

15 October 2010

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Developing Productive Capacities in Least Developed Countries: Issues for Discussion

Pre-conference Event to UNLDC-IV: Building Productive Capacities in LDCs for Inclusive and Sustainable Development

I. Recent development experience

During the period 2002–2007, least developed countries (LDCs) as a group experienced high gross domestic product (GDP) growth rates, which surpassed the 7 per cent target of the Brussels Programme of Action. However, about a quarter of the LDCs continued to experience very sluggish growth or economic regression. Moreover, even in the more successful countries, growth was associated with a pattern of insertion into the global economy based on commodity exports, low-skill manufactures and tourism, which meant that they were highly vulnerable to external shocks. Omitting oil-exporting countries, there was little improvement in domestic investment and savings, and very slow technological progress in the LDCs. Agricultural productivity growth lagged and there was widespread de-industrialization rather than a progressive structural transformation. Most significantly, the form of economic growth was not associated with broad-based improvements in human well-being, but rather very slow poverty reduction.

In 2008 and 2009, there was a sharp though very heterogeneous slowdown in growth in the LDCs. The LDCs did not fare as badly as other developing countries, partly because commodity prices recovered in 2009 and partly because multilateral institutions provided increasing official flows. But it has been estimated that the number of people living in extreme poverty was 7.3 million more than it would have been without the crisis in 2009 (Karshenas, 2009). More significantly, about half the population of the LDCs still lives in extreme poverty and the long-standing structural weaknesses and vulnerabilities which contribute to the LDCs' continued marginalization in the global economy remain.

II. The key policy challenge

Many LDCs are now at a critical moment in which they face a double challenge.

Firstly, they must find productive jobs and livelihoods for the millions of young people who are entering the labour force each year.

The scale of this employment challenge is formidable. In Mali, for example, it has been estimated that the number of new entrants to the labour force were 171,800 in 2005 and they will increase to a peak of 447,800 per annum in 2045, when the annual additional labour force will start to decline. In Madagascar, the new entrants to the labour force in 2005 are estimated as 286,200 and their number will increase to 473,400 per annum by 2035, when the additional labour force will begin to decline.

Moreover, the nature of the employment challenge is changing. In the past, most of the new labour force was absorbed in low-productivity livelihoods in agriculture. But farm sizes are diminishing and farmers are being forced to cultivate more ecologically fragile land. The failure to improve agricultural productivity means that agricultural livelihoods are pitifully poor as well as physically onerous and full of drudgery. Thus, more and more people are seeking work outside agriculture and urbanization is accelerating. But LDCs have not been able to increase agricultural productivity significantly, nor to generate productive jobs and livelihoods outside agriculture. The number of survivalist informal economic activities in urban areas has been multiplying.

Secondly, the LDCs must deal with the employment challenge in an open-economy context. Very few LDCs have restrictive trade regimes at present, and most have undertaken rapid and extensive trade liberalization. But their existing production and trade structures offer very limited opportunities in a rapidly globalizing world driven by new knowledge-intensive products and services with demanding conditions of market entry. At the same time, rapid opening up in more traditional sectors is exposing existing producers to an unprecedented degree of global competition. Benefiting from recent technological advances requires advancing towards and crossing various thresholds in human capital, research and development (R&D) and management practice, which most LDC economies have lacked the resources to do. The relentless logic of cumulative causation strongly threatens to push LDCs even further behind, and LDCs will also face new challenges associated with climate change.

The recent food, fuel and financial crises have highlighted the economic vulnerability of the LDCs. The global financial and economic crisis must be seized as an opportunity for moving beyond business as usual.

III. Productive capacities as the basis for a paradigm shift

There is a widespread search for pragmatic and constructive policies which can foster new, more inclusive development paths in LDCs. UNCTAD has argued in successive *LDC Reports* that the key to achieving sustained development and poverty reduction in the LDCs is to put the development of productive capacities – and the related expansion of productive employment – at the heart of national and international policies.

The term “development of productive capacities” is understood by different people in different ways. From the UNCTAD perspective, it does not refer to the expansion of export supply capacities or to technical assistance which is oriented to improve entrepreneurial capabilities, though both of these elements are usually part of the process. Rather, the development of productive capacities refers to the expansion of productive resources, acquisition of technological capabilities and creation of production linkages which permit a country to produce an expanding array of goods and services and enable a beneficial integration into the global economy on the basis of an internal momentum of growth development.

