In this cluster, the formal employment in the footwear sector went up from 3,000 workers in 1995 to over 12,000 workers in 2005 and this employment growth places Nova Serrana at the top among the small cities in Brazil with the highest growth in the manufacturing employment from 1995 to 2005. Therefore, this data suggest that local firms in this city increased compliance with the labor legislation.

The other two cases (Jaraguá in Goiás and Toritama in Pernambuco) were selected based on direct interviews with the staff of SEBRAE in Brasilia. In these two clusters, firms' higher compliance with the law resulted from firms' compliance with the environmental legislation in one case (Toritama) and with the tax legislation in the other (Jaraguá). In Jaraguá, firms took serious steps to comply with the tax legislation and to ban piracy (the production of counterfeit jeans), while in the cluster of garment firms in Toritama most laundries started in 2003 a program to comply with the environmental legislation. Next, I will describe the main characteristics and the barriers to growth in the three clusters I visited.

3.1) The three case studies: main characteristics and problems.

The clusters I visited had many characteristics in common such as the high rate of informality in the 1990s. In these places, the environmental law was not enforced; taxes, when collected, were kept at a minimum and labor inspectors did not enforce the labor legislation. Under such “unregulated” environment, the economic growth of non-registered firms increased the pollution and worsened labor conditions. In addition, since the economic growth in these places happened hand in hand with high tax evasion, local governments could not meet the local demand for health, education and infrastructure¹⁰. This was a kind of low-road economic growth, where the growth is based on lowering environmental and labor standards. And it is interesting to note that the economic growth in these clusters coupled with firms'

¹⁰ For instance, according to the Secretariat for Industry and Commerce of Nova Serrana, the economic growth of Nova Serrana as a result of the growth in the local footwear sector has increased the demand for children's education by 2,000 new students per year. These new students are usually sons and daughters of immigrants who move every year to Nova Serrana looking for a job in the booming footwear sector.

non-compliance with the law was sometimes reinforced by the policies adopted by the state and local government to foster firms' development.

In these places, ED-agencies and state development secretariats had promoted the local industry for years, but they had been doing that by granting subsidies and exempting SME from complying with the law. This kind of support was named by Tendler (2002) as the “devil’s deal”, an unspoken deal between local government and firms that increases the benefits for firms to stay in the informality. Sometimes, policymakers exempt firms from complying with the law because they believe that SME cannot face the burden of acting in accordance with the law and, therefore, it is better for the local government to have firms hiring local workers despite firms' no compliance with the law than otherwise. It has nothing to do with rent-seeking or corruption; it is related to policy makers' genuine concern for local development in a situation in which they view economic growth and firms' compliance with standards as a trade-off. But this situation started to change at the end of the 1990s, when the economic growth of these “informal firms” in clusters made them visible and started to attract the attention of both law enforcers and the media¹¹. Additionally, the Brazilian government started to promote some of these industrial clusters and these policies to promote group of firms instead of individual ones increased policymakers' perception of the high informality in small cities. In sum, clustered firms came to the spotlight in the last years thanks to their own economic growth under informality and the increasing interests of policymakers in applying the lessons of the cluster literature as a means to support the development of SME in Brazil. The cases I describe next show three different examples of what I believe is a common pattern among many industrial clusters in Brazil.

¹¹ The *Exame* magazine, for instance, published an article in 2001, showing that in the garment cluster in the Sulanca region in the countryside of Pernambuco state, the garment firms did not pay taxes. See (EXAME 2001)

a) **Water pollution control in Toritama (PE)**¹²

Toritama is one of the oldest agglomerations of garment manufacturers in Brazil. This city, together with Santa Cruz do Capibaribe and Caruaru constitute the Sulanca region, a region whose name is a combination of “Sul”, or South, where most of the fabrics came from, and “*helanca*”, which refers to the type of material (a synthetic fiber similar to lycra) used in the 1970s in this cluster. This region became famous for selling low-priced products to the North and Northeast region in Brazil and for being a place of high informality.

Despite the high informality during the 1980s and the 1990s, the economic growth of this garment cluster placed Toritama and Santa Cruz do Capibaribe among the cities with the lowest poverty rates in Northeast Brazil¹³ in 2000. More recently, informality has decreased and the local tax revenue has increased sharply in Toritama. For instance, Toritama was not among the 100 cities with the highest local tax revenue in the state of Pernambuco in 1995. But during the last 10 years and especially after 2000, the tax revenue growth in Toritama outpaced the tax revenue growth of other 50 cities, placing Toritama among the 50 municipals in Pernambuco with the highest local tax revenue¹⁴.

According to SEBRAE, garment producers in Toritama account for 15% of the jeans produced in Brazil and the main problem in the city at the end of the 1990s was the laundries' daily discharge of a cocktail of bleach, dye and detergents; equivalent to 4.5 million liters of water¹⁵, into the Capibaribe river. The high level of pollution of the local river rendered it useless to supply water for households' consumption and the increasing jeans production in the city increased both the demand for water and the price laundries and households had to pay to buy it. The raising of water prices increased the cost of this input for the local laundries, decreasing the competitiveness of firms in the city and increasing firms' incentives to evade

¹² See (Almeida 2005; Lins and Lima 2006).

¹³ Poverty rate here means the percentage of the local population earning less than half Brazilian minimum wage per month. According to this measure, Toritama had a poverty rate of 27.3% and Santa Cruz do Capibaribe a rate of 37.8% in 2000. These rates place these two cities among the ten with the lowest poverty rates out of 1,800 cities in Northeast Brazil. But the development of Toritama is still far behind the economic progress in the city. See (Lins 2005).

¹⁴ The data on tax collection of each city in Brazil is available at the website of the Brazilian National Treasury: http://www.stn.fazenda.gov.br/estados_municipios/index.asp

¹⁵ This amount of wastewater discharged daily by the Laundries in Toritama is equivalent to the consumption of 37,500 individuals. Since Toritama has 26,000 inhabitants, the laundries discharge daily an amount of water higher than the amount used for household consumption in the city.

taxes and to pollute. But this situation would eventually change as a result of the local prosecutors' action to enforce the environmental legislation together with subsidies made available by SEBRAE to help firms introduce a cleaner technology.

In 2001, the local prosecutor from the state attorney's office decided to enforce the environmental legislation in the city, because some local citizens had filed out complaints against the pollution caused by the laundries and the media had published few articles and aired a broadcast about the pollution in the city. The prosecutor, however, faced a dilemma. He wanted to enforce the law, but he feared that his action would further decrease the laundries' competitiveness and penalize small firms' economic growth. He solved this predicament by building a coalition of public institutions, which successfully helped laundries to get subsidized funds to acquire and implement a low-cost technology to clean the water and comply with the environmental law¹⁶. In the end of this process that had started in 2001, the laundries implemented the equipment to control water pollution and started to recycle the water, decreasing the production costs. The positive-sum outcome in this case is the laundries' compliance with the environmental legislation while still being competitive.

b) The register of firms and increasing tax collection in Jaraguá (GO)¹⁷

Jaraguá is a city with 35,000 inhabitants located 100 km from Goiânia, the capital of the state of Goiás in Brazil's Center-west. This city is a cluster of small and medium-sized garment firms that had started manufacturing garments in the 1980s and grew in the 1990s fueled by copying famous designer jeans. The manufacturing of counterfeit jeans was a highly profitable business during the first years of garment manufacture in the city (Castro 2004) and the output used to be sold by truck drivers who passed in the city through the Belem-Brasília highway, a road which is pointed out by many in the region as one of the factors behind the cluster development.

The selling of knockoff products by truck drivers lasted for years with the complacency of the state and local governments, until the economic growth of the cluster

¹⁶ It is important to stress that two factors made the adoption of a technology to control water pollution in Toritama more complicated than elsewhere. First, the laundries in Toritama are located far away from each other, what made it impossible to build a single treatment plant to control for the joint pollution. And second, the technologies available to control for water pollution adopted by the laundries in South and Southeast Brazil (activated sludge process, hydrogen peroxide, and producing ozone through electrical discharge) were too expensive for the small and medium laundries in Toritama.

¹⁷ The process of firms migrating out of the informality and developing private labels is described in a publication of SEBRAE: Casos de Sucesso (Oliveira 2004).

attracted the attention of the media, law enforcers and labor union representatives. A national TV network aired a broadcast on the informality and the production of fake brands in the city and sometime after that, the buyers of knockoff products decided to default, feeling that they could not be sued for failing to pay for illegal products. The informality and the reputation for producing counterfeit products started to harm the local economy and in 2000 a group of producers decided to act collectively through the local business association to ask for help from the state government and SEBRAE. After that, SEBRAE started a program to encourage local producers to develop their own private labels and help them to set up a local trade fair. It was during this process that many firms started to register, collect taxes and develop private brands, sharply decreasing the piracy in the city. In addition, during this process the garment labor union from the state capital opened a regional office in Jaraguá, helping to improve the labor conditions for workers.

