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Lessons learned in developing productive capacities from countries graduating and graduated from the LDC category*

Summary

Expanding productive capacity in LDCs is critical in progress towards sustainable development, including the eradication of poverty. Developing productive capacity requires integrated polices in five areas: development governance; social policies; macroeconomic and financial policies; industrial and sectoral policies; and international support measures. Lessons learnt point out that there are at least three pathways leading to graduation with different implications for productive capacity and overall progress towards sustainable development.

One pathway to graduation is through rapid but volatile income growth from natural resource exploitation. However, without sufficient investments in human assets and a lack of economic diversification, this pathway does not move countries towards achieving the sustainable development goals and often leaves large parts of the population in poverty. Weak development governance is the key constraint that prevents countries on this pathway from channelling natural resource revenues into social sectors. Not counting expenditures for human assets formation as investment further exacerbates a neglect of social sectors.

A number of mostly small countries are on a second pathway that combines income growth with investment in human assets. These economies typically specialize in sectors such as tourism or natural resources with low employment and limited backward and forward linkages to other sectors, reinforcing vulnerabilities and in some cases inequalities. Good development governance underpins success in these countries, based on state legitimacy and institution-building. This facilitates human assets development, prudent macroeconomic policies, as well as a pragmatic and strategic application of industrial and sectoral policies. Some countries on this pathway harnessed official development assistance (ODA) for development by effective national coordination of donor support and adopted far-sighted diaspora and remittances policies.

A third pathway, typically associated with economies having large populations and internal markets, is characterised by investments in human assets and structural transformation towards high-productivity manufacturing and services, contributing to a steady, albeit slow progress towards sustainable development, including the eradication of poverty. Productivity-enhancing agricultural reforms focusing on small-scale agriculture and massive investments in rural infrastructure are the launching pad of development. On this pathway, the state plays an active and crucial role in designing appropriate policies in all relevant areas and creating and constantly adapting development-focused governance structures.

In all pathways to graduation, peace and security are critical foundations for productive capacity and sustainable development. Strong national ownership of the development agenda and building of development oriented institutions enables countries to successfully develop and adopt unorthodox social and macroeconomic policies, enabling resource-poor countries to rapidly increase access to health and education and create employment opportunities, in particular for women.

* Excerpt from Committee for Development Policy, Report on the nineteenth session, See Official Records of the Economic and Social Council, 2017, Supplement No. 13 (E/2017/33)

Recommendations

As part of its contribution to the 2017 theme of the Council, the Committee reviewed the experiences of fourteen countries, including former least developed countries (LDCs), current LDCs approaching graduation, and other developing countries, in developing productive capacities, progress towards graduation and the achievement of the sustainable development goals. The analysis finds that domestic policies are most critical and that international support measures play an important enabling role. These experiences provide important lessons for all LDCs and their development partners including the UN development system (UNDS).

(a) The CDP recommends that the Council request UNCTAD to further develop its monitoring methodology for measuring progress and identify obstacles in the development of productive capacity in LDCs, taking into account the findings in chapter II of the CDP Report to ECOSOC (E/2017/33).

The CDP also recommends that UNCTAD share the outcome of its work as an input to the DESA impact assessments and the CDP monitoring reports on countries graduated or graduating from the LDC category.

(b) To further contribute to the smooth transition of countries graduating from the LDC category, the CDP recommends that the Council invites the EIF, UNCTAD, UNDP, UNFCCC, UNIDO, WTO, the UN regional commissions and other relevant international development partners to provide inputs to the impact assessments prepared by DESA, highlighting these entities' operational activities related to building productive capacity in LDCs and the possible impact of graduation on these activities.

1. Introduction

Structural challenges and the weak economic and social performance of LDCs are often ascribed to the limited development of their productive capacity. Productive capacity is the productive resources (natural, human, physical and financial), entrepreneurial and institutional capabilities, and production linkages which together determine the capacity of a country to increase production and to diversify its economy into higher productivity sectors for faster growth and sustainable development. Hence, expanding productive capacity in LDCs is key in making progress towards sustainable development, including the eradication of poverty. Increased productive capacities enable structural transformation towards more productive activities and sectors, ideally creating enough decent jobs to reduce poverty on a broad scale. At the same time structural transformation can also generate resources for social protection, aimed at those who are permanently or temporarily unable to escape poverty with their own resources. Given that LDCs feature widespread and persistent poverty, eradicating poverty at the global level requires a focus on LDCs.

