TDS Working Papers

LOCAL NETWORKS OF ENTERPRISES IN THE WORLD ECONOMY

SOME KEY ISSUES AND POLICY QUESTIONS

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LOCAL NETWORKS OF ENTERPRISES IN THE WORLD ECONOMY: SOME KEY ISSUES AND POLICY QUESTIONS

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Policy interest in the development of local productive systems, enterprise clusters and networks of enterprises appear universal. In national and subnational governments, in developed and developing economies, in advanced and peripheral regions, in transition economies, and in jurisdictions adhering to laissez-faire and dirigiste economic philosophies, policymakers are turning to cluster-based strategies in an attempt to replicate successful agglomerations of highly competitive firms. Indeed, for some, the development of enterprise clusters epitomises a new form of industrial policy. This Congress will examine recent experience in this field based on a selection of examples from around the globe.

This note discusses some of the main issues that will be explored during the congress and identifies some key questions for discussion. It focuses on the nature and importance of clusters and the characteristics of cluster policies and reviews the three themes for the round tables in day one of the congress:

− The dynamics of enterprise agglomerations in different regions of the world.
− Local productive systems as a response to new challenges.
− Governance and the competitiveness of territories.

The aim is to stimulate reflection and debate throughout the congress. Separate notes are available on the issues and messages for the Forums and on the key features of the exchange fair experiences presented on day two.

1. The nature and importance of enterprise clusters

What is an enterprise cluster?

“Local productive systems”, “clusters”, “industrial districts”, “enterprise agglomerations” -- while the terminology varies the phenomenon remains the same: all refer to geographical groupings of firms in related lines of business. A cluster can contain a small or a large number of enterprises, and small and large firms in different proportions. Some clusters, such as many of Italy’s industrial districts, comprise mainly small and medium sized enterprises. In others, large firms, sometimes of foreign origin, form the nucleus of the cluster. Different clusters involve varied degrees of interaction among the firms

1. This document was originally presented as an issue paper at the "World Congress on Local Clusters", organised by the OECD LEED (Local Economic and Employment Development) Programme and the French DATAR (Délégation à l'Aménagement du Territoire et à l'Action Régionale -- Delegation for Territorial Planning and Regional Action), held in Paris (France) in 2001.
involved, ranging from loose networks of association to multifaceted forms of co-operation and competition.

**How do clusters influence the competitive position of firms?**

The physical concentration of businesses can give rise to locally concentrated and specialised labour markets. Clustering can also encourage specialisation and an enhanced division of labour among firms (providing scale economies for individual enterprises). Buyers and sellers can gravitate to the cluster, while the proximity of firms creates opportunities for efficiency-enhancing collaboration. For example, networks operating within clusters have enabled co-operation on issues as diverse as training, finance, technological development, product design, marketing, exporting and distribution.

Ideas and information, which are keys to innovation, often flow easily within clusters. For example, frequent exchanges between producers and users of capital goods are likely to have underpinned the innovative performance of firms in many industrial districts. Information flows occur formally and informally, as when employees change employer, through contacts with common suppliers, and through social exchanges. As emphasised in the writing on Italian industrial districts, purely commercial inter-firm exchanges are sometimes overlaid by common membership of artisanal and commercial associations, labour associations, and various community-based institutions. The clustering of firms can also reduce the unit costs of providing technical services to members of the cluster. And by operating in close proximity enterprises can more easily subcontract to competitors those orders that exceed their own capacities, which may allow firms to retain valued customers.