From the UNCTAD perspective, the development of productive capacities occurs through three inter-related processes – capital accumulation, technological progress and structural change. Capital accumulation and technological progress not only lead to the expansion of existing productive potential. They facilitate a process of diversification away from sectors characterized by diminishing returns towards sectors characterized by increasing returns, as well as a shift in the form of integration of LDCs with the global economy. Substantial poverty reduction occurs as employment opportunities increase along with the transformation of the productive base of the economy. The ways in which productive capacities are developed are also critical for ensuring sustainable development and the emergence of a low-carbon trajectory.

In line with the principle of *policy diversity*, given the variety of the LDCs, heterogeneity of market conditions among countries at different levels of economic development, as well as structural global asymmetries, the shift to a productive-capacities-led policy approach will have to be flexible and take into account differences in development and income levels, economic structures and factor endowments. But focusing on building productive capacities will require a paradigm shift with respect to current national and international policies – a different approach to poverty reduction, to the role of the state, and to international trade, finance and technology.

IV. The nature of the paradigm shift

A. The approach to poverty reduction

The paradigm shift advocated here places production and employment at the heart of efforts to reduce poverty. This does not mean that social sector spending and human development targets are unimportant. Indeed, health, education and social welfare should be seen as part of the process of developing productive capacities. However, it goes beyond this. It links sustained and substantial poverty reduction to the development of productive base of a society. The capacity to consume of a society is related to its capacity to produce. Employment expansion is at the heart of poverty reduction.

B. The role of the State

The idea of developing productive capacities is not absent from the current policy approach. At present, emphasis is being placed on improving the overall investment climate, in particular through the reduction of bureaucratic red-tape and governance-related costs of doing business. But whilst this is important, it is insufficient in an LDC context characterized by extensive structural weaknesses. The paradigm shift advocated here involves a different approach to the development of productive capacities. There is a need for a more proactive approach to developing productive capacities which will require the state playing a more developmental role and a better balance between markets and the state. Empowering national leadership in the design and implementation of national development strategies, and policy space for pragmatic experimentation are vital issues.

C. The new approach to international trade, finance and technology.

The paradigm shift advocated here also involves a different approach to international trade, finance and technology.

Since the early 1980s, there has been a strong tendency for ideas from international trade theory to dominate understanding of development processes. This occurred initially through comparisons between the relative success of “outward-oriented” and “inward-oriented” development strategies, which were associated with particular trade policy regimes. But it was reinforced during the 1990s through arguments that fast and full integration with the world economy was the key to seizing the opportunities of globalization and minimizing the chance of being left behind. From this perspective, global integration began to substitute for national development as the major policy objective of Governments.

Recent experience shows that this is much too simplistic and indeed the most successful developing countries have not followed the orthodox policy prescription. In the approach advocated here, international trade is seen as essential for the development of productive capacities, and the development of productive capacities is seen as essential for international trade. But the paradigm shift entails starting at the development end, rather than the trade end, of the relationship between trade and development. National and international policies which can facilitate this must be rooted in a development-driven approach to trade rather than a trade-driven approach to development. The policy approach advocated here thus focuses first on production, and then from this perspective identifies how international trade can support capital accumulation, technological change, structural change, employment creation and poverty reduction. What matters is not to maximize trade, but to maximize these beneficial effects of trade. Issues related to changing the form of trade integration (via increased domestic value-added, upgrading or diversification) are central.

With regard to finance, aid inflows to LDCs increased significantly in the 2000s. But the long-term shift in the composition of aid away from production sectors and towards social sectors has been reinforced in recent years. Due to low levels of domestic resource mobilization, LDCs also remain in conditions of unhealthy aid dependency, which is undermining the possibility of genuine ownership of national development strategies. Changes in the aid architecture are thus important as well as a broader approach to development finance in which aid works to leverage other forms of development finance. More fundamentally, the productive capacities approach gives greater emphasis to domestic resource mobilization and the promotion of investment, both domestic and foreign. Using aid to end, rather than reinforce, aid dependence is an important objective.

With regard to technology, it is clear that the building of science, technology and innovation (STI) capacity in the LDCs is a prerequisite for structural change and long-term economic growth and poverty reduction. Applications of science and technology have also become central in facilitating the achievement of international development goals related to poverty reduction, health, education and the environment. Indeed, technology has become the dividing line between development and underdevelopment, and LDCs lag far behind in their technological capacities. Changes in the international knowledge architecture are necessary to foster technology transfer, and national policies must also be adjusted to promote effective absorption and diffusion of technologies in LDCs.