As previously highlighted by the CDP[1], developing productive capacity requires integrated policies in five areas: (i) development governance; (ii) policies for creating positive synergies between social outcomes and productive capacity; (iii) macroeconomic and financial policies that support productive capacity expansion and increase resilience to external shocks; (iv) industrial and sectoral policies and (v) international support measures in the areas of trade, official development assistance and international tax cooperation. Given the diversity among LDCs, one-size-fits all policies will not be successful. Instead, the various country groups require different national strategies and different support from the international community.

Building on last year's work, the CDP analyzed the experiences of fourteen graduated and graduating countries, as well as non-LDC economies, in expanding productive capacity. It identified three pathways leading to graduation with different implications for productive capacity and overall progress towards achieving sustainable development. Whereas resource endowment and country size are co-determinants for the pathways, policies are most critical.

2. Pathway I: Rapid growth through natural resource exploitation

One pathway to graduation is through rapid economic growth from natural resource exploitation. On this pathway there is a high risk of graduation without deepening productive capacity or meaningful social and economic transformation, leaving human assets and economic diversification at low levels and poverty widespread despite the relatively high level of aggregate income. Weak development governance is the key constraint that prevents countries on this pathway from channelling natural resource revenues into expanding productive capacities for sustainable development. In addition, excessive dependence on exploitation of natural resources can reinforce the lack of transparency and accountability in the management of resource rents.

1 See ECOSOC, 2016, Supplement No. 13 (E/2016/33), Chapter II.

Domestic price distortions and the perception that economic policy reforms are less urgent, due to high resource revenues, limit the likelihood of economic diversification in most resource-dependent economies. This is often exacerbated by non-transparent governance structures and lack of accountability, which can misalign the allocation of public expenditure between sectors that are identified as priority areas (for example social sectors) and those where the actual public investment takes place, often consisting of mega infrastructure projects. An important lesson for other resource-rich LDCs is to combine the building of a system of good governance with a planning process designed to match resources with social and productive public sector investments and monitor implementation regularly. Another lesson is the need to identify and develop strategies to enhance global value chain integration and boost domestic value-added.

Simple budget rules can help in moving towards a sustainable use of resources, but it is essential that investment in health and education are permitted to count as investments, even if this departs from national accounts conventions. Restricting investments to physical infrastructure further increases bias against social sectors, in particular if resource revenues dominate state revenues, as is often the case in countries following this pathway. However, experience also shows that lack of good development governance does not inhibit countries from devising production sharing agreements that enable them to appropriate a commensurate share of revenues. Hence, development governance deficits appear to affect public expenditures more than public revenues, so that expenditure policies require special attention.

3. Pathway II: Economic specialization and investment in human capital

A number of mostly small graduated and graduating countries follow a pathway characterized by income growth driven by economic specialization and improvements in human assets. A key driver of development progress, despite limited scope for economic diversification, is the quality of good development governance, in some cases complemented by traditional and customary laws and supported by concerted efforts in institution building and the maintenance, or reestablishment, of peace and political stability. 'Good development governance' is not a given, but needs to be built through proactive policies aimed at building institutions, employing an inclusive approach to policy design and implementation and introducing rules and regulations that instil transparency and accountability in public administration and budget allocation.

Strengthening State legitimacy based on a national vision designed to generate and reinforce national identities is critical. This approach to good development governance is particularly relevant for LDCs where State legitimacy is often in question because of ethnic and geographical diversity. The perception that the State is acting in the long-term interests of all social groups can help ensure consent for difficult policy decisions.

This development governance framework enables countries to allocate significant resources in human asset development. It supports the adoption of a prudent macroeconomic and fiscal policy framework backed by prioritization of sectors based on (potential) comparative advantage and strategic planning. It also facilitates public investment in infrastructure development in general as well as in specific targeted sectors with the objective of encouraging economic specialization and stimulating increased domestic and foreign investment in priority sectors. Successful policies have often been the product of trial-and-error or the pragmatic response to changing circumstances.

ODA has played an important role for building productive capacity in many countries. One success factor for harnessing ODA for development is the importance of effective coordination of donor support, including by mainstreaming ODA into national development plans and adopting sector-wide approaches to programming. These are valuable lesson for LDCs that continue to rely on ODA for social sector investment, infrastructure development and job creation through public expenditure. Some countries have also adopted far-sighted diaspora and remittances policies, demonstrating how domestic policies can help maximize the benefits derived from the diaspora, including the mobilization of resources and knowledge needed to expand productive capacity.