**Why is there a policy interest in clusters?**

Policymakers are aware that membership of clusters and inter-firm networks can enhance the productivity, rate of innovation and competitive performance of firms. For example, the Bank of Italy has shown job creation, real wages and return on investment in Italy’s industrial districts to be consistently higher than elsewhere, even in periods of recession. The many well-known examples of affluent regions containing dynamic clusters of firms have caused local, regional and national governments to consider cluster-oriented policies. These policies are sometimes part of regional development policies, as is the case in France. Disappointment with policy approaches reliant on large firms has also spurred interest in clusters. Another driver of policy in this sphere is the recognition that large firms possess significant advantages in increasingly global markets, while many small firms are smaller than the efficient optimum in different stages of production, marketing and distribution. This consideration has been important in shaping policy towards the creation of localised enterprise networks aimed at overcoming the constraints of limited scale. Innovation and productivity are crucial concerns for many policymakers, with clusters influencing both variables in a variety of ways. The structure of some clusters can also lead to high rates of enterprise start-up, a frequent goal of public policy.

**Why do clusters form?**

The formation of clusters is favoured by a range of factors including:

− *Supplies of specialised labour,* such as occur around many universities.

− *The presence of input and equipment suppliers.*

− *Proximity to markets.* Despite today’s low-cost international transportation, being near to markets can still be important in cluster development.
The availability of specific natural resources.

Economies of scale in production, which may allow only a small number of efficient-scale plants in a given market.

The availability of infrastructure.

Low transaction costs. When firms operate near to each other, and the frequency of interaction is high, familiarity, trust and social norms may reduce the costs of contract negotiation and enforcement.

Superior access to information.

2. Cluster policies

Characteristics of policies supporting clusters

The content of cluster programmes is often similar. Cluster development strategies frequently target small and medium sized enterprises, and use a variety of means to foster business networks and promote collaborative behaviour. Programmes usually supply information: both generic information and information specific to the firms in a particular cluster. The infrastructure and training requirements of a cluster are key considerations in many cases, and policy sometimes entails the provision of business services ranging in sophistication from basic research to advice on bookkeeping. Various sub-national bodies have sought to facilitate clustering through the provision of real estate. Finally, programmes often provide a forum for public/private sector dialogue through which the quality of policy and public service provision affecting a cluster is assessed.

While there are recurrent features to many cluster programmes, there are also important differences. For example, while the public sponsors of cluster strategies are usually local and regional governments, national and even supranational governments have played active roles. Central government in the United Kingdom, for example, has recently announced the creation of a major clusters and incubation challenge fund (to be administered through regional development agencies). Some programmes focus on developing an existing economic base, others on attracting firms into the cluster, and still others combine the two approaches. Some programmes use restrictive selection parameters in choosing the cluster to develop, while others employ little rigour in the choice of target cluster.

Working towards best-practice policy

As in most fields of local economic development, policy must be guided by general economic rules tailored to particular circumstances. A policy on clusters should essentially provide a framework for dialogue and co-operation between firms, the public sector (particularly at local and regional levels of government) and non-governmental organisations. This dialogue can lead to efficiency-enhancing collaboration amongst firms, such as in joint marketing initiatives, joint design and sponsorship of training, etc. Such a dialogue can also lead to an improved quality of policy and government action (such as in training, the provision of information, and infrastructure supply). Policymakers can lock-in some of the benefits of existing or emerging clusters in different ways. For example, they can promote suppliers’ associations and learning circles, facilitate subcontracting arrangements within the cluster, and ensure effective extension services, all increasing the benefits to firms of belonging to a cluster. Firms should have access to such arrangements whether they belong to a cluster or not. However, it is likely that the benefits of such schemes will be magnified by cluster membership, and the cost-effectiveness of provision may be greater when supplying to a clustered rather than a dispersed group of firms. Policy must be shaped
to the specific circumstances of each cluster, while acknowledging that the appropriate areas of public intervention should still rest on an analysis of what the public sector can do best relative to the market.