Similar to what happened in Toritama as to the poverty rates, the local economic growth of the garment cluster in Jaraguá cut the poverty rate in the city from 57.8% in 1990 to 30.7% in 2000; one of the largest drop in this figure among all cities in the Center-west region. This positive outcome, measured by the fall in poverty rates, happened despite the high informality in the city and it shows how difficult it is for policymakers or law enforcers as well to shut down firms in places like Toritama and Jaraguá, even when entrepreneurs refuse to obey the legislation. And it is difficult to enforce the law because local politicians do not want to be accused of causing a crisis, if they try to force small firms' owners to pay taxes and register their workers. Therefore, the problem in Jaraguá as well as in Toritama took the form of a trade-off. As I mentioned above, this trade-off was eventually transformed in a positive-sum outcome; firms started to register and the local tax collection in Jaraguá increased, placing Jaraguá today among the 30 cities with the highest local tax revenue out of 230 municipalities in Goiás. The success in this case is characterized by firms' higher compliance with the tax legislation and the development of local brands, which helped decrease the illegal copying.

c) Compliance with labor and tax legislation in Nova Serrana (MG).

Nova Serrana is a city with 37,000 inhabitants (2000) located 115 km from Belo Horizonte, the capital of Minas Gerais. This city is known for its economic dynamism as a result of a vibrant industrial cluster formed by more than 1,000 small and medium-sized footwear firms. Firms in Nova Serrana produce shoes since the 1940s, when the first firm was established to produce leather half-boots (“*botinas*”) for the local market, but the development of the cluster only came about in the 1970s, when a new highway (BR 262) started to cross the city, making it easier for manufacturers to reach new markets in other states and regions. Until 1995, the majority of shoe manufacturers in Nova Serrana did not comply with either aspect of the legislation: tax, labor or environmental law.

In the second half of the 1990s, however, local footwear firms funded a local business association (SINDINOVA) with the strong support of SEBRAE and the association started to provide many different services to local entrepreneurs: managerial advice, technology support through the use of CAD/CAM, benchmarking services, etc. As a result of the actual services provided by the association, firms owners gradually started to participate in the meetings and joined the association to have access to the real services provided to its members. It was just before that time that labor and tax inspectors had increased their visits to firms in Nova Serrana, which triggered a process led by the business association to help firms owners to register both the firm itself and the workers. In order to encourage SME to become formal, the association hired outside consultants to help a group of firms set up waste control and quality standard procedures to cut costs with the purpose of complying with the tax and labor legislation.

In the more recent years, the city producers have been accused of copying sport shoes from international brands – piracy. A TV network aired a program about the widespread piracy in the city¹⁸, sparking a controversy about the production of counterfeit shoes in the cluster. The business association took serious steps to control the “piracy” in the city, although many entrepreneurs claim that piracy in the cluster is restricted to only a few manufacturers and that the widespread of copying (reverse engineering) is a common practice in many clusters in the world.

¹⁸ One of my interviewees in the business association of Minas Gerais (FIEMG) believes that the program aired about piracy in Nova Serrana was encouraged by footwear manufacturers in the South Brazil that could not compete with Nova Serrana’s manufacturers.

From 1995 to 2005, the manufacturing employment in Nova Serrana increased by over 12,000 workers and this growth means that Nova Serrana is the city with fewer than 100,000 inhabitants boasting the highest growth in the manufacturing employment (registered workers) in Brazil. Nowadays, the city is no longer considered a place of high informality and many firms from this cluster actively participate in the most important footwear trade fairs in Brazil¹⁹, although informality is still high for a group of very small firms (“*bancas de pés ponto*”). As to the positive outcome in this case, the register of firms and firms’ compliance with the labor legislation seem to be the most important positive outcomes in Nova Serrana²⁰.

To summarize the preceding discussion, the informality of firms and workers were high during many years in all the clusters I mentioned above. But this situation of high informality has changed in the last ten years because of the initiatives adopted by economic-development agents and law enforcers, which increased both the benefits for firms to comply with the law and the risks of being informal. In the following sections, I claim that the benefits for firms to comply with the law resulted from three factors: (1) selective policies implemented by economic-development agencies to promote firms’ economic development; (2) mobilization of local entrepreneurs through associations to promote the cluster, and (3) multi-institutional taskforce to solve specific bottlenecks in these clusters.

4. GETTING STATE INTERVENTION RIGHT: HOW TO PUT TOGETHER STANDARDS AND COMPETIVENESS.

In order to understand the following sections, it is important to be aware that many contracts are not self-enforcing and the enforcement of contracts is imperfect (North 1990). The enforcement is imperfect because the contracts are enforced by agents (judges, labor inspectors, prosecutors, etc) who usually lack the means to perform their jobs and are not neutral – these law enforcers have preferences and these preferences influence the outcomes of their work. For instance, a typical prosecutor in a small city in Brazil needs to check if local firms comply with the environmental legislation, if the mayor is spending the city’s budget according to the constitutional rules, if households’ garbage is collected apart from the

¹⁹ According to SINDONOVA, 53 firms from Nova Serrana participated in the FRANCAL and 110 firms participated in FEBRAC in 2006. These fairs are important national trade fairs in the footwear sector in Brazil.

²⁰ The employment growth in Nova Serrana continues today, while the employment has decreased by over 30,000 workers in the two most important footwear clusters in Brazil (Franca in São Paulo and Sinos valley in Rio Grande do Sul) since 2005. See (Pastore 2006).

industrial garbage, if the local government's acquisitions are in accordance with the public procurement law, etc. Since a single prosecutor cannot do everything, he or she focuses his or her work on a limited set of topics he or she is more familiar with or in those that deserves his or her immediate attention.

The same happens with municipal inspectors (*"fiscais da prefeitura"*). In São Paulo, the biggest city in Brazil, municipal inspectors need to check if households and commercial establishments comply with fifty thousand metropolitan laws (see OESP, 2007). Since the number of municipal inspectors is low compared to the scope of their work, the inspectors only respond selectively to the most serious law infractions reported by citizens. Another example of how discretion and preferences affect the outcomes of law enforcers is the work of lower court judges in Brazil. According to (Pinheiro 2003), lower court judges in Brazil believe they have a "social role" and this role is justified when they rule against what is written in the contracts²¹. In another research, Lamounier and Souza (2002) found the same for the prosecutors of the "*Ministério Público*" (MP).

In addition to lacking the means to do their job and not being neutral, law enforcers also follow incentives (formal and informal) established in their agencies. This is the case for labor inspectors, whose part of their salaries depends on a punctuation bonus which is based on a plan designed and adopted by the secretariat of labor inspections at the Ministry of Labor in Brasilia²². This plan establishes which sectors in every region and state labor inspectors should concentrate their inspections, to check whether firms are complying with the legislation. Since the number of labor inspector in Brazil is low, they tend to concentrate the inspections in large firms in those sectors they expect to find firms not obeying the law. For instance, there are fewer than 100 labor inspectors in the state of Goiás to inspect the same number of firms that 3,000 tax inspectors have to inspect. Since the number of labor inspectors is not sufficient to enforce firms' compliance with the labor legislation and they still have to reach a minimum punctuation based on their field work to receive a bonus on their salaries, labor inspectors told me that they focus the inspections on large firms in those sectors they

²¹ Based on his sample, Pinheiro found that 73% of lower court judges believe that social justice justifies ruling against contracts. see (Pinheiro 2003).

²² See the work of Pires in this project to understand how the bonus system affects the work of labor inspectors. (Pires 2007)

know they can find some irregularities²³, leaving the small and medium firms in small cities off the radar.

Once we recognize that the work of law enforcers is highly discretionary, we need to understand when these agents decide to enforce the law in a way that leads to positive outcomes for firms (higher compliance together with higher competitiveness) and different from the traditional command-and-control approach in which the law agents enforce the regulations by compulsion and coercion, exacting fines for those firms that deviate from the standards and issuing judicial orders to shut down non-complying firms. This is important to understand because it is the work of these enforcers that will ultimately establish the transaction costs in the economy²⁴. And if the work of these agents differs from one place to another within the country, this means that the transaction costs in the economy will depend on how the national rules are enforced in different cities. Therefore, the debate on how to improve the business environment for firms to grow is a debate whose solution we might find at the local level, since it could depend not only on the local legislation -concerning the ease or difficulty to open a firm- but also on the way the work of law enforcers is coupled with the work of economic-development officials at the local level: how prosecutors or labor inspectors enforce the law in an industrial cluster, what kind of firms and sectors they decide to inspect, the kind of policies and tax exemptions economic-development officials grant to local firms in one place and not in other, etc²⁵.

