

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE LEAST DEVELOPED COUNTRIES REPORT 2008

Growth, Poverty and the Terms of Development Partnership

OVERVIEW

by the Secretary-General of UNCTAD



UNITED NATIONS

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
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Overview

The strong growth performance of the least developed countries (LDCs) as a group has been one of the most encouraging features of the global economy in the current decade. Economic growth since 2000 has been higher than in the 1990s. In 2005 and 2006, there was further growth acceleration and the LDCs together achieved their strongest growth performance in 30 years. Their average growth rate in both these years exceeded the 7 per cent target set by the LDCs and their development partners as a key goal in the Brussels Programme of Action for the Least Developed Countries for the Decade 2001–2010, agreed at the Third United Nations Conference on the Least Developed Countries in 2001. It is estimated that, in 2007, there was only a slight slowdown, to 6.7 per cent.

Against this background, this Report considers three issues. Firstly, it assesses how sustainable economic growth is in the LDCs and examines how many LDCs are participating in the growth surge. Secondly, it considers the extent to which economic growth is leading to improvements in human well-being, and in particular to accelerated poverty reduction and improved progress towards the Millennium Development Goals. Thirdly, it assesses progress towards country-owned development strategies in LDCs and the role of recipient-led aid management policies at the country level as a practical policy mechanism to strengthen country ownership. These are central aims of the Paris Declaration on Aid Effectiveness, adopted in March 2005, whose implementation status will be assessed in Accra, Ghana, in September 2008.

There are major downside risks to the sustainability of rapid growth. This reflects the fact that the type of growth which is occurring in most LDCs is strongly affected by trends in international markets and, in particular, commodity prices. On top of this, the LDCs depend heavily on external sources of finance, particularly official development assistance (ODA), rather than domestically-generated resources. The LDCs are growing rapidly, but without a positive process of diversification and structural change. As a result, they are very vulnerable to trade shocks due to the volatility of commodity prices, affecting both exports and imports. But the aid inflows which provide their major source of external finance are mainly directed towards improving social

services and social infrastructure, including governance mechanisms, rather than increasing their productive capacities and promoting structural change and diversification.

The expectation implicit in the prevailing development policy paradigm was that investment in productive sectors would be taken care of by the international private sector, through access to international capital markets or inflows of foreign direct investment (FDI). But this has proved to be an illusion in the former case, as LDCs remain almost entirely marginalized from this source of finance. As for FDI, inflows have concentrated on a few LDCs and have often been weakly linked with the rest of the economy. Workers' remittances are growing and — while playing a role in directly alleviating poverty for those who receive them — their contribution to development by financing investment remains to be proven. They should not be seen as a substitute for long-term capital inflows, and deliberate policies are required to enhance their developmental impact.

The relationship between economic growth and human well-being is a complex issue. Rapid economic growth in the LDCs has been associated with a slow rate of poverty reduction and human development, as gauged by their progress towards the Millennium Development Goals. In 2005, 36 per cent of the total population of the LDCs lived in extreme poverty — that is to say on less than \$1 a day — and 76 per cent subsisted on less than \$2 a day. Although the incidence of poverty (i.e. the share of the population living in poverty) is falling slowly, the number of people living on less than \$1 a day or on less than \$2 a day was larger in 2005 than in 2000.

The LDCs as a group are off track to achieve the goal of reducing the incidence of poverty by half between 1990 and 2015, and there is no evidence of a significant change in the trend since 2000, after the adoption of the Millennium Declaration and more socially-oriented policy reforms. For most human development indicators for which data are available for a wide sample of LDCs, less than half the countries are on track to achieve the Millennium Development Goals, and for some indicators, only one third of the countries or even less are on track. The effects of soaring international food prices in 2007 and early 2008 are likely to be more severe in the LDCs than in other developing countries. Rising international prices are already being transmitted to national markets, and rising food prices will have negative effects on poverty trends

in the LDCs, further slowing progress towards the Millennium Development Goals.