The widespread interest in enterprise clusters has led both the OECD’s Local Economic and Employment Development Programme (LEED) and the Délégation à l’Aménagement du Territoire et à l’Action Régionale (DATAR) to undertake extensive work on the topic. Indeed, the OECD set out a series of detailed policy recommendations on clusters and networks at the June 2000 Ministerial-level Conference in Bologna entitled “Enhancing the Competitiveness of SMEs in the Global Economy: Strategies and Policies”. Participants are invited to consult the paper on enterprise clusters and networks -- entitled “Local Partnerships, Clusters and SME Globalisation” -- prepared for the Bologna Conference. This document contains the policy recommendations on clusters and networks incorporated into the Bologna Charter, a declaration adopted by 47 Ministers and representatives of government attending the Bologna Conference.

3. The dynamics of enterprise agglomerations in different regions of the world

The ways in which enterprise agglomerations can confer competitive advantage on firms are by now well documented. Nevertheless, there is a considerable diversity of types of enterprise agglomeration. For example, a cluster may comprise few or many firms, involve limited or extensive internal subcontracting, be dominated by a small number of key enterprises or by none, have no experience of inter-firm collaboration or a significant history of co-operation, contain industries allowing significant or only limited vertical integration, etc. Such differences can determine the policy priorities facing any given cluster.

The dynamics of a cluster may also be strongly affected by the broader economic environment in which it is found. For instance, a cluster in a traditional sector operating in a developing economy with only a short industrial history and underdeveloped infrastructure may have significantly different policy needs from those of a high-tech agglomeration in an affluent region of an OECD member country. The growing usage of electronic communications technologies may also facilitate inter-firm networks in ways not previously available.

There is, as already noted, some diversity in the policy approaches to cluster development. Indeed, recent cluster and networking programmes have the advantage of being able to learn from previous experience. For instance, in Slovenia, an ongoing cluster initiative sponsored by the Ministry of the Economy in the automotive and transport sector has been preceded by extensive analysis and has avoided many of the pitfalls affecting initiatives elsewhere. Similarly, a new World Bank-sponsored cluster programme -- the Pro North-East Initiative -- launched by the governors of the Brazilian states of Pernambuco, Bahia and Ceará, has the opportunity of avoiding well known patterns of error.

**Questions for discussion**

- What are the most instructive examples of cluster policy -- both at national and local level -- in the countries and regions that participants represent?
- What are the main differences in policy experience as between developed and developing economies?
- What should the common or guiding principles of cluster policy be, regardless of place?

2. See http://www.oecd.org/tds/bis/leed.htm
In transition economies, with the break-up of many long-standing industrial structures, the emergence of new industrial clusters could be quite rapid. Has this been the case?

Is there any visible pattern linking the emergence of clusters in transition economies and the location of foreign direct investment?

4. Local productive systems as a response to new challenges

Local productive systems are operating in a changing environment, characterised by increased openness to international economic forces and rapidly changing technologies and markets. Any overview of the recent processes of globalisation reveals the extensive and rapid economic changes at play. The environment for trade and investment is becoming more open, with the creation of the World Trade Organisation and multinational free trade areas such as the European Community, the North American Free Trade Area and Mercosur, and markets have undergone much recent deregulation and liberalisation. As incomes rise, we are also witnessing the fragmentation of markets and the emergence of numerous market niches. Technologies are flowing more quickly between countries, product life cycles are becoming shorter, innovation is becoming more important and there is a premium on knowledge and human capital. New industries are emerging, like biotechnology and opto electronics, whilst information and communications are advancing rapidly and becoming increasingly essential for companies to do business.

Whether they are located within or outside local productive systems, the key challenge for all firms today is to adapt to internationalisation and rapidly changing technologies and markets. We should remember that local productive systems, or clusters, are the results of living processes. They form and evolve and they can decline or die. There are many examples of once thriving clusters that have now all but disappeared because they failed to adapt to change. But others, like Silicon Valley, have successfully made the transition to new products, new processes and new forms of organisation. The key to success is to maintain flexibility and adaptability in the local production system.

International competition

Firms today must compete internationally to secure their domestic as well as their foreign markets. Even where they address a very specific niche product, local firms can lose their markets to those in other locations which innovate more rapidly or have lower costs. The infrastructure, services, networks and competencies built up in local productive systems are critical in helping firms to respond to the challenges of international competition.