The basic dilemma the reader must have in mind through the rest of this paper is that competitiveness might result from two different strategies: the low road and the high road (Pyke and Sengenberger 1992). In the first, firms' competitiveness comes from a strategy of cost-cutting and small firms are exempting from labor and environmental standards. While in the high road, firms face the costs involved in meeting labor and environmental standards but are still competitive. The key to continue to be competitive is to make labor more productive,

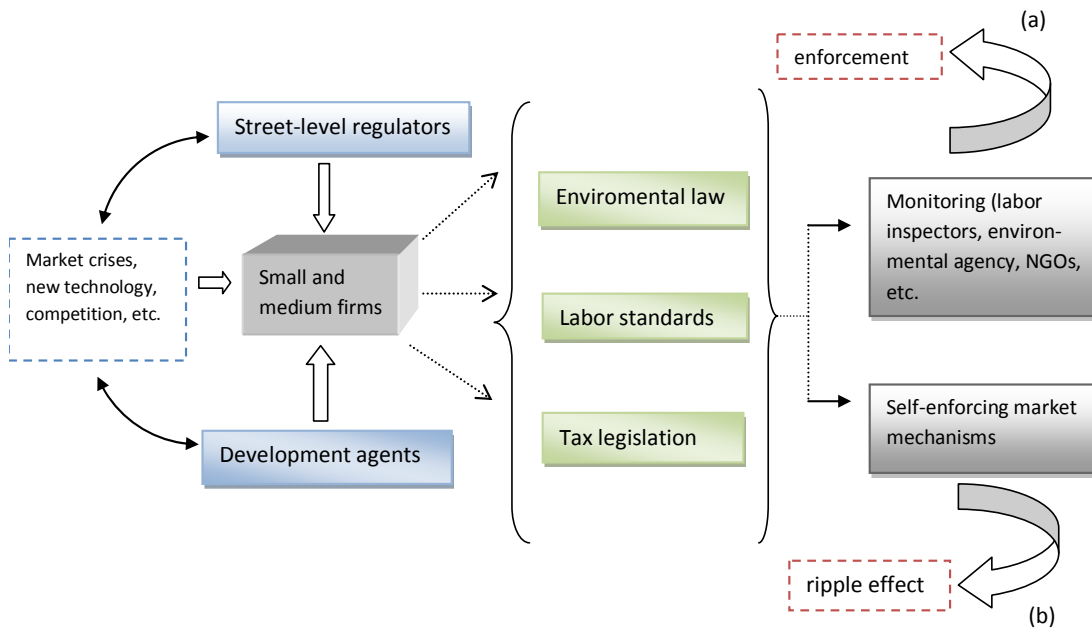
²³ In the state of Goiás, labor inspector focus the inspection on large supermarkets; slaughterhouses and rural farmers. The inspectors in Goiás visit the industrial clusters, but they do that randomly and not as often as tax inspectors do.

²⁴ Transaction costs depend on formal rules, informal norms and how the rules are enforced. Therefore, the way law agents enforce the law will affect the transaction costs in the economy. See (North 1990).

²⁵ This close interaction between ED-agents and law enforcers is more likely to happen when the enforcement of the law is based on what is called in the environmental literature the compliance-based approach. In this approach, the enforcement agencies recognize that some firms are not complying with the environmental legislation and try to work with the polluters to reduce pollution with the least social and economic costs.

improve the organization of the firm, and use better technologies. The general framework of this research is to understand how firms change gradually from non-compliance (low road) to compliance with the law (high road) as a result of the action of economic-development agents and street-level regulators (see diagram 1).

Diagram 1 – Path of firms’ transition from non-compliance to compliance



Finally, as we can see from the diagram 1, there are two different possible outcomes that might emerge from firms’ compliance with the law. In one, firms start to comply with the law but agencies need to monitor firms’ compliance because the outcome is not self-enforcing. In this case, there is no convergence among firms toward higher compliance, and law enforcement is the main mechanism to enforce the law within the cluster and in nearby cities. In the other outcome, firms’ compliance with the law is self-enforcing and the need for monitoring is minimal. This happens when the compliance with the law increase firms’ competitiveness and access to high-price markets. In this case, the enforcement of the law might cause a ripple effect throughout the local economy. With this framework in mind, I turn next to explain which factors explain how SME in the three clusters mentioned above made the gradual transition from non-compliance to compliance with the law.

As I showed above, informality was high in all the clusters I visited and the historical legacies in these places – lack of cooperation among entrepreneurs, low mobilization of the workers, and the predominance of small and medium firms selling to low-priced markets--

were mainly negative to explain the kind of positive outcome that ultimately took place, an outcome that is characterized by firms moving away from the informality toward higher compliance with the law. Therefore, the key difference between the cases I visited and others in which we do not observe firms complying with the law is the way law enforcers and ED-agents acted together to help firms upgrade and comply with the law. The problem is not always the legislation, which is usually ambiguous and open, but rather how law enforcers interpret and apply the environmental, labor or tax legislation at the local level, and if law enforcers can count on ED-agents to help them to enforce the law. Based on the evidence I gathered from the places I visited, I am prone to believe that the compliance with the law in the cases I studied is the end of a process that involved three different intertwined factors.

First, it sometimes started with firms' owners demanding subsidies and exemptions of the law from the local, state and federal government. But instead of granting further subsidies, SEBRAE and the secretariats of the local and state government took a different path and promoted a set of policies to support changes local entrepreneurs were already implementing to cope with the adverse circumstances brought about by crises, market competition or the sanctions imposed on firms by law enforcers (tax collectors, environmental inspectors, etc.). *Second*, ED-agents in the successful cases chose to focus on a few problems, making the problems manageable to be tackled by their agencies (SEBRAE, local and state secretariats of government)²⁶. And *third*, law agents enforced the law partially and in a gradual way. In none of the cases I studied the different kinds of law enforcers acted to enforce the tax, labor and environmental legislation simultaneously. I will turn next to explain the importance of each of these three aspects for each case study.

4.1 – Subsidies, gradual compliance and selective law enforcement.

In the case of the laundries in Toritama, entrepreneurs were not interested in complying with the environmental law in 2000. One local laundry owner was looking for a technology to cut costs by recycling water and this entrepreneur succeeded in getting support from the

²⁶ In studying rural development projects in Northeast Brazil, Tandler found that the same agency performed well in some tasks and badly in others and the reason behind this apparent discrepancy had to do less with the agency and more with the nature of the tasks the agency was implementing (for instance, water supply vs. irrigation). Tandler claims that the redefinition of the tasks or the focus on one component of the project as the locomotive (“*carro-chefe*”) of the others is among the facts that explain the successful cases of rural development in Northeast Brazil. See (Tandler 1993).

Pernambuco garment business association (SINDIVEST), which had a partnership with the Bavarian business association (BFZ) from Germany in a program to promote SMEs' development in developing countries. The engineers hired by BFZ developed the technology to recycle water for the laundry in Toritama free of charge. Once the water cleaning system was in place, a prosecutor from the state MP came to get to know this technology, and he realized that this system could reduce overall water pollution, if other laundries in Toritama implemented the same system to recycle water. Then, the prosecutor decided to enforce the environmental law because he felt confident that laundry owners could bear the costs of investing in this clean, low-cost technology. At the same time, SEBRAE and the Technological Institute of Pernambuco (ITEP) set up a program to help firms make the investments required to implement the system, and SEBRAE supplied subsidies for entrepreneurs interested in hiring an engineer to make a tailor-made project to install the water cleaning equipment.

Another interesting factor behind laundry owners' decision to invest in pollution control was the way law agents and inspectors decided to enforce the law. The prosecutor had decided to enforce the law gradually, granting a grace period for the laundries to comply with the environmental law and also accepting firms' partial compliance. After the laundries installed the water pollution control system, pollution was reduced by 50% but the wastewater dumped from the laundries was still polluted based on the standards imposed by the Brazilian environmental legislation. In spite of that, the prosecutor and the "Companhia Pernambucana de Recursos Hídricos" (CPRH) accepted this partial compliance, fearing that the requirement for firms to install an additional costly filter could damage entrepreneurs' initial efforts to reduce pollution.

In this case, the institutions (MP and CPRH) reduced the scope of the problem in order to solve swiftly (around two years), SEBRAE provided subsidies to help small laundries to implement a technology that had already been implemented in one local laundry (a solution that firms had already discovered) and the MP and CPRH enforced the environmental law gradually and selectively (so far, laundries have not yet installed the filter that will render them fully compliant with the environmental legislation). Nevertheless, this partial solution to the problem of water pollution in Toritama was positive for many reasons. First, the laundry owners, during this process, started to press the public sector to build a new sewage collection and a water supply system, which would benefit not only the individual laundry owners but

the entire population in the municipality. Second, laundry owners in Toritama recently set off an intensive lobby for the MP to enforce the environmental legislation in the nearby cities, being an important channel to spill over better standards in the region (MPE-Pernambuco 2006). And third, all the laundries in Toritama registered and started to pay taxes during the program to control pollution, which means that the solution to one problem (water pollution) paved the way to the solution of another (compliance with the tax legislation).