The weak correlation between growth and improvements in human well-being arises because of the type of economic growth which is occurring. This can not generally be equated with an inclusive process of development. In most LDCs, the majority of the population is employed in agriculture, but agricultural labour productivity is very low and growing very slowly. As it is difficult to make a living in agriculture, more and more people are seeking work in other sectors of the economy. However, remunerative employment opportunities are not being generated quickly enough to meet this growing demand for non-agricultural work. With this accelerating process of “deagrarianization”, poverty in LDCs now has two faces. One face is low-productivity, small-scale agriculture; the other is low-productivity, urban, informal-sector activities in petty trade and services.

As discussed in the last three *Least Developed Countries Reports* — on *Knowledge, Technological Learning and Innovation for Development* (2007), *Developing Productive Capacities* (2006) and *Linking International Trade with Poverty Reduction* (2004) — the trends which are occurring are related to policy choices, in particular the development model which has been pursued in most LDCs. This model has sought to deepen the integration of the LDCs into the world economy, increase the efficiency of resource allocation and free markets. Global integration is vital for development and poverty reduction in LDCs. However, without the development of productive capacities and associated employment, external integration does not lead to inclusive development. Export-led growth without associated expansion of sectors serving domestic markets often leads to an exclusive pattern of economic growth. The impact of the soaring international food prices illustrates the vulnerability of LDCs following the current approach, and underlines the need for a policy change towards more sustained and inclusive development. As UNCTAD said at the High-level Conference on World Food Security in June 2008 in Rome, the food crisis is a development crisis.

With the global economic outlook worsening, most LDCs will face major challenges in the period ahead. This will require renewed efforts by both the LDCs and their development partners to develop the productive base of LDCs and address their structural weaknesses. Otherwise, the marginalization of the LDCs in the global economy is likely to deepen. Most of them are highly

vulnerable to rising oil and food prices. Their export performance depends heavily on volatile commodity prices or on low-skills manufactures in which global competition is intensifying. In addition, as the reaction to the recent food price increases shows, with the high levels of poverty in LDCs, external shocks can easily lead to social unrest and conflict. To build economic resilience, they need to improve agricultural productivity and diversify their economies to create non-agricultural employment opportunities. As argued in earlier *Least Developed Countries Reports*, this requires a new development model focused on building productive capacities and shifting from commodity-price-led growth to catch-up growth.

Achieving a more sustainable type of economic growth and better poverty reduction and social outcomes in LDCs requires effective national development strategies, effective development aid and development-friendly international regimes for trade, investment and technology. The fundamental priority for LDC Governments is to formulate and implement national development strategies that promote sustained development and poverty reduction. Their development partners need to: (a) scale up aid flows to meet their commitments; (b) align aid flows to the priorities expressed in LDCs' national development strategies; and (c) deliver aid in ways which respect country leadership in the formulation and implementation of their national development strategies and help to strengthen their capacity to exercise such leadership.

Unfortunately, the Report finds that there are still major constraints on the ability of LDC Governments to exercise effective leadership in the design and implementation of their national development strategies and policies. This arises because of very high levels of dependence on donor finance, weak technical capacities, the continuing bark and bite of policy conditionality, the slow progress in aid alignment with country plans and budgets, and donor financing choices.

Weak country ownership has negative consequences for governance. When politicians and policymakers feel inhibited from saying and doing certain things because of a sense of aid dependence, the political qualities of a free-thinking society atrophy. The Report shows that weak country ownership is also having adverse consequences for development effectiveness. This is particularly due to: (a) the weak integration of the macroeconomic framework with sectoral and trade policies; (b) the downscaling of ambition in relation to increased aid inflows; and (c) the low financing of productive sector development.

Increasing country ownership should be a major priority for both LDC Governments and their development partners in order to improve development effectiveness. This will involve action on a range of fronts, which include in particular further consideration of the issues of policy conditionality and aid predictability, and the building of local research and policy analysis capacity which can support the generation of policy alternatives and in particular home-grown solutions. However, one of the principal recommendations of the Report is that a first step towards improving country ownership could be to adopt recipient-led aid management policies within LDCs. The Paris Declaration encourages countries to do this. Moreover, some LDCs are global pioneers in the introduction of country-level aid management policies. The Report urges other LDCs to follow their lead.

HOW SUSTAINABLE IS LDCs' GROWTH?

The importance of trade

The record rates of economic growth achieved by the LDCs as a group in 2005 and 2006 were underpinned by a record of level of exports — which was particularly associated with high commodity prices for oil and minerals — and record levels of capital inflows, particularly aid.