Another strength of clusters is that they tend to be very flexible production systems, and this gives them an advantage in responding to the recent evolution of markets and technologies. Firms are now confronted with increasingly differentiated and variable consumer demand, shorter product life cycles, information and communications technologies that aid networking and the availability of new computer-based general purpose machinery that can compete in efficiency with dedicated equipment. In this context, networks of small and highly specialised firms can efficiently exploit rapidly changing market niches, and compete successfully against large firms that can no longer rely on scale alone to dominate markets. In theoretical terms, clusters appear to be at the vanguard of a shift from traditional ‘Fordist’ mass production (dominated by standardised goods and services, standardised production methods, low skilled labour and price competition) to a system of flexible production or ‘flexible specialisation’ (dominated by production of a wide and changing range of customised products and services using flexible, general purpose machinery and skilled adaptable workers).
Being grouped together in clusters can also help firms to develop exports and international strategic alliances. For example, clusters of Irish software firms often set up shared marketing offices in other countries, with the help of Enterprise Ireland, and entrepreneurs from the footwear cluster of the Marches, Italy, have recently undertaken a joint mission to Mexican footwear clusters in Leon and Guadalajara to arrange joint ventures, sales and distribution agreements and technology licensing projects.

**Foreign direct investment and clusters**

Local productive systems are increasingly exposed to the challenges and opportunities of foreign direct investment. There has been a notable increase in investment by foreign firms in the local productive systems of northern Italy, for example, and this has aroused local fears that multinationals will simply appropriate markets and shift technologies and knowledge overseas. But foreign investment can flow in two directions, and at the same time as foreign firms set up and acquire operations in clusters, firms from clusters may invest, license or subcontract overseas. This again arouses local fears, particularly where internationalisation is motivated by a desire to reduce costs by outsourcing from cheap locations. Does the gradual internationalisation of local productive systems mean that the internal dynamic of clusters will gradually dissipate? This may happen when the foreign investment represents a significant part of the cluster, but equally openness to inward and outward foreign investment enables clusters to keep ahead in technology, finance and markets. This question has not yet been sufficiently studied.

**Territorial marketing**

The quality of the local territory is the critical factor which enables local businesses to compete internationally and which helps local productive systems to retain their high value added activities in a period of greater international footlooseness. Indeed it can be argued that small enterprises networked in a cluster are more locally embedded that large, relatively self-sufficient enterprises. Because the small firm depends on specialised local service providers, subcontractors, skills and infrastructure within the cluster for its competitiveness it can less easily relocate elsewhere than a large enterprise. Governments, and in particular local and regional governments and development agencies, are increasingly aware of this. They can respond by taking various initiatives to strengthen local clusters. However, they can also put into place ‘territorial marketing’ campaigns that promote the special image of their cluster, based on its specific competencies and specialisations. Pioneering areas are finding that this helps to build enthusiasm for cluster actions and helps to attract and retain investment. Large enterprises and multinationals invest huge resources in advertising and communication, but small enterprises in local productive systems are largely excluded because of the scale of investment required. Joint territorial marketing and image building initiatives focused on promoting the cluster as a whole can also help local small firms to compete.

**The challenge of innovation**

In the modern economy, the key driver of economic development is innovation. Competitiveness is based on the growth of productivity, on rapid adjustment to the changing needs of consumers and on the continuous adoption of product and process innovations. In many ways, local productive systems already represent particularly beneficial environments for innovation. For example, although specialised on one industry, as a network of small firms they can make constant and quick adjustments to changes in competition and markets. It is often argued that this makes them less vulnerable to external shocks than single large plants. Their fertility as incubators for spin-offs and start-ups is also often remarked upon. And despite the fact that information and communications technologies (ICT) now enable the rapid transfer of information over large distances, the interpersonal face-to-face interactions and the local
mobility of labour within clusters improves the circulation of the commercial, financial and technological knowledge that stimulates innovation.