V. Key general issues for discussion

The pre-event will examine what the focus on developing productive capacities means for firstly, the design of national policies to promote development and poverty reduction in LDCs and secondly, international support measures for LDCs by their development partners.

Issue One: What is the role of the State in the development of productive capacities? How to build capable developmental States in the LDCs?

UNCTAD has argued that developing productive capacities necessarily entails a more developmental role for the State. It has advocated a mixed economy model in which the government harnesses the profit motive of the private sector towards the achievement of national development objectives. This requires:

- Macroeconomic policies oriented to promote growth, investment and employment;
- A developmental agricultural policy and a developmental industrial policy to promote productive development in sectors;
- A strategic trade policy which uses available flexibilities to promote diversification and value-addition;
- An active approach to promoting firm-level entrepreneurial capabilities and innovation to create new activities.

Issue Two: What international support measures can effectively promote the development of productive capacities?

At the Third United Nations Conference on the Least Developed Countries (LDC-III) in Brussels, the major innovative idea was the Everything But Arms Initiative of the European Union (EU). A basic aim of the pre-event will be to contribute to building political consensus and analytical basis for thinking about a new generation of international support measures for LDCs. Such measures should dovetail with national policies and work more effectively to achieve sustained growth, productive employment generation and poverty reduction. What new initiatives are possible for LDC-IV? Is it possible to move away from an exclusive reliance on market access preference-based support measures and to work towards a new set of measures which focus on the development of productive capacities?

These initiatives could involve forms of technical and financial assistance which improve national policies, as well as various forms of South-South development cooperation and new global initiatives.

VI. Concrete actionable initiatives

Possible initiatives here could include:

- International financing of national technology funds to promote enterprise innovation in LDCs;
- Periodic forums under the auspice of the United Nations in which LDCs meet and exchange experience on aid and debt management;
- Incentives for public-private partnerships to support private investment, including foreign direct investment (FDI), in infrastructure in LDCs;
- A regional approach to infrastructure development based on spatial development corridors;
- Mechanisms which can increase the developmental impact of Southern FDI; and
- Making preferential market access for the exports from LDCs commercially meaningful and beneficial for development of productive capacities.

A. International financing of national technology funds to promote enterprise innovation in LDCs – the Spark Initiative

In the last 10 years, the focus on increasing access to finance in LDCs has been on microcredit and deepening capital markets. This has addressed the problem of financing of microenterprises and large enterprises. However, there is a critical gap in access to finance for the few firms in the “missing middle” of the enterprise structure. Since enterprise innovation is the backbone of successful industrial development, there is a need to provide a policy, financing and institutional framework for rectifying the weakness of the enterprise sector in LDCs in this area. The International Spark initiative could be a way for the international community to address these issues. It would involve the setting up of national technology/innovation funds which would be internationally financed through official aid, and/ or private foundations or sovereign wealth funds.

The fund should support different kinds of small and medium-sized enterprises (SMEs), including dynamic microenterprises in the informal sector. The types of innovation to be supported should cover a broad spectrum of activities: equipment modernization, technology transfer from abroad, development of local technological capabilities, introduction of new materials, imitation, backward engineering, design, engineering, learning/training, and R&D. However, given the weaknesses of the private sector in LDCs, it is important that the financing mechanism be designed for bundling with various business development services. Part of the innovation process may involve technology transfer, which has its own specific challenges, and these could also be incorporated in the initiative. For example, SMEs in industrialized countries have untapped potential for technology transfer, but they need to be offered incentives, such as a subsidy, as market prices are not enough. But technology transfer will only be effective if it is accompanied by supporting the building of technology capability in the transferee. In general the International Spark Initiative could provide a way of making Article 66.2 of the Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement, which obliges developed countries to provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to LDCs, work.

B. Periodic forums under the auspice of the United Nations in which LDCs meet and exchange experience on aid and debt management

One important obstacle to a more development-oriented economic model in LDCs is a low national ownership of development strategy. In general, the latter has been a product of policy advices of international financial institutions through Poverty Reduction Strategy Papers (PRSPs) and official development assistance (ODA) donors' conditionalities. There is thus a constant tension between the promotion of country ownership and the desire of the international financial institutions (IFIs) and the bilateral donors to ensure that their assistance is being used to support what they regard as credible development strategy.