The export performance of the LDCs as a group was particularly remarkable. In nominal terms, the value of merchandise exports from LDCs rose by some 80 per cent from 2004 to 2006, reaching \$99 billion in 2006. This aggregate picture is being driven to a large degree by the enhanced export performance of oil-exporting LDCs (Angola, Chad, Equatorial Guinea, Sudan, Timor-Leste and Yemen), as well as by mineral exporters (Democratic Republic of the Congo, Guinea, Mali, Mauritania, Mozambique and Zambia). Seventy-six per cent of the total increase in LDCs' merchandise exports from 2004 to 2006 can be attributed to these countries. The increase is largely explained by rising international commodity prices.

For the LDCs as a group, dependence on commodities has increased since 2000, along with the growth acceleration. Primary commodities increased from 59 per cent of total merchandise exports in 2000–2002 to 77 per cent in 2005–2006. Within this overall pattern, however, there was considerable

divergence between African, Asian and island LDCs. The Asian LDCs continued to diversify their economies away from commodities towards manufacturing, while African LDCs increased dependence on primary commodities. Island LDCs remained primarily dependent on service exports, which also exhibit high levels of volatility.

The widening regional divergence between African and Asian LDCs in terms of the form of their integration into the global economy is evident in their different export structures. In the period 2005–2006, over 92 per cent of all exports from African LDCs consisted of primary commodities, including fuels, while in Asian LDCs, this figure was less than half (44 per cent). This type of specialization rendered Asian LDCs much less vulnerable to external fluctuations. Some of them also achieved high rates of export growth based on manufactures. However, the share of medium- and high-tech manufactures exports originating from LDCs remained very small (8.4 per cent). The slowness of the process of export upgrading, even in Asian LDCs, remains an issue of concern.

The ability to compete in global markets and increase manufactures exports has helped Asian LDCs promote a limited degree of structural transformation in which manufacturing is increasing as a share of gross domestic product (GDP). However, for the LDCs as a group, the recent growth surge is not generally associated with a structural transition in which the share of manufacturing in total output is growing. In fact, compared to ten years ago, half of the LDCs have experienced deindustrialization as measured by a declining share of manufacturing in GDP.

Whilst exports have boomed in LDCs, imports have also surged. In 2006, 42 LDCs had trade deficits and, in 37 of them, this deficit was higher in 2006 than it was in 2003–2004. The merchandise trade deficit of oil-importing LDCs has increased from \$25 billion in 2005 to \$31 billion in 2006. By contrast, the merchandise trade surplus of the oil-exporting LDCs rose from \$11 billion in 2004 to \$29 billion in 2006. Together, oil and food constituted 30 per cent of LDCs' merchandise imports in 2006.

Most LDCs are highly dependent on food imports. In 2005–2006, the food import bill of the LDCs as a group reached \$14.6 billion, which was equivalent to 4.4 per cent of their GDP. This is \$6.1 billion higher than in 2000–2002, an increase equivalent to some 2 per cent of their GDP in 2005–2006. It is against

this background that soaring food prices in 2007 and early 2008 are having such a negative impact on LDCs.

Continuing high dependence on external finance

Despite the record rates of economic growth, LDCs remain highly dependent on external finance. The level of domestic savings continues to be low in many LDCs, including good performers, which have achieved rapid economic growth. In 2006, only one third of the LDCs had gross domestic savings rates above 15 per cent of GDP. Fifteen LDCs had negative domestic savings rates, meaning that they were relying on foreign savings not only to finance domestic investment but also their domestic consumption.

ODA inflows are particularly important. In this regard, it is encouraging to note that net aid disbursements reached the record level of \$28 billion in 2006. Sixteen LDCs also received significant debt relief in 2006, with \$27 billion ODA principal being forgiven for 16 of them through the Multilateral Debt Relief Initiative. However, only eight Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee members (Luxembourg, Norway, Denmark, Sweden, Ireland, Netherlands, Belgium and United Kingdom) met the Brussels Programme of Action target of making net ODA disbursements equal to or higher than 0.15 per cent of their gross national income (GNI), whilst six of these countries (the above countries minus Belgium and the United Kingdom) met the higher target of 0.20 per cent of GNI.