Local productive systems must nonetheless continually innovate and adjust. They must remain territorial environments that are conducive to innovation. To do so, they need to advance in at least three key areas:

- **Adjustment.** Local productive systems must secure long term structural adjustment by keeping abreast of leading technologies and by shifting into new and growing markets. Clearly this is critical for any firm or industry. But the fact that specific local productive systems are associated with specific territories adds a further obligation to innovate, because if the local productive system fails to adjust to changing technologies and market demand the territorial economy will lose its principal motor.

- **Information and communications technologies.** Clusters also need to make use of advances in information and communications technologies, such as electronic mail, computer conferencing, electronic databases, the Internet and Intranets. ICT is increasingly important in all areas of business, including recruitment, ordering, market research and process control. It is important that firms within local productive systems are not just connected up, but also really using ICT to its full capacity.

- **The knowledge economy.** A high proportion of new job creation in coming years is likely to be in knowledge-intensive industries and competition in all sectors will increasingly be based on the exploitation of skills and knowledge. Territories with a highly skilled workforce, a good technology base and inter-firm networks are therefore more likely to be competitive and successful. In the context of the new ‘learning economy’, local productive systems must develop skilled, adaptable and entrepreneurial workforces, networks and infrastructures capable of generating and exploiting knowledge.

**Questions for discussion**

- How can clusters best exploit new information and communications technologies?
- What are the advantages and threats of ownership by large firms in local productive systems?
- How can we ensure that local productive systems remain innovative and entrepreneurially dynamic?
- How can local cluster firms collaborate to export?
- To what extent is it possible to revitalise old clusters?

5. **Governance and the competitiveness of territories**

The development of local clusters responds to significant social and structural changes reflecting a broad diversity of factors such as:

- The increased decentralisation and devolution of government and autonomy of territories.
- The growing need for local co-operation in the age of globalisation.
- The end of mass industrialisation and Taylorism and the emergence of a totally different approach to work organisation.
− The end of national policies supporting large national champions in leading industrial sectors.
− The need to respond to high levels of unemployment concentrated in particular local, rural and urban communities.
− The pursuit of a sustainable development in societies that are conscious of their environmental problems, and sensitive to issues such as the local quality of life, etc.

Organisational links within the territory

The case of the Italian industrial districts draws attention to the particular relationships among economic actors within clusters, which are based as much on competition as on co-ordination. The difficulties met by small businesses in transition countries show that this relationship is not easy to form and that at the outset enterprises see themselves as competitors. It also appears that the structure of local clusters encourages the internal mobilisation of resources rather than the search for external ones, as well as an improved capacity for internal adaptation and flexibility. Enterprises within clusters innovate by putting in common resources involving human as much as physical capital. These relationships extend to informal exchanges of information and tacit knowledge.

Clusters are often characterised by strong links between the world of education and the world of active life. Local clusters help to bridge the gap of the transition from education to work through increased relationships between universities and enterprises, development of research centres, common programmes and the creation of centres of information and training.

Indeed, local productive systems are underpinned by a wide range of players, including firms, their suppliers, competitors and customers, research institutes, universities, colleges, consultancies, trade associations, chambers of commerce, local public administrations and so on.

We should not think of the co-operation between them in terms of simple market-based contracts or input-output linkages. Local productive systems are places where relationships are started and maintained by people, by the citizens of a territory, linked through various historic and social ties. This testifies to an original link between local entrepreneurship and citizenship.

Linking entrepreneurship and citizenship

The case of local clusters is notable not just because of the economic benefits for the performance of cluster firms but also because it draws our attention to the presence of a different entrepreneurial and local culture. This is based on:

− A higher degree of inter-relation between economic and social ties. The fact that enterprises are located together in the local territory helps to generate trust and a willingness to co-operate together, which makes for a qualitative difference between networking locally and networking at a distance.