Country ownership of national development strategies is the cornerstone of development effectiveness and also aid effectiveness. One step that can be taken to increase country ownership is the adoption of an aid management policy in LDCs. This can play an important role in reducing the multiple ways in which aid delivery is undermining ownership by being unaccounted, off-budget, off-plan and misaligned. An aid management policy differs from a national development strategy. The latter identifies goals, objectives and targets, and the actions needed to achieve them, whereas the former should ensure that assistance received is of such a type, and is so deployed, as to maximize its contribution to the priorities set out in the country's development strategy. In this way, development strategies would no longer be devised with a view to seeking aid, but instead they would focus on LDCs' strategic interests and national needs as identified by their own policymakers.

One possible international support mechanism for the LDCs would be an international forum under the auspices of the United Nations, in which they could periodically share their experiences with aid and debt management policies. Such a forum could build on existing work by UNCTAD and the United Nations Development Programme (UNDP) on debt management. This would help them draw up best practices building on the pioneering experiences of countries such as Uganda and the United Republic of Tanzania, which have already adopted such policies.

C. Incentives for public-private partnerships to support private investment, including FDI, in infrastructure in LDCs

Given the scale of the needs for infrastructure development in the LDCs, efforts should also be made to increase private sector participation in the provision of infrastructure. One way to do that is to focus on the challenge of mitigating risks for foreign investors in LDCs, particularly in infrastructure. Several proposals could be made in that direction:

- Increase funding of multilateral risk insurance agencies such as Multilateral Investment Guarantee Agency (MIGA) for the creation of a special purpose capital or guarantee pool by like-minded donors which would be dedicated to covering political and non-commercial risk in LDCs;
- Sponsor a regional risk cover agency or create institutional capacity at the EU level which would focus on LDCs political risk cover and would seek the same status as MIGA;
- Create more capacity in regional development banks for providing regional risk cover;
- Increase the non-commercial risk insurance capacity of bilateral export credit agencies and official bilateral insurers through specific funding and subsidies to cover a wider range of non-commercial risks in LDCs;
- Provide project-related subsidies to cover the premium costs of political risk insurance and non-commercial risk insurance for specific projects being undertaken by Organization for Economic Cooperation and Development (OECD) source countries or eligible developing-country firms in LDCs; and
- Establish credit enhancement arrangements for mobilizing available domestic funding – in developing countries in general but also, particularly, in LDCs.

These measures could be further enhanced through home-country measures that encourage outward FDI to LDCs. In this regard, Development Assistance Committee (DAC) donor countries could consider:

- Providing full (100 per cent) or a large percentage (50–80 per cent) of tax credits, rebates or deductions (depending on which of these would have the greatest impact on influencing TNC behaviour in the donor country concerned) on equity invested by the home-country companies in LDCs against their tax liabilities in their home countries;

- Establishing special-purpose investment promotion departments for FDI in LDCs (with commensurate budgets) within bilateral aid or investment agencies, thus ensuring that support for FDI flows to LDCs becomes a major priority in bilateral aid;
- Exploring the possibility of establishing a small special-purpose LDC infrastructure investment fund that would provide equity and debt financing and of mobilizing domestic-currency resources for lending to infrastructure projects in LDCs.

If such measures were to be implemented to attract private capital inflows for infrastructure development, it would be important to ensure that their spillover effects (such as technology and skills transfer) also benefit domestic investors.

D. A regional approach to infrastructure development based on spatial development corridors

To bring down trade costs, LDCs have to invest in upgrading infrastructure and in trade facilitation reform. The LDCs' public sectors, however, lack the funds to support such investments and have insufficient institutional and human capacity to conduct such reforms. By working with private stakeholders, governments of developing countries can leverage capital for investments in infrastructure and promote improved and coordinated infrastructure planning. The economic viability of private investment is often limited by low traffic volume and long investment recovery periods, however. Development aid combined with public-private partnerships (PPPs) could provide a viable means to (a) fill the financing gap, (b) reduce the risk associated with the investment and (c) provide know-how or skills that might be new to government agencies and would require the allocation of extra resources and time.

The effectiveness of infrastructure investment and trade facilitation reforms multiplies when projects are planned as part of a cross-border or regional initiative. The development of transport corridors provides an example where public and private investment and joint efforts are focused on improving commonly identified trade facilitation and transportation bottlenecks across national borders. Developing cross-border infrastructure would strengthen regional integration initiatives. Building transnational structures such as roads, railways, waterways, air transport links, telecoms and energy supply lines (development corridors) has an even stronger impact on the development of productive capacities of neighbouring countries if it is accompanied by local development projects in different sectors (e.g. agriculture and industry).