Multilateral and bilateral aid commitments are increasingly concentrated on social infrastructure and services. ODA commitments to social infrastructure and services constituted 42 per cent of total ODA commitments to LDCs in 2006, up from an average of 34 per cent during the period 2000–2004 and 31 per cent in the second half of the 1990s. In 2006, the share of aid going to education, health, population programmes, water supply and sanitation, Government and civil society all were higher than during the period 2000–2004. This reflects the impact of the focus on the Millennium Development Goals as well as the concern to improve governance. In contrast, aid to build productive sectors and economic infrastructure has continued to receive less priority. The share of aid committed to economic infrastructure and production sectors (including multisector) constituted just 25 per cent of total ODA commitments to LDCs in 2006. This was similar to the level during the period 2000–2004.

Despite all the rhetoric of a renewed interest in economic infrastructure, the share of aid committed to transport, storage and energy was less in 2006 than it was in 2000–2004, and the portion committed to agriculture (including forestry and fishing) and industry (including mining and construction) also declined over that period. The share of aid committed to economic infrastructure and production sectors was also much lower than in 1995–1999, when it had been 38 per cent. Aid commitments to improve economic infrastructure decreased from 18 per cent of total commitments to LDCs in 1995–1999 to 12 per cent in 2006. Commitments to transport and storage infrastructure decreased from 11 per cent of total commitments to LDCs in 1995–1999 to 6 per cent in 2006, and disbursements to energy-related sectors shrunk from 5 per cent to 2 per cent in 2006.

These trends perhaps reflect the assumption that the international private sector can take over from official finance in these sectors. In practice, however, this assumption has proved flawed. LDCs remain marginalized from international capital markets. There has been a trend towards increased FDI inflows, which reached a level of \$9 billion in 2006 after faltering in the previous years. Moreover, manufactures-exporting LDCs are now also attracting more FDI. Nevertheless, most FDI still remains concentrated on natural resource extraction, particularly of oil and minerals, and profit remittances on FDI are rising rapidly.

Migrant remittances reached the record level of \$13 billion in 2006 and are particularly important for a few Asian countries. However, channelling these resources to finance long-term development rather than just short-term poverty alleviation remains a challenge to policymakers.

To sum up, the record rates of economic growth are welcome, but LDCs remain locked into a pattern of economic growth which makes them highly vulnerable to external shocks and in particular international commodity price volatility. Given the high levels of poverty, there is little surplus to deal with shocks, and domestic savings are very low. The development of productive capacities and diversification thus depends heavily on external finance. ODA is particularly important because LDCs have very limited access to international capital markets and FDI is mainly resource-seeking and focused on a few countries. However, ODA is mainly directed towards social sector development rather than building economic infrastructure and productive capacities. The allocation of ODA to health, education and other social purposes is of course important, and in itself makes a partial contribution to building productive

capacities, but the key to strengthening the resilience of LDC economies is to build the capabilities of domestic producers and to diversify and strengthen linkages.

TRENDS IN POVERTY AND PROGRESS TOWARDS THE MILLENNIUM DEVELOPMENT GOALS

Trends in terms of poverty reduction and progress towards the Millennium Development Goals have not been as apparently positive as the economic growth trends. Indeed, improvements in human well-being on these dimensions have been quite slow.

Trends in poverty

The incidence of extreme poverty (measured as the proportion of the people living on less than \$1 a day) has decreased from a peak of 44 per cent in 1994 to 36 per cent in 2005. But the absolute number of extremely poor people continued to rise in the LDCs until 2003, when the upward trend leveled off. Poverty reduction has been much faster in Asian LDCs than in African LDCs, where the absolute number of extremely poor people continues to rise. In 2005, we estimate that 277 million people lived on less than \$1 a day in all LDCs, including 206 million in African LDCs, 71 million in Asian LDCs and 1 million in island LDCs. Classifying LDCs according to their export specialization, poverty incidence is highest in commodity exporters, i.e. those for which petroleum, mineral and agricultural products account for the majority of their exports.