However, the experience of countries following this pathway also shows that development through human development and economic specialization leaves a country vulnerable to economic and environmental shocks, though this is largely a consequence of fixed country characteristics such as size and location. In addition, despite the success in building human capital, a number of countries continue to face high levels of social inequalities, which is partly explained by the limited employment and low backward and forward linkages of sectors such as tourism and national resources.

4. Pathway III: Graduation through economic diversification, structural transformation and the development of human capital

Typically larger countries are on a pathway characterised by investments in human assets and structural transformation towards higher productivity manufacturing and services. These countries show that significant and meaningful progress can be achieved even within a short period when countries pursue the process of expanding productive capacity and structural transformation under conditions of peace and security.

For countries on this pathway, rural development has been the key launching pad for gaining the momentum for growth, expanding productive capacity and promoting structural transformation. This requires agricultural reforms focusing on small scale farmers and massive investment in rural development. These reforms aim at rapid improvements in agricultural productivity and food security. Land use and tenure reforms that improve the rights of women as well as public support to farmers through agricultural extension services and subsidizing inputs have proven successful. This, in turn, increases human assets through reducing malnutrition as well as sustained growth and the transfer of labour from agriculture to more modern sectors.

In all countries on this pathway, the State plays an active and critical role in designing appropriate macroeconomic, social, fiscal, trade and industrial policies, and in creating a development-focused governance structure. An important and distinctive feature is the significance given to institution-building in support of both policy implementation and sectoral level development, which provides a solid foundation for expanding productive capacity and progress towards graduation. In most cases, the institutional arrangements established have been the result, not the cause of development.

Some countries have consciously tried to imitate the 'developmental State model' applied in East Asian economies, where the State took a lead role in setting the development vision and creating, through public investment, the basic infrastructure and institutions necessary for expanding productive capacity and attracting private investment in priority sectors. The selection of priority sectors and activities has been an important feature of the policy making process in all countries on this pathway, though the strategy of 'picking winners' has not always been successful.

Ownership of the process of development is critical, as reflected in the choice of policies, including 'unorthodox' macroeconomic and industrial policies and the importance attached to policy space and independence. Similarly, social policies have also been successfully 'unorthodox', closing gender gaps in health and education including through changing social norms by empowering women in the delivery of social services. This includes institutional setups under which non-profit service providers deliver public health and education services, demonstrating the advantages of an inclusive development strategy involving both governmental and non-governmental actors. Another positive example has been the deployment of 'health extension workers' throughout the country to achieve almost complete coverage with public health programmes.

International support for trade enhancing policies (in particular duty-free and quota-free access to most developed countries and in an increasing number of developing country markets) can be instrumental in integrating LDCs into the global economy, if LDCs have sufficient (latent) capacity to take advantage of global market opportunities and adopt complementary domestic policy reforms. Few LDCs are tapping into these trade support measures which signals the need for greater industrial and technological upgrading along with a proactive negotiating capacity.

5. Productive capacity building and structural transformation in non-LDC developing countries

The experiences of other developing countries that in the past shared key characteristics with LDCs reveal that these countries often face development challenges similar to LDCs, including the need to re-invest natural rents for sustainable development, ensuring that increased agricultural production also improves food security, the critical role of access to reliable and affordable energy, and the need to ensure that higher productivity services generate sufficient employment opportunities. This implies that LDCs will need to continue expanding productive capacity and promoting policies and strategies for economic diversification, structural transformation, poverty reduction and sustainable development after graduating from the LDC category.

An active integration into the world economy by attracting foreign direct investment and pro-actively participating in regional trade agreements combined with domestic reforms improving agricultural productivity and enabling the private sector to become a driving force can turn countries into globally important trading partners, provided that supply capacities can rapidly be developed. However, such a strategy is successful only if countries manage to upgrade their technological and skills base, so that they remain competitive by producing increasingly more sophisticated goods and services. It also depends on a favourable global economic environment, underscoring the importance of an open and development-oriented international trading system.

Experiences also show that while bold policy reforms can liberate the economy from unnecessary constraints and initiate structural transformation, the sustainability of the growth and development momentum depends on complementary and synergistic institutional reforms and good development governance ensuring transparency and accountability. Good development governance is not static, but needs to adapt over time to be able to promote innovation, for example through strategic government procurement, to harness information technologies and to develop commensurate human capacities.