The same elements identified above were present in Nova Serrana, where most small and medium-sized firms in 1994 did not comply with the tax, labor or environmental legislation. This situation started to change when a group of entrepreneurs involved in boosting the local business association (hereafter named SINDONOVA) actively sought help from SEBRAE and the state government to promote the footwear sector in Nova Serrana, which was under a severe stress brought about by the domestic credit squeeze in 1995, as a result of the effects of the Mexican financial turmoil on the Brazilian economy. The local entrepreneurs requested funds to buy a CAD/CAM system, resources to build the association's headquarters, and funds to bring in business consultants to Nova Serrana. But SEBRAE and the state government were not sensitive to these demands because the footwear cluster in Nova Serrana was notorious for the high rate of informality. But this group of five entrepreneurs (self-called the "*multiplicadores*") decided to make the same demands to SEBRAE and the state government using a slightly different approach. Instead of demanding subsidies in exchange for nothing, they would present a plan to SEBRAE and to the state government (Secretariat of Technology), designed to encourage local firms to comply with the labor and the tax legislation.

The plan involved setting up tailor-made courses, with the help of outside consultants, for the group of SINDINOVA entrepreneurs. The courses methodology entailed splitting the firms into three different groups and each group would devise proposals for the firms to cut costs by decreasing the waste of inputs. The goal was to help firms cut costs, so that workers' registration would be made possible. And SEBRAE would provide the funds for SINDINOVA to supply these courses. Since informal firms in Nova Serrana were highly inefficient, the plan to improve the use of inputs resulted in lower costs for many firms, allowing a good number of them to comply with the labor legislation and still decrease costs. According to the former head of SINDINOVA who coordinated this plan, at the end of the program, 2,000 workers had been registered by local firms and the resources SINDINOVA received from SEBRAE were

used to build a new headquarters for the association and to install a CAD/CAM system which was granted to association by the state secretariat of science and technology.

The courses described above took place at the same time that labor inspectors and tax inspectors started to visit firms in Nova Serrana, setting fines for those firms that did not comply with the law. The frequency and the hostility of the inspections led SINDINOVA chairman to visit the regional labor department office to convince labor inspectors that the association was taking major steps to encourage firms to register workers. Therefore, frequent inspections at that moment could jeopardize the association's efforts to help firms register in order to comply with the law. It seems that the labor inspectors were convinced by the entrepreneurs' arguments and they decreased the frequency of their visits to Nova Serrana, giving time for the association to work out its plan to convince firms to register their workers. Gradually, firms started to register their workers, collect taxes, and in the last years the city has boasted the highest manufacturing employment growth among those cities with fewer than 100,000 inhabitants.

The plan for Nova Serrana worked out because of the same facts I explained above for Toritama. *First*, the entrepreneurs' initial demand was for subsidies to support the cluster development, but SEBRAE and the state government were not comfortable to support a cluster that was notorious for high informality. Then, the entrepreneurs insisted on the subsidies but in exchange for a group effort by the association to convince local firms to comply with the tax and labor legislation. *Second*, the business association focused on solving a specific problem the entrepreneurs perceived as being negative to get the support they needed to grow: the high rate of informality owed to the firms' non-compliance with the labor legislation. Other problems faced by the cluster, such as copying shoes from international brands and the environmental issue, were put aside. And *Third*, labor inspectors enforced the law gradually after being convinced by the local entrepreneurs to stop the inspections in Nova Serrana to give time for firm owners to register their workers. As to the environmental law, only recently this law has been enforced by the "Ministério Público"; which led SINDINOVA to start a new program together with the state business association of Minas Gerais (FIEMG) and the state environmental agency, to control pollution (more on this later).

A process similar to the one described above happened in Jaraguá, a cluster of jeans manufacturers. Small and medium-sized firms in this city were under a severe financial stress in 1999/2000 that resulted in the default by many buyers who believed that firm owners could

not sue them for failing to pay for counterfeit products (the copy of famous jeans labels). In the same period, the police had been seizing products in Jaraguá from those producers who had been reported by the lawyers hired by large garment firms in Brazil whose private brands had been copied by some firms in Jaraguá. Many entrepreneurs bankrupted and a small group of entrepreneurs joined the local association (hereafter named ACIJ) to debate different strategies to handle the crisis. The entrepreneurs decided that they had to develop their own brands and promote the cluster by bringing new consumers to the city. And they agreed that the best way to bring new costumers into city and promote local brands was to set up a local trade fair. The first fair was held in 2000 but it only grew in importance after SEBRAE and the state government got involved in providing subsidies to the organization of this annual fair. At first glance, the organization of an annual trade fair does not seem to be important. But this was the most important event behind the changes that took place in Jaraguá, since firms had to register and bring their own brands to the fair. Therefore, for the first time ever, local entrepreneurs had a strong incentive to register their firms and to develop their own private brands, in order to participate in the local trade fair. During this process, many firms stopped copying branded jeans and SEBRAE started to offer a number of courses in the city to help firms invest in design, control costs and cope with the costs of registering their workers.

The case of Jaraguá is more recent but it shows the same three important aspects showed in the two other cases. *First*, subsidies were involved but in a way that turn the supply of subsidies selectively to a group of firms that wanted to make an effort to comply with the law (firms that wanted to participate in the trade fair). *Second*, the local association and SEBRAE target at one specific problem to solve, which was to encourage firms to register and develop their own brands, in order to participate in the local trade fair. At a first moment, the labor and environmental legislation were put aside. But the increasing register of firms led many firms to invest in improving the working conditions, once the state garment union decided to open a local office in Jaraguá. Today, there is a local representative of the garment union in Jaraguá who provides legal counsel to any worker in the city. The union representative is a local person who knows most local entrepreneurs and workers, and she is in charge of making entrepreneurs provide to non-registered workers the same benefits accrued by registered workers when the labor contract is terminated. And *third*, tax inspectors increased the enforcement of the tax legislation in Jaraguá attracted by the economic dynamism of the garment sector that increased fast in the 1990s thanks to illegal copying of famous branded jeans. But these agents enforced the law gradually and the environmental and

labor legislation were until then put aside²⁷. Only recently prosecutors from the MP are enforcing the environmental law in the city.

In sum, we can draw three general lessons from the cases above. *First*, economic-development agencies like SEBRAE can use their policies to grant subsidies only to those firms which are interested in upgrading to comply with the law. This is what happened in Toritama, where subsidies provided by SEBRAE through SEBRAETEC targeted only the laundry establishments interested in hiring an engineering firm to design the project to clean the water. It also happened in Nova Serrana, where the subsidies were used to help firms upgrade and cut costs, so as to comply with the labor legislation. And subsidies were also used to promote the local fair in Jaraguá, an initiative that only benefited those firms that wanted to register and develop their own brands to participate in the trade fair²⁸.

Second, in each case reported above the “success” or the positive outcome resulted from entrepreneurs’ efforts to solve only one specific problem. In the case of the laundries in Toritama the focus was to solve the pollution problem. In Nova Serrana the major problem perceived by local entrepreneurs back in 1995 was the high informality and firms’ lack of compliance with the labor legislation. And in Jaraguá the major problem was the copy of products by non-registered firms. In none of the cases SEBRAE, prosecutors, tax or labor inspectors formed a team to force firms’ full compliance with each aspect of the legislation. In one case the prosecutors enforced the environmental law, in the other entrepreneurs responded to the enforcement of the law by promoting firms’ compliance with the labor legislation; and in the last case entrepreneurs registered their firms and started to comply with the tax legislation, to participate in a trade fair.

²⁷ Today, tax inspectors adopt a “rule of thumb” to guide their work in Jaraguá. As long as the tax revenue keep increasing year after year, tax inspectors stay away from Jaraguá. But if the local tax collection decreases, tax collectors do an intensive inspection in the city.

²⁸ One clear drawback as to the use of subsidies to encourage firms to comply with law is the drain of scarce fiscal resources. But the programs in the three clusters reported here were cheap compared to both incentives state governments disburse to attract large firms and financial incentives the federal government will provide in the next 10 years to foster the shipbuilding industry in Brazil. For instance, only in the state of Goiás, the amount of subsidies used by the state government to attract outside large firms amounts to US\$ 15 billion (flow of expected future incentives in the next fifteen years discounted to 2007), and the recent program adopted by the federal government to build shipyards involves subsidies of US\$ 1.5 billion to build 26 oil tankers in Brazil. In Jaraguá, the state government and SEBRAE disbursed US\$ 200,000 per year during four years to subsidize the local trade fair. In Toritama, the subsidies SEBRAE provided through SEBRAETEC to help the 60 laundries in the city to implement the pollution abatement equipment cost less than US\$ 200,000. And in Nova Serrana, SEBRAE disbursed around US\$ 400,000 during two years (1994 and 1995) to promote the upgrading of footwear firms in the city.