Although the incidence of extreme poverty is declining, the proportion of the population living on more than \$1 a day but less than \$2 a day has remained constant, at approximately 40 per cent of the population. The population living on less than \$2 a day has been declining only very slowly. In 2005, 581 million people lived under these conditions in the LDCs. This corresponds to three quarters of the population, which shows that poverty continues to be pervasive in these countries.

Growth and poverty in the LDCs

The relationship between economic growth and human well-being is a controversial subject with many different viewpoints. This Report finds that the recent period of rapid economic growth in the LDCs has been associated with a slow rate of poverty reduction and progress towards the Millennium Development Goals because of the type of economic growth that is occurring and the development model in place in the LDCs.

Since 2000, economic growth has accelerated sharply in the LDCs, but this has been accompanied by only a marginal increase in the pace of poverty reduction, contrary to expectations. Thus, the relationship between economic growth and poverty reduction has weakened in the LDCs since then. This is explained by five main reasons:

(a) Private consumption has been growing at a lower rate than total GDP.

Private consumption provides the link between macroeconomic growth and well-being at the household level. Standards of living can only improve if private consumption is rising. Conventionally, private consumption growing by less than GDP frees more resources to finance investment and the provision of public services. However, in a context of widespread poverty, there may be a conflict between the objectives of domestic resource mobilization and poverty reduction, which can only be lessened through foreign savings;

(b) The population of the LDCs has been growing faster than in any other large groups of countries.

Reducing poverty under these circumstances requires that the economy create productive jobs and livelihoods at a very fast pace in order to absorb the rapidly growing working-age population. Economic growth in most LDCs, however, has not led to a hefty expansion of employment, and the jobs that are being created are mostly low-productivity and low-paying jobs. This reduces their contribution to poverty reduction;

(c) Economic growth in LDCs has mostly been led by the expansion of exports.

This type of growth dynamic is often concentrated within an externally oriented enclave, such as capital-intensive natural resource extraction sites or export-processing zones, with few linkages with the rest of the economy. Such a pattern of growth generally benefits limited segments of the population (those somehow linked to export activities), while leaving the majority excluded. This is particularly the case for those earning their livelihoods from agriculture. They are almost 70 per cent of the population and their earnings depend on agricultural productivity. This has traditionally

been low in most LDCs and — more worryingly — it has been growing only very slowly since the early 1990s. This situation tends to perpetuate pervasive poverty in the LDCs;

- (d) A more recent development has compounded the difficulties in combating poverty in these countries, namely deagrarianization.** This refers to a process in which more and more people from rural areas seek work outside agriculture. It could be positive if people were pushed out of agriculture by rising productivity and pulled into other sectors by the new employment opportunities being created outside agriculture. There are signs of such a structural transformation in a few Asian LDCs, which have combined rising food productivity based on a “Green Revolution” with steady industrialization founded on expansion of manufacturing exports. However, for most LDCs, deagrarianization is a negative process in which people are pushed out because they cannot make a living in agriculture. Even worse, they cannot find remunerative work elsewhere. As a result, there are now two faces of poverty in LDCs: poverty associated with long-standing agricultural neglect; and urban poverty, most dramatically evident in growing numbers of unemployed youth; and
- (e) Income inequality is hindering poverty reduction in many LDCs.** Worsening income distribution — i.e. increasing inequality — can slow the shrinking of poverty, even in countries experiencing strong economic growth. This has been the case in recent years in a majority of LDCs for which data are available.

Progress towards the Millennium Development Goals

Very low material living standards are associated with very low levels of well-being in terms of a broad range of social indicators. As with the analysis of poverty trends, lack of data availability seriously hampers analysis of progress towards the achievement of the Millennium Development Goals that deal with human development. However, for the few indicators for which it is possible to get information for a wide range of countries, a clear pattern is emerging. This pattern has four basic features:

- (a) Some LDCs are making significant progress towards achieving some specific Millennium Development Goals, but there are very few LDCs that are making progress on a broad front encompassing more than three targets;
- (b) More progress is being made on targets which depend primarily on the level of public service provision, and Governments and donors are committed to

increasing public expenditure and implementing well-targeted programmes. In this regard, progress towards universal primary school enrolment shows what can be done in quantitative terms;

- (c) There is a distinct hierarchy of achievement which reflects two factors: the priorities of Governments and donors who are funding the scale-up, and the magnitude and time-scale of investments required to meet the targets. The conjunction of these two factors largely explains why achievements in increasing primary education enrolment outstrip progress in improving access to water, which in turn outstrips achievements in improving sanitation; and
- (d) Progress towards targets that depend more on household incomes rather than mainly on public service provision has been slowest. In this regard, progress has been slow in reducing the incidence of extreme poverty and hunger. It has also proved difficult to maintain progress in reducing child mortality, where trends reflect the effects of both private incomes and public services.