One example of this combination of projects is the Spatial Development Initiatives (SDIs) launched by South Africa. Its main project is the Maputo Development Corridor involving the Maputo Corridor Toll road, the railway from Ressano Garcia to Maputo and the Maputo Port and Harbour, as well as projects in agriculture, mining and tourism. The New Partnership for Africa's Development (NEPAD) also plans to help establish Pan-African corridors and networks. Since these are large-scale and long-term projects, their financing requires a combination of funding from national budgets, donors (from the North and South) and regional and multilateral financing institutions.

E. Mechanisms which can increase the developmental impact of Southern FDI

FDI flows from developing countries to LDCs can provide a number of development benefits, but these positive effects are not automatic; they generally require a number of policy actions. For example, governments of developing countries that invest in LDCs should strongly encourage their firms to adopt mechanisms that promote the development of productive capacities in LDCs. The home-country governments can directly influence their outward investors, especially if these are State-owned companies, financed by official institutions or sovereign funds.

Home-country governments can also adopt policy measures to influence the behaviour of their private firms dealing with LDCs. They can grant preferences (e.g. financial and fiscal incentives) to enterprises investing in LDCs to promote development through their FDI, for example by creating more domestic linkages in the host LDC economies, effectively transferring knowledge to LDC firms, developing innovative activities and generating more fiscal revenues for the host countries.

Many of the conditions and objectives that determine the development impact of FDI are contained in agreements between foreign investors and host-country governments. In addition to the fair appropriation of natural resource rents by national agents, several other measures for improving the development impact of FDI can be included in LDC host-country legislation or in the terms of agreements between the recipient LDC governments and investors. The following are examples of such measures:

- Requiring TNCs from developing countries to provide training and knowledge transfer to their local employees, as well as subcontracting farms and firms with which they establish backward linkages;
- Modalities that result in a greater development impact of FDI on LDC agriculture;
- Targets for sourcing a certain proportion of inputs domestically;
- Targets for introducing a level of processing of raw materials in the host country, where this is technically feasible; and
- Conducting some R&D activities in the LDC host country.

LDC host-country Governments should formulate an FDI policy that provides incentives for foreign investment in sectors and areas that would help resolve supply and delivery bottlenecks as well as structural deficiencies in their countries. These policies and objectives should be reflected in the terms of establishment negotiated with the foreign direct investors. Multilateral and regional financing institutions can also facilitate FDI from developing countries, which is conducive to LDCs' long-term development and diversification. Such institutions should favour those sectors or investment projects that are the most likely to foster local employment creation, transfer of knowledge and the building of linkages with the domestic economy.

F. Making preferential market access for the exports from LDCs commercially meaningful and beneficial for development of productive capacities

Product coverage and Rules of Origin (RoO) are two major issues regarding preferential market access of LDCs. In United States, African Growth and Opportunity Act (AGOA) benefits for sub-Saharan Africa are significant for those receiving apparel benefits because preferential margin is large and existing preferences are fully used by eligible exporters. In contrast, Asian LDCs trading under normal General System of Preferences (GSP) scheme do not enjoy similar preferences. This implies scope for improvement by extending product coverage for Asian LDCs. Rules of origin, for their part, have been identified as one of the main obstacles for full utilization of the preferential market access. Therefore, rules of origin for LDCs' exports should be liberalized, simplified and made more transparent in accordance with the Hong Kong (China) Declaration.

In addition, new, innovative ways to make preferential market access for the exports from LDCs commercially meaningful should be explored. For example, developed countries could encourage their domestic firms through the provision of favourable tax treatment or grant support for partial cost-coverage to develop supply sources in the LDCs. This would enable the LDCs to take advantage of the preferential market access they have been offered but are at present unable to exploit due to their insufficient supply-side capacity. Another possibility is to encourage developing-country investors to invest in LDCs to take advantage of LDCs' preferential market access. This form of South-South cooperation could strengthen development in both LDCs and other developing countries. Duty-free quota-free initiatives could also be linked with support measures aimed at building productive capacities, facilitating integration into supply chains, promoting trade and competitiveness in beneficiary LDCs such as Aid for Trade.

VII. Outputs from the event

The discussion within the event should provide two types of output. Firstly, recommendations on the type of language which might go into a New Programme of Action for LDCs. Secondly – and perhaps most important – a set of proposals for deliverables (concrete actionable initiatives) which would support the development of productive capacities in the LDCs and could constitute part of a new set of LDC-specific international support mechanisms. The six possible international support initiatives for LDCs listed above are meant to be catalytic rather than exclusive.