And *last*, in none of the cases above, the labor, tax or environmental legislation were simultaneously enforced and it is difficult to guess what could have happened had the full legislation been enforced simultaneously. The legislation was partially enforced and in a gradual way. But this gradual enforcement of one piece of legislation seems to make firms more visible to law agents and unions, paving the way for firms to gradually comply with other aspects of the legislation. Once entrepreneurs in Toritama implemented the water pollution control system, they had to register the laundries and became visible to tax inspectors. In Nova Serrana, the register of firms and workers in the second half of the 1990s made the cluster visible to prosecutors, calling their attention to the joint collection of the industrial and household waste. And the register of firms in Jaraguá triggered the interest of the state labor union in this garment cluster. Therefore, these cases seem to suggest that even firms' partial compliance with the law is a positive fact because, once the firms start to comply with one piece of the legislation they become "visible" to law inspectors²⁹.

Next, I will explain the role of local business association behind the three cases reported in this paper. This is an important point because local business associations are different from their national counterparts and these local sectoral associations are more encompassing³⁰ than someone would guess at first glance.

4.2. Business association, local leaders and economic growth.

In all the cases that I perceived firms making efforts to comply with the law, I also noticed that the local business leaders (or the better-off entrepreneurs) played an important role behind the positive outcomes. This is quite unexpected since we usually think about better-off entrepreneurs and business groups as being rent-seekers who demand private goods from the state at the expense of those citizens who are not organized. But this sharp difference does not apply in small cities, where the economic interests of the better-off entrepreneurs are similar to those of small entrepreneurs as I will explain below. In the cases reported here,

²⁹ Of course, once firms register and become visible to authorities it does not mean that they will be able to comply with the law. But this is a first step anyway. On this see (Blackman 2000).

³⁰ I mean by encompassing associations those associations in which members have investments in different economic sectors and, hence, their requests for government support tend to be less sectoral and more inclusive than the demands of those associations whose members belongs to the same economic sector.

business leaders and business associations were important to promote firms' higher compliance with the law for three different reasons.

First, there is usually a strong convergence of interests between small and medium firms owners in small cities. In these cities, the business elite is formed by the better-off entrepreneurs who happen to be medium entrepreneurs who face similar problems to grow as the small entrepreneurs. As a result, entrepreneurs of different sizes usually share the same problems in these clusters and they usually require the same kind of economic-development support from the local and the state government. This strong convergence of interests among entrepreneurs in these clusters, where most firms sell to domestic market and face the same constraints to grow, is different from what happens in large industrial clusters where small and medium firms are located next to large firms whose interests are different from those of SME³¹. *Second*, I have noticed that the local business elite in these small cities are economically powerful at the local level but they lack access to the managers of SEBRAE and the secretaries of the state who ultimately decide which industrial sectors (and clusters) the state government and SEBRAE will promote. In small cities, the better-off entrepreneurs usually do not have access to policy-making (legislative lobbying and personal networks) except through business associations. This fact by itself is an important incentive for the better-off entrepreneurs to join and promote business associations. And *third*, local business associations in these cities help ED-agents (SEBRAE, state secretariats, etc) to implement local policies aimed at SME and they also lobbied for public goods. This is common in small cities since business leaders in these places usually have investments in different sectors (industrial sector, restaurants, hotels, etc), meaning that these leaders are interested in the development of many economic sectors. Next, I will explain each of these factors.

³¹ Schmitz (1999) shows that in Sinos Valley, the largest industrial footwear cluster in Brazil, the presence of many business associations representing different firms' interests (selling to the domestic market vs. export) contributed to increase the conflict among firms and to the failure of a state program devised to help firms design and market their own products. The large firms that were linked to global buyers boycotted the program and the program failed because business associations were not able to reach a consensus.

a) **Convergence of interests between small and medium firms owners.**

We usually assume that better-off members in a community will have interests different from those of small firm owners. Some firm owners want to make alliances with global buyers to export, while others want especial programs to help them invest in design to increase their sales in the domestic market, etc. But these different interests among firm owners are less likely to occur in places where firms target the same market and they have similar size³². In these places, it is common to find a strong convergence of interests between better-off entrepreneurs and small firms owners. In Nova Serrana, for instance, firms' non-compliance with the tax and labor legislation was a common problem for the majority of the footwear firms in 1994 independent of firms' size. Therefore, the program to promote firms' compliance with the labor law coordinated by a small group of entrepreneurs from SINDINOVA was a program that raised the interests of many firms in the city. In Toritama, the problem of laundries dumping water with chemicals into the river was a problem common to every laundry and, hence, the program to help laundries comply with the law was a program that affected all the laundries, even those that were not willing to comply with the law and had to be closed. And last, the widespread default of buyers in Jaraguá and the high informality in the city was a problem that affected every firm and, for this reason, the program to increase the register of local firms and promote the development of local brands was a program that benefited most firms.

It is important to notice that in all these clusters the majority of firms only sell to the domestic market. In none of these places the local exports reached over 5% of the local production. So, in addition to having similar sizes, firms were also selling to the same market (low-priced markets) and these firms faced the same challenge: how to upgrade to comply with the law. It is true that once the cluster develops and some firms started to grow more than others, this uneven growth within the cluster can increase the differences among firm owners. This is what happened with the cluster of shoe manufacturers in Sinos Valley in Southern

³² Tendler in a paper about Bolivian cooperatives shows that better-off leaders had a positive role behind the successful outcomes she observed in some Bolivian coops. Tendler explains that this happened because the better-off farmers shared the same economic interests of their poorer farming neighbors. This is similar to what I found in these industrial clusters. See (Tendler 1988).

Brazil, where there is a sharp divide between the interests of small and medium shoe firms that sell to the domestic markets and those of large shoe firms linked to global buyers³³.

But the absence of large firms and common interests among firm owners are not enough to induce collective action. It is necessary that some of the better-off members of the local business community promote the organization of local enterprises. And entrepreneurs usually do that because they want to participate in policy making.

b) Business political participation through business associations

Business usually tries to participate in policy making because government policies affect the business environment and affect firms' growth. For instance, when the government changes the tax or the labor legislation these changes affect firms' costs to comply with the law and its profits. Therefore, it is natural to expect that entrepreneurs will try to influence policy making.

There are many different ways business might participate in policy making (Schneider 2004; Schneider 2005). *First*, large firms might finance political campaigns and get privileged access to political leaders and/or appoint their representatives to government positions. *Second*, large firm owners might use their personal networks with government officials to affect government policies. And *third*, business might invest in collective action through associations. In the cases of industrial clusters located in small cities, firm owners usually lack personal network in the state and federal governments. This means that entrepreneurs in small cities will only have the option to influence state and federal policy making if they choose to do that through a business association.

In the three cases I researched, the local business associations played an important role in helping firms to comply with the law and in negotiating with the state and local government policies to promote the industrial sector. The three business associations I visited differ in membership size, time of foundation, selective policies supplied to their members, etc. But each one was an important channel for local business to participate in policy making.

³³ See (Schmitz 1999).

In Nova Serrana, the organization of the local footwear business association (SINDINOVA) started in the first half of the 1990s, when a native entrepreneur, who had spent years working for a multinational in different places in Brazil, retired and moved back to live in Nova Serrana. This entrepreneur noticed that footwear firms in Nova Serrana were highly inefficient and the firms did not have access to modern production process techniques. (CAD/CAM). He invited five other better-off local entrepreneurs to start a business association to promote the local footwear sector. They prepared a ten-year plan for the footwear sector and submitted the development plan to SEBRAE and state secretariats to get funds for its implementation. The growth of SINDINOVA opened the door for its first chairman to meet with state secretaries, president of Brazilian public banks, and even to meet with ministers of the federal government. This access to state political leaders and high-ranking officials of the federal government was something that was difficult even to the mayor of Nova Serrana. When the mayor noticed the increasing access to important political leaders enjoyed by the head of SINDINOVA, he started to get involved with the association and even to pay for some firms to become a member of the association. In subsequent years, the association grew and, today, the members of SINDINOVA are active in mediating firms' interests with SEBRAE, prosecutors, state and local government.

The importance of SINDINOVA in the cluster today is so high that the local secretary of industry and commerce is a member of the association and has an office in the association's headquarters, where he goes daily to meet local entrepreneurs. In sum, the business association in Nova Serrana is the only open channel for local entrepreneurs to influence policy making. And it is through the association that entrepreneurs can influence the work of both economic-development and enforcement agents. In so doing, the association helps economic-development agents to design and implement the policies to promote the footwear sector, and sometimes help indirectly the law enforcers to do their work as it happened back in 1994 when the association encouraged firms' compliance with the labor legislation in order to obtain funds from SEBRAE and the state government.