The overall implication of these trends is that broad-based success in achieving progress towards the Millennium Development Goals is as yet elusive in the LDCs. It is likely to remain so unless the achievement of the Millennium Development Goals is placed in an economic development framework and efforts focus on generating productive jobs and livelihoods, rather than just increasing the provision of public services directly linked to the Millennium Development Goals. An outcome in which the education targets were achieved but school leavers were left without the employment opportunities to exercise their skills and meet the new expectations would be tragic and dangerous.

THE IMPACT OF THE GLOBAL FOOD CRISIS ON LDCs

Rapidly rising international food prices in 2007 and early 2008 will have negative effects on poverty trends in LDCs and slow progress towards the achievement of the Millennium Development Goals. The negative effects will arise for the following reasons:

- (a) Rising food prices are restricting the ability of households to meet essential subsistence needs, given that their budget constraints were very tight even before the soaring prices;

- (b) The large increases in food prices threaten economic growth through rising import bills in countries that already face rising trade and current account deficits;
- (c) Rising food prices will have second-round effects on economic growth but farmers may not be able to adequately take advantage of rising prices because of their limited access to land, weak productive capabilities and a production and marketing cost squeeze associated with rising input and transport costs; and
- (d) Dynamic growth forces can be stalled, given that these prices will compress profits in formal businesses — as subsistence wages adjust to higher food prices — and the available resources of the self-employed, whose accumulation activity, to the extent that it occurs, is directly related to their food consumption costs.

The overall effects are likely to be particularly severe in the LDCs, because most of them are net food importers and they already have large trade deficits. Levels of poverty and food insecurity in LDCs are already high, and many people spend as much as 50–80 per cent of their household income on food. Moreover, for 20 LDCs, the price rises will exacerbate already-existing food emergencies, which require external assistance, owing to such factors as natural disasters, concentrations of internally displaced persons and localized crop failures. Food price riots had already occurred in eight LDCs by June 2008.

The need for a paradigm shift in development policy

The trends in economic growth, poverty, human development and food security that are taking place in LDCs and that are analysed in the preceding section are related to policy choices and to the development model which has been pursued in most LDCs. The current pattern of economic growth is neither robust nor inclusive enough. A basic message of this Report, therefore, is that it is time for a paradigm shift in development policy.

For some observers, the policy shift now required is a return to agricultural development. Indeed, as shown in *The Least Developed Countries Report 2007*, there has been a serious neglect of agricultural research and development, which is so important for increasing agricultural production and improving the living standards of small-scale producers. However, whilst improving agricultural productivity is vital, it is also important to improve productive

employment activities outside agriculture, particularly in view of the process of deagrarianization which is occurring. What is therefore required is not a shift in sectoral focus, but rather a deeper change in approach which puts production, productive capacities and productive employment opportunities at the heart of policies to promote development and poverty reduction.

The nature of this paradigm shift is discussed in some detail in *The Least Developed Countries Report 2006*, and its policy implications in relation to knowledge, technological learning and innovation are set out in *The Least Developed Countries Report 2007*. In brief, what we have been advocating has three elements:

- Policy should focus on production, productivity and productive capacities rather than global integration and international trade *per se*. International trade is essential for productive development and productive development is essential for international trade. But policy should start at the development end, rather than the trade end, of the relationship between trade and development;
- Policy should recognize the primary importance of productive employment as the basis for substantial poverty reduction. This does not mean that social sector spending and human development goals are unimportant. Improved health and education standards are essential in the LDCs. However, there is a need for a better balance between the roles of private incomes (based on employment) and public services (through which health and education are primarily provided) in poverty reduction; and
- There is a need for a better balance between States and markets in promoting development and reducing poverty. The persistence of pervasive poverty and the food price bubble indicates massive market failure. Whilst Governments are not omnipotent, there is need for creative solutions based on public action which mobilizes key stakeholders, including in particular the private sector, to resolve development problems and create development opportunities.