− Trust relations among enterprises. The case of transition countries shows how vital trust is to any form of co-ordination, which was often destroyed during years of undemocratic rule.

− The notion of partnerships between private and public actors.
Enhanced visibility of local actors and of the civil society, as much in economic as in social and political terms, as demonstrated for instance by the increased visibility of networks of women entrepreneurs at a local level.

Stronger representations of collective local interests, through associations and closer links to authorities.

A new approach where the actor is a group of enterprises instead of the enterprise as an isolated economic actor.

A new relationship between territorial proximity and the use of new technology.

Rethinking systems of governance

The development of local productive systems therefore requires the rethinking of governance systems and industry policies, so that mechanisms of public intervention are adapted to their special features. In particular, this means a decentralisation policy design and delivery to the local level. There are two key features of local productive systems that imply a need to adapt existing policies in this way:

Firstly, local productive systems are founded on synergies between local firms and institutions. Local actors in clusters are linked through various pacts, contracts and relationships, involving a mix of competition and collaboration. Policy for supporting clusters and governance frameworks should therefore involve local actors when it comes to design and implementation of strategies and programmes.

Secondly, all clusters are different. The clusters we see today are the result of a process of historical development specific to each cluster. Local productive systems are different in their areas of specialisation, labour markets, environments, networks and states of maturity for example and each has its own gaps and opportunities to address. Different clusters must therefore develop and implement their own strategies and interventions and governance frameworks should be tailored to their local circumstances.

What specific governance structures are required for local productive systems? This must reflect the realities of what already exists in different countries and regions. In the USA, for example, ‘network brokers’ are popular. These are often non-profit sector organisations that co-ordinate the network and generate demand for network services. They bring firms together for activities such as strategy building, seminars and workshops on industry topics and benchmarking initiatives. They also help generate demand for joint projects such as training courses, exporting programmes and research collaboration. In the United Kingdom, Regional Development Agencies are network promoters, in conjunction with local government, Training and Enterprise Councils, the Small Business Service and other agencies. Elsewhere organisations such as trade associations, chambers of commerce and local government play the lead role.

In all cases, however, policy should seek partnership and participation. Public policy in clusters must be designed through collaboration, involving local firms, institutions and citizens in the development of the strategy and actions. We must recognise that all people in the territory are stakeholders who are affected by the development of the cluster. Mechanisms are therefore needed so that they are given the opportunity to be involved in the decisions about it. Too often, pre-existing government administrative boundaries get in the way of such partnership and participation, since clusters do not always fit conveniently into existing boundaries. But we need to make sure that governance is targeted on real
functional clusters, through facilitating co-operation between different administrations or rethinking administrative boundaries where necessary.

Clusters may need to develop further support in a range of different areas. For example, for the creation of new firms, for the provision of venture capital and business services, for the development of skilled labour, to build the technology base and support commercialisation, to attract foreign investment, to develop trade strategies and international linkages and so on. What is important is to bring this all together by working locally with all the relevant actors in a way that helps to bridge gaps in networks and to create synergies.

The economic and social advantages of clusters are numerous. First of all, they are structures that enhance the economic performance of enterprises in terms of innovation, competitiveness, production, exportation, efficiency and specialisation. Second, within clusters, the gaps that exist between the private and public spheres and between different economic actors can be bridged. Third, clusters provide a different perspective on socio-economic relationships, given that economic activity is also based on an active social participation and collaboration. Nevertheless, it is very important to avoid over-prescription of the concept of local clusters, through overly abstract terms or excessive generalisations, because the essential strength of clusters is that they are built on the particularities of each territory.

The special nature of local productive systems implies the need for a new territorial policy to manage them. This should be developed locally through partnership and participation, bringing together different actions in a way that meets the needs of each individual cluster.

Questions for discussion

- What is the role of the public sector in clustering?
- What governance structures are most appropriate for cluster management?
- How can managing local productive systems support social inclusion?
- Can we see in local clusters a model for economic democracy?