A group of better-off local entrepreneurs who joined the local business association was also important to explain how garment firms in Jaraguá started to invest and promote local brands and to curb illegal copying. At the end of the 1990s, a group of local business leaders started to meet regularly in the local association ("*Associação Comercial e Industrial de Jaraguá-ACIJ*") to debate a program to invest in local brands and to promote a local trade fair,

so as to attract new buyers to the city. All the efforts of the entrepreneurs were directed toward these two actions and the group contacted SEBRAE and the state government to get support to implement these policies. The association increased its membership from 12 to near 200 members in three years and the head of the association started to meet with policymakers from the state and federal government to get support for the cluster development. The head of ACIJ succeeded in getting funds from the Ministry of Science and Technology to build a training center for the garment sector in Jaraguá, persuaded SEBRAE to keep a full-time paid employee in the association, and later he was elected city mayor.

And last, the business association in Toritama (*Associação Comercial e Industrial de Toritama –ASCIT*) was created recently during the process in which the laundry owners had to negotiate with the prosecutor and the state environmental agency (CPRH) to comply with the environmental legislation. The first elected president of the association was the entrepreneur who had been the first to install the equipment to control pollution in his laundry and one of the better-off local entrepreneurs. This business leader helped the prosecutor and enforcement agents from CPRH to meet with the other laundry owners and the association helped these agents to enforce the law within the city by reporting the entrepreneurs who were moving to the countryside to evade the law. The organization of the local association also allowed local entrepreneurs to meet with the state secretaries and to have access to state and federal policymakers. Such close access made it possible for local entrepreneurs to apply direct pressure on the environmental secretary of the state of Pernambuco to build a new water supply and sewage collection system in Toritama.

In sum, small and medium entrepreneurs in small cities in Brazil's countryside lack both personal networks and access to state political leaders and federal government. Under these circumstances, entrepreneurs might succeed in influencing policy making when they join a local business association. But a key question we need to ask is whether increasing entrepreneurs access to policy making leads to positive outcomes for the local population and not only to the local elite. There is some evidence that powerful business associations sometimes use their political power to get privileges from the government at the expense of other non-organized groups³⁴. But I believe this is not the case for business associations in small cities in Brazil's countryside for at least two reasons. *First*, the better-off entrepreneurs in these small cities usually have multiple investments in different sectors. For instance, the

³⁴See (Olson 1982).

president of SINDINOVA has investments in restaurants and hotels in addition of owning a shoe factory in Nova Serrana. The same happens for many other entrepreneurs in this association and in the two others I have visited (ASCIT in Toritama and ACIJ in Jaraguá). Therefore, the sectoral business associations in these small cities work like encompassing business associations, whose members have investments in different sectors and the association demands more public than private goods.

And *second*, these associations usually interact with multiple institutions and multiple levels of governments, making it difficult for them to exert their local power on one institution to derive private benefits. For instance, when SINDINOVA in Nova Serrana negotiated a grace period with the state environmental agency for firms to start to comply with the environmental law, this negotiation had to be bound by the rules imposed by the prosecutor. In Jaraguá, when the association asked SEBRAE to fund a local trade fair, SEBRAE required that entrepreneurs paid part of the costs and also that the association got additional funds from other institutions. All the institutions involved in financing the fair closely supervised how the money was spent and each supervised one another.

The point raised above, as to the positive role business associations might play on the local economy is not to say that business associations replace civil society. But rather to show that they are not necessarily bad and they might be an important stakeholder to help economic-development planners to design and implement public policies toward the development of SME. As I show next business association might also help law agents to enforce the law.

c) Local business associations: mediators and allies of street-level bureaucrats.

There are many studies showing how business associations help the government design and implement public policies; and soften up entrepreneurs' resistance to policy changes (Meyer-Stamer 1998; Nadvi 1999; Schneider and Doner 2000; Locke 2001; Schneider 2004). Business associations might help economic-development agents to coordinate the implementation of a program to promote the industrial cluster, provide a forum for local entrepreneurs to meet and collectively discuss their problems; work together with law agents to regulate local business practices and enforce the law; provide real services to firms such as technical and managerial advice and play a catalytic role in enabling the process of industrial

upgrading. All the business associations I mentioned above performed one or more of these tasks and helped local firms upgrade and comply with the law.

In its first years, SINDINOVA convinced and actively helped many firms to cut costs, in order to comply with the labor and tax legislation. The association did that because it needed resources to promote the cluster and the high informality in the shoe sector in Nova Serrana was perceived by the business leaders as a barrier to get additional resources from SEBRAE and from the state government. More recently in 2006, SINDINOVA, together with the state industrial business association (FIEMG) negotiated with Minas Gerais Environmental Agency (FEAM) a grace period for local firms to implement a system to collect industrial waste and comply with the environmental law. Had the association not mediated the conflict between the prosecutor and entrepreneurs, it is likely that local firms would not have started the investments to comply with the law or would have brought the dispute to the courts. In this case, SINDINOVA acted as a mediator between the entrepreneurs and the attorney office, since the prosecutor wanted to enforce the environmental law immediately, against the will of entrepreneurs, who claimed that they were short of funds to implement the changes in a short time. SINDINOVA also successfully lobbied to get funds from “*Instituto Evauldo Lodi (IEL)*” to help firms hire consultants and implement the changes needed to comply with the environmental law.

In another recent episode, SINDINOVA had organized a trade fair in Nova Serrana and the executive members of SINDINOVA asked the local judge not to issue any court order seizing the production of any local firm accused of illegal copying (“*pirataria*”) during the trade fair. The judge agreed to postpone issuing court orders during the trade fair, since he was convinced by the association members that if one entrepreneur was accused of illegal copying in the fair, this accusation would harm all producers even if the claim later proved to be wrong.

One might think that the examples above show a kind of quid pro quo between the associations and law enforcers that increases the uncertainty involved in enforcing the law, and, hence, it increases the transaction costs. But it is the opposite. It is the involvement of the association, together with economic-development and law agents, that make possible for small and medium firms to move in a coordinated way from sheer informality to compliance with some aspects of the law. The first-best solution (immediate enforcement of the law) is an option not available in these places and this “second-best solution” which involves a gradual

law enforcement, helping firms to have access to resources to comply with the law is better than exempting firms from complying with the standards.

The role of ASCIT in Toritama was also important to help the prosecutor, the environmental inspectors and laundry owners to reach a consensus over the TACs³⁵ for each laundry to comply with the environmental legislation. It was the president of the association who organized the meetings between and entrepreneurs and the prosecutor to debate alternative options for the laundries to comply with the law. At first, the prosecutor, together with environmental agency considered relocating all the laundries away from residential areas to a specific industrial site to be defined by the city administration, where a communal effluent treatment plant would be built. But during the negotiations between entrepreneurs and the public agents, the prosecutor agreed to keep the laundries in the city and to implement the low-cost technology introduced by one laundry establishment in the city, which could be customized for each laundry size. As I mentioned above, the solution in Toritama was not the most efficient one, since the water discharged by laundries is still considered polluted by the Brazilian legislation standards. However, the implementation of a low-cost technology allowed most laundries to reduce water pollution by 50% in less than two years. In this case as in the others, the first-best solution was simply not available.

In sum, the cases reported above suggest that business associations were important mediators between the firms and the public sector regarding firms' compliance with the law. In some cases, the business association became responsible not only for mediating the negotiations but also for granting subsidies and providing technical advice to help firms to comply with the law. The double role associations played in negotiating with law agents and helping firms to make new investment increased the interest of local entrepreneurs to join the association, strengthening even more the role of these associations. The case of SINDINOVA in Nova Serrana is a good example of this point., SINDINOVA grew overtime and started to call for a more active role in designing the programs to boost the footwear cluster. Today, the institutions involved in promoting the industrial development of the footwear cluster in Nova Serrana has to invite SINDINOVA to participate in the meetings to decide how the money will be spent to promote the cluster. This process has displeased SEBRAE, who does not seem to

³⁵ TAC stands for "*Termo de Ajustamento de Conduta*". It is an agreement between the attorney office and individual firms or public agencies. In this agreement, the firm (or the public agency) recognizes that it is violating the law and establishes a plan to comply with the law and the fine the firm has to pay in case of failure to meet the deadline set in the TAC.

like the fact that it is accountable to SINDINOVA³⁶. In Toritama, something similar happened, when the ASCIT refused to fund construction of individual sewage systems, claiming that the local government was responsible for sewage services. Later, the association negotiated with the prosecutor to convince the local and state government to sign a TAC to implement a sewage collection and water supply system in the city.

One final question we need to have in mind when talking about the role of associations in promoting local development is to understand under what circumstances the associations lead to positive outcomes instead of seeking rents. What are the enforcement mechanisms that make associations use the rents they get from the government to increase firms' competitiveness? There are two important enforcement mechanisms to explain why associations use public resources to develop the cluster and not to enrich its leaders (see Doner and Schneider 2000). One is the sector's or industry's market vulnerability. When firms have to change their traditional way of doing business to continue to be competitive in reaction to crises, the association will use the resources it gets from the government productively. This is especially true when business leaders are accountable to associations' members. The courses provided by SINDINOVA and sponsored by SEBRAE, the subsidies to help local producers in Jaraguá to set a local trade fair, and the subsidies from SEBRAE to help laundries in Toritama to hire consultants to implement the water cleaning project are all examples of the productive use of resources in a context of crisis.