Making such a change towards a more sustainable and inclusive development model depends on the decisions and political will of LDC Governments. However, they are also engaged in a development partnership for poverty reduction with donors. The terms of this development partnership affect both the nature of the current strategic approach and policies, and also the potential to change them.

CHANGES IN THE TERMS OF DEVELOPMENT PARTNERSHIP

Importance of country ownership

Since 2000, development cooperation has been based on a partnership approach. The roots of the approach can be traced to the OECD report, *Shaping the Twenty-first Century: The Contribution of Development Co-operation* (1996). That report not only argued that aid should be focused on achieving a limited set of international poverty reduction and human development targets (a list that later formed the basis for the Millennium Development Goals), but also stated that the key to making a difference in achieving those targets was the establishment of development partnerships between donor and recipient Governments. The basic principle, according to the OECD report, was that “locally-owned country development strategies should emerge from an open and collaborative dialogue by local authorities with civil society and with external partners, about shared objectives and their respective contributions to the common enterprise. Each donor’s contributions should then operate within the framework of that locally-owned strategy in ways that respect and encourage strong local commitment, participation, capacity development and ownership”.

The idea of country ownership of national development strategies is at the heart of the partnership approach to development cooperation. Its importance was affirmed by the then President of the World Bank, James Wolfensohn, who made “ownership” one of the four key principles of the Comprehensive Development Framework, and in 1999 said that: “Countries must be in the driver’s seat and set the course. They must determine the goals, and the phasing, the timing and sequencing of programs”. Country ownership is also one of the key operational elements in the preparation of poverty reduction strategy papers (PRSPs). It was also part of the Monterrey Consensus on Financing for Development agreed in 2002, which states that “effective partnerships among donors and recipients are based on the recognition of national leadership and ownership of development plans”. It was reaffirmed at the G8 summit at Gleneagles in 2005, where, as well as bold commitments to cancel debt and scale up aid, it was agreed that: “It is up to developing countries themselves and their governments to take the lead on development. They need to decide, plan and sequence their economic policies to fit with their own development strategies, for which they should be accountable to all their people” (Gleneagles

Communiqué, “Africa”, para. 31). Moreover, enhanced country ownership is one of the main components of the 2005 Paris Declaration on Aid Effectiveness, the implementation of which will be assessed in Accra, Ghana, in September 2008.

Within the LDCs, PRSPs are the main operational instrument of the partnership approach to development and the key locus where country ownership is being forged. This Report assesses progress towards country ownership in the formulation and implementation of recent PRSPs in LDCs using evidence from case studies to be found in the literature. It focuses in particular on progress towards the exercise of leadership in the design and implementation of their development strategies and in coordinating development actions. This is one of the key commitments of the Paris Declaration but it is not the aspect of ownership that is currently being monitored.

Defined in these terms, the notion of country ownership is very difficult to monitor. However, the case studies enable the identification of some ways in which the nature of the aid relationship is working to strengthen or weaken country ownership. They also enable the identification of some of the adverse consequences of weak country ownership.

Progress towards country ownership

The Report finds that in the context of the PRSP approach, significant steps have been taken to enhance country ownership. Donors and international financial institutions are making major efforts to stand back and give country authorities greater space for formulating and implementing their development strategies and policies. However, it also finds that various processes continue to weaken country ownership in LDCs and this is having adverse consequences for development effectiveness and aid effectiveness. These processes cannot be attributed to the practices of donors *per se* or recipients *per se*, but rather depend on the nature of aid relationships. Ensuring that high levels of aid dependence do not result in donor domination is a complex challenge for both aid donors and aid recipients.

The processes weakening country ownership come into play at the level of policy formulation or at the level of policy implementation. The latter may arise because donors deliver part of their aid in ways which are off-plan, off-budget or simply unknown, or because, even when aid is integrated with government

priorities, processes and systems, the way in which PRSPs are implemented is strongly influenced by policy conditionality, monitoring benchmarks or donor financing choices.