A second mechanism of enforcement over business associations is the state (economic-development agencies and law enforcers). The subsidies SEBRAE and the state government granted to firms directly or through the associations in the cases reported in this paper took the form what Amsden³⁷ calls reciprocity – when the state grants subsidies or benefits to associations or firms in exchange for economic performance (or compliance with the law in the cases reported here)³⁸. In Nova Serrana, the performance standard was the number of

³⁶ In my interviews in SEBRAE at the national headquarters and also in the states branches I noticed that some employees tend to point as successful, cases in which SEBRAE was the key actor in promoting the organization of the business association and in coordinating the programs in the cluster. Although this is not unusual in any public agency, this might introduce a selection bias and led to the wrong conclusions about the factors behind the successful experiences in which SEBRAE participate.

³⁷ See (Amsden 1989).

³⁸ I will argue in the next section that the presence of many institutions involved in solving the problems in the cluster also helped the public sector to act close to entrepreneurs while keeping its autonomy, since each institution cross check each other's policies to help firms comply with the law.

workers registered after the courses ministered by SINDINOVA; while in Jaraguá the criteria was the number of firms that registered to participate in the local fair; and in Toritama the amount of polluted water dumped by the laundries. Therefore, in each case there was a performance standard to check firms' efforts to comply with the law.

4.3 Multi-institutional taskforce to solve problems.

One key factor behind all the cases reported here was the involvement of many institutions to solve a problem³⁹. In Toritama, the enforcement of the environmental law involved enforcement agents (MP and CPRH); development agencies (SEBRAE and ITEP) and business associations (ASCIT, SINDIVEST, and BFZ). Laundries succeeded in complying with the law because one agency developed a low-cost technology later replicated by a state research institute (ITEP) to the local laundries; SEBRAE provided subsidies for firms to develop the project to install the equipments to clean the water, CPRH and the MP enforced the law and granted a grace period for firms to comply with the environmental legislation after extensive negotiations with business associations (SINDIVEST and ASCIT). Therefore, the final positive outcome marked by laundries acting in accordance with the law resulted from the work of a multi-institutional taskforce that involved both enforcement and development agents.

The same happened in Jaraguá and in Nova Serrana. In Jaraguá, when the local business association (ACIJ) applied for subsidies to organize the annual trade fair; SEBRAE and the development state secretary provided the subsidies in 2001 and have been doing that since then. The plan to set up a trade fair and to develop private brands started as a reaction to the state treasury efforts to increase tax collection in Jaraguá and the police raids to apprehend counterfeit jeans. In addition, a generalized default from buyers at the end of the 1990s increased firms' uncertainty to continue to do business informally (increased the transaction cost of being informal). There was no formal cooperation between development and enforcement agents. But the development agents were there to help firms become formal and to meet the requirements imposed by the police and the state treasury on small and medium-sized firms.

³⁹ Part of this section is based on many discussions I had with my colleagues Roberto Pires and Salo Coslovsky. In his paper, Salo developed the argument that cooperation among institutions is crucial for reaching the kind of positive outcomes explained in this paper. See (Coslovsky 2007).

Finally, in Nova Serrana, the entrepreneurs' efforts to register the firms and their workers in mid 1990s resulted from the enforcement of the labor legislation by labor inspectors, coupled with subsidies granted by SEBRAE to a group of entrepreneurs from SINDINOVA to encourage firms to register. The state secretary of science and technology also granted non-refundable resources to SINDINOVA to buy a CAD/CAM system to help firms in Nova Serrana to upgrade. Again, the process that ultimately increased the number of small and medium firms complying with the labor and tax legislation resulted from the enforcement of the law combined with subsidies granted by development agents from SEBRAE and the state government. Similar to what happened in Jaraguá, there was no formal cooperation between law enforcers (labor inspectors), SEBRAE and the state development secretariat. However, these stakeholders were at the same place at the same time, making it easier for firms to upgrade and to comply with the law.

In all the cases above, the process of firms' moving away from informality was sparked by a reaction to a crisis (Jaraguá and Toritama) and/or the initiatives of enforcement agents to enforce the law (Toritama, Jaraguá and Nova Serrana). But the key point we need to have in mind is that the process of change from a non-compliance equilibrium to the one where firms comply with the law was the result of a long process that involved the efforts of many institutions that packed together the carrot (subsidies) and the stick (law enforcement). As I have told above, granting subsidies to help firms to upgrade and comply with the law is a second-best solution, but the first-best one (only enforcement of the law) is not available in these places where firms are small and mainly sell to low-priced markets. In my view, the second best solution is still better than exempting small and medium firms from complying with labor and environmental standards.

In sum, I am claiming here that a multi-institutional taskforce seems to be important to explain the path transition from non-compliance to firms' compliance with the law. I will give below some examples for the same clusters, when institutions acted alone and failed to enforce the law. But before explaining these examples, it is important to have in mind two characteristics about the work of enforcement agents. *First*, the work of these agents is extremely demanding and they simply do not have time to look for underground firms in Brazil's countryside. In the state of Goiás, for instance, tax inspectors told me that they focus the inspection on firms that are already registered, since they have to visit as many as 100 firms in two days. The same happens with the labor inspectors. These inspectors cannot break

into the houses back door, where many informal firms operate, because they need either a search warrant or an opportunity to catch the firm owners red-handed⁴⁰. And *second*, since the number of law enforcers is small, these agents rely many times on denouncements made by workers or entrepreneurs. When there is no reporting, it is extremely hard for law enforcers to discover a small firm operating in the backyard of a house, under unsafe conditions, with unregistered workers and, sometimes, even with child labor. Therefore, law enforcers are more prone to succeed in making firms act in accordance with the law when they can count formally or informally on the support of economic-development agents.

In the places I visited to carry out this research, I could perceive that it is difficult for prosecutors and law inspectors to make firms comply with the law when they act by themselves. In Jaraguá, the police, pressured by the lawyers of international brands, tried unsuccessfully to ban piracy. I asked a local labor union representative why they do not report those entrepreneurs that manufacture knockoff jeans and she told me that these “pirate” entrepreneurs are the ones who pay the highest wages in the cluster. Therefore, the workers themselves pressure the labor union to keep from denouncing the producers involved in illegal copying. Under these circumstances, it is extremely difficult for the police alone to ban the production of piracy goods. It seems that the most effective action in Jaraguá to ban piracy has been the annual trade fair where many firms can only sell their own brands.

In Nova Serrana, since the 1990s there has been a tug of war between local producers accused of illegal copying and law enforcers (the police and the judiciary). But the police and judiciary have been ineffective to ban the illegal counterfeiting because neither the business association nor the local government agrees that footwear entrepreneurs make illegal copying. According to one of my interviewees in Nova Serrana, copying and reverse engineering is something common in the footwear sector and, when producers use a color combination similar to the ones used by famous international brands, he does not think it is piracy. The business association and the local authorities believe that the real cases of piracy are limited to a few manufacturers who do not participate in the business association. Similar to Jaraguá, in Nova Serrana, the most effective policy to ban piracy has been the subsidies firms receive from SEBRAE, state government and FIEMG to participate in national trade fairs and to

⁴⁰ Leonardo Soares, the head of the department of labor inspection at the Ministry of Labor, reported to a Brazilian newspaper that labor inspectors can only inspect 200 thousand children employed by registered firms out of 2.9 million children who might be employed in Brazil. This happens because labor inspectors cannot inspect non-registered firms that operate within households. See (Sofia 2007).

participate in courses supplied by outside consultants at the business association's headquarters.

It is difficult to enforce the law in these places where small and medium firms are important for the local economy because when prosecutors act alone to enforce the law, their legal actions might be overruled by judicial courts. This happened in Jaraguá. The prosecutor in Jaraguá tried to force laundries, located in residential areas and next to the river, to relocate to a site out of the city. The laundry owners failed to make the investments to relocate and they brought the case to courts to fight against the prosecutor. The laundry owners defeated the mandatory action from the "*Ministério Público (MP)*" to relocate in both the low and superior courts. In their decision, the judges stated that they were afraid that the requirement for laundries to relocate could impose an excessive burden on these firms, resulting in unemployment and turmoil in the local economy⁴¹. After the MP was defeated in its case before the court, the prosecutor started a new round of negotiations with laundry owners to settle a new agreement, granting five years for laundries to relocate with the financial support of the local government.

A case similar to the one explained above happened recently in Nova Serrana. A young prosecutor tried to compel the local mayor to stop collecting the industrial garbage, which should be collected by a private firm and disposed in a site separated from the household garbage. But both entrepreneurs and the mayor reacted angrily against the prosecutor's demands, since the prosecutor required an immediate solution to the problem. Every entrepreneur refused to sign an agreement with the MP and they joined the mayor to get help from the local and state business association to negotiate a plan with the state environmental agency (FEAM) and not with the MP. The state environmental agency (FEAM) granted a grace period to firms for them to comply with the law and the state business association (FIEMG) granted subsidies for firms to make the necessary investments. Again, subsidies were used to make it easier for firms to upgrade and comply with the law and the enforcement

⁴¹ This is consistent with the way judges rule in Brazil when they have to decide between the law and the social impact of their decisions. See (Pinheiro 2003) and (Pinheiro and Giambiagi 2006) chapter VIII.

of the law by the state environmental agency occurred gradually, differently from the plan envisaged by the MP⁴².

And last, the success to enforce the environmental legislation in Toritama was not followed by any major improvement of garment firms' compliance with the labor legislation. And the reason for that is the lack of institutional cooperation. The action of labor inspectors in Toritama seems to be meager and the other institutions in the city have not taken any steps to help labor inspectors enforce the law. SEBRAE is an institution that could, eventually, try to convince small entrepreneurs about the importance of complying with the labor legislation. But the agents of SEBRAE do not seem to believe in the importance of small and medium firms to comply with the labor legislation, especially in times of crises⁴³. Therefore, when SEBRAE agents work by themselves, they do not make major efforts to convince firms to comply with the law and neither do they see themselves as important actors who might indirectly help law agents to enforce the law.

In sum, it seems that law enforcers are able to make small firms to act in accordance with the law in small cities when these agents can count on the work of economic-development agents to ease firms' investments to upgrade. It is difficult to expect that law agents can succeed in enforcing the law using the traditional command-and-control approach. Small firms simply lack the resources to make new investments or they will challenge in courts the mandatory actions required by the MP. In other cases, small firms will continue to evade labor standards because they are "invisible" to labor inspectors: the number of firms is too high and the number of labor and environmental inspectors is too low. In Brazil, there are 3,000 labor inspectors; a number similar to the number of tax inspectors in just one state (Goiás). Therefore, it seems to be easier to enforce the law in small cities in Brazil when enforcement agencies can count on other institutions' help to ease firms' needed investments to comply with the law. This is what I named in this section multi-institutional taskforce to solve problems.

⁴² The state environmental agency implemented a different plan from the one conceived by the MP because entrepreneurs had not yet signed any agreement with the MP, since the prosecutor who had started the talking with the entrepreneurs moved to another city. Before the arrival of a new prosecutor, the business association acted quickly to sign an agreement with FEAM under more favorable conditions.

⁴³ In one of my interviews with an agent of SEBRAE he told me that in times of crises he advises firms not comply with the law if non-compliance helps firms' survival. This makes sense based on this agent's view, who believes that his prime task is to help firms' owners in any possible way and not the workers.

5. CONCLUSION

This paper analyzed three cases of clustered firms located in small cities (fewer than 100,000 inhabitants) in Brazil, where firms upgraded and started to comply with some aspects of the law after decades of being informal as to labor, tax and environmental legislation. The firms flourished under informality until their modus operandi clashed with the environmental law (Toritama), labor legislation (Nova Serrana) and tax legislation (Jaraguá). When this happened, economic-development agents helped firms make new investments, thus facilitating firms' compliance with the law. However, this process of firms starting to comply with the law has been gradual, partial and in some cases is still an unfinished process.

I am claiming in this study that the successful enforcement of the law depends not only on the work of law enforcers, but also on the work of economic-development agents. These two kinds of civil servants do different jobs but they are complementary; they reinforce each other. When SEBRAE or the state economic development secretariat provide subsidies for firms to adopt clean technologies they are helping firms to comply with the environmental legislation and also helping law enforcers to enforce the environmental legislation. Therefore, based on the cases I have studied, I believe that development-minded public officials can successfully work together with law enforcers to increase the benefits of formalization and help firms become formal. The main points developed in this paper are summarized as follows:

First, in all the cases shown here there was a clear link between compliance with the law and profits. Firms were interested in complying with the law in order to gain access to subsidies to participate in trade fairs or to use the services provided by SEBRAE or by the state government through the local business associations. This means that the law agents might succeed in enforcing the law in small cities, when firms have access to subsidies to upgrade, cut costs and then face the burden of the legislation. The cases reported here seem to suggest that subsidies (subsidized courses to small entrepreneurs; subsidies for firms to participate in trade fairs, etc.) were important to foster firms compliance with the law in these places where most firms and workers are informal.

Second, the alliance between economic-development agents, law enforcers and business associations explained in this paper helped to promote the upgrading of many firms in the cluster and firms' higher compliance with the law. In Nova Serrana, for instance, a

small group of entrepreneurs successfully lobbied SEBRAE and the state government to support the establishment of a local footwear business association in exchange for the association's effort to help firms register their workers. And in Toritama the association has been the main channel to raise the environmental standards in the region, since its members are pressuring the state attorney office to enforce the environmental legislation in nearby cities. In addition, I showed that members of business associations in small cities in Brazil have similar interests and the better-off members usually have investments in different economic sectors in the city, meaning that these associations look like encompassing associations whose members are from different economic sectors.

Third, historical legacies (history of cooperation, religion, etc) had a minor role to explain the changes that occurred in these clusters, once the economic-development agencies together with law enforcers took serious steps to promote the local development and firms' compliance with the law. The natural economic path in these places would be for SME continue to be informal, as they had successfully been doing in previous years with positive impact on the local economy, when measured by the low poverty rates. Firms did not comply with the law because they were not required to; there was no enforcement at all. Firms only decided to start to comply with the law when law enforcers began to lay a heavy hand on enforcing the law and/or firms had to register to get benefits provided by economic-development agencies to small and medium firms.

Fourth, all the cases developed here involved the implementation of quite simple policies tailored to solve specific problems in each city and cluster. The bad news is that "one size does *not* fit all", but the good news is that simple policies might work as an important incentive to increase firms' compliance with the law. In Nova Serrana and Jaraguá, the policy to subsidize firms' participation in trade fairs had a positive impact on the increased number of registered firms and the number of registered workers. In Toritama, decades of pollution were solved by applying a low-cost technology to clean and recycle the water. Today, local entrepreneurs in Toritama worship the state prosecutor. In Jaraguá, the majority of entrepreneurs have a deep esteem for the work of SEBRAE and in Nova Serrana local entrepreneurs developed a close alliance with the state business association (FIEMG/IEL) and the state government.

Fifth, based on the evidence I gathered for this research, it seems that the positive outcomes as to small and medium firms' compliance with the law only worked because the

enforcement of the law was gradual. It is easy for someone to travel to any of these small cities in Brazil and see that in many places firms are not acting in accordance with the law. And the key problem is to find out how law enforcers can solve this situation without closing the firms. Unfortunately, in the cases I developed throughout this paper, it seems that there was no first-best solution. The fast enforcement of the law might have caused an economic turmoil in these places, increasing both unemployment and poverty. But there was a second-best solution when the enforcement of the law occurred alongside incentives provided by economic-development agents and the enforcement of the law was gradual⁴⁴. In none of the cases I explained here law enforcers tried to enforce simultaneously every aspect of the legislation. In one case firms started to comply with the labor legislation (Nova Serrana); in the other firms started to comply with the environmental legislation (laundries in Toritama) and in one firms started to collect taxes (Jaraguá).

One last point about this research is that all the industrial clusters I visited so far, most firms sell only to the domestic market and I have not looked carefully how changes in the legislation might have facilitated firms' registration. In all the cases reported here, firms' higher compliance with the law resulted from the action of law enforcers coupled with incentives granted by economic-development agents to help firms obey the law. In a new round of interviews for this research, I will investigate how standards imposed by foreign downstream buyers on their supplies might help small and medium firms to upgrade. I also want to investigate which effects changes in the legislation have on firms' higher compliance with the law. It is true that in Brazil an entrepreneur needs to go to nine different agencies to start a business and in Latin America, only Venezuela and Haiti regulate business more heavily than Brazil (IFC-BIRD 2006). But I had the feeling that in the small cities the excess of regulation involved in opening and closing businesses is not the major bottleneck linked to informality. I will turn to this issue in a next paper.

⁴⁴ It is always difficult to make small and medium firms comply with the law and many studies suggest that enforcing the law is more successful when law inspectors help firms to implement the needed changes to act in accordance with the law. This seems to suggest that a gradual enforcement of the law together with tutorial actions provided by law inspectors might work vis-à-vis enforcement only. See (Piore 2004) and (Schrank 2005) on how labor inspectors through pedagogical actions help firms to comply with the labor legislation in Mexico and Dominican Republic.

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Annex 1 - Map of the Clusters – Toritama (PE), Jaraguá (GO) and Nova Serrana (MG)