The Report shows that although progress is being made in the context of the drive to improve aid effectiveness, there is a continuing problem of poor alignment and harmonization of aid with Government plans, budgets and processes. Some LDCs are caught in what the OECD has called a “low ownership trap”, where there is low capacity in Government and donors fear aid will be mismanaged and so set up parallel systems, which in turn undermine Government capacity. There are also continuing problems of predictability that disrupt planning and budgeting, and Governments have incomplete information on how much aid money is entering the country and what it is used for. These widely recognized problematic features of aid delivery continue to undermine ownership in LDCs. Progress in this regard will be a key consideration at the meeting to assess the status of implementation of the Paris Declaration in Accra, Ghana, in September 2008.

The ability of countries to exercise effective leadership in the process of policy formulation is undermined by weak technical capacities. As a result, countries sometimes have to rely heavily on donor support in the design of national strategies. Freedom of action in policy design can also be constrained by the need to mobilize aid inflows and the sense, justifiable or not, that signs of lack of commitment to the types of policies that donors and international financial institutions believe are the best ones can work against aid mobilization. Second-generation PRSPs are now very broad documents that include an amalgam of elements, including: (a) a core policy agenda which is strongly owned by the national Government; (b) a policy agenda that is directly or indirectly negotiated with donors and around which there is broad consensus and agreement; and (c) a policy agenda that is more closely aligned with donor preferences and that enjoys very little or very narrow country ownership. There is thus an ownership frontier *within* the PRSPs. It is possible, therefore, for aid to be aligned and harmonized with the document but for this to be done in a way that is more focused on donor priorities within the national plan.

A consequence of this is that the processes of policy implementation are now a very important mechanism through which country ownership can be strengthened or weakened. The Report shows that there have been major shifts in the practice of policy conditionality. There is an increasing tendency

for policy conditionalities to be drawn from Government documents and there has also been a shift towards administrative benchmarks rather than legally binding conditionality. However, macroeconomic stabilization, privatization and liberalization are still important types of conditionality. Policy conditionality has not been conducive to policy pluralism.

Given the broad policy agenda contained in PRSPs, donor financing choices are also an important determinant of how PRSPs work out in practice. This is the case even when donors give budget support, as this support usually involves performance assessment frameworks that are negotiated to set priorities. Donors are particularly oriented towards financing social sectors and social infrastructure.

Consequences of the weakening of country ownership

The second-generation poverty reduction strategies in LDCs are quite different from the early PRSPs. They seek to place poverty reduction and the achievement of the Millennium Development Goals within a broad economic development framework. In many LDCs these strategies have the potential to become effective development strategies. However, realizing this potential depends on meeting a broad range of development governance challenges, rather than merely focusing on poverty-oriented public expenditure and budgeting, which have been the key concerns in the first-generation poverty reduction strategies up to now. The weakening of country ownership is having adverse consequences for addressing these challenges and also development effectiveness.

There are three major adverse outcomes that are related to weak country ownership.

Firstly, the macroeconomic framework of poverty reduction strategies is weakly integrated with sectoral policies and trade policies. This lack of integration is problematic because the parameters of macroeconomic responses, such as the impact of public spending, depend on sector-level issues (costs and consequences). It also means that there has been a failure to properly integrate trade into poverty reduction strategies as the macroeconomic forecasts of exports and imports are divorced from the actual trade policies within the strategies.

Secondly, there is a downscaling of ambition in relation to increased aid inflows. It is clear that most LDC Governments want increased aid inflows, but there is a fundamental mismatch between this desire and the way in which PRSPs are written. This arises because the macroeconomic framework is usually based on modest projections of future aid inflows. In fact, with these forecasts the PRSPs are downscaled to be realistic in terms of past aid inflows rather than upscaled to explore how increased aid inflows can be effectively used to promote economic growth, poverty reduction and the achievement of the Millennium Development Goals. This results in minimalist poverty reduction strategies rather than poverty reduction strategies that explore the effects of the scaling-up of aid.

Thirdly, there is a low level of financing of productive sectors. One of the hallmarks of the second-generation PRSPs is that they are no longer narrowly focused on increased social expenditure but also include the development of productive sectors. However, as noted above, there has been no change in the relative share of aid disbursements going to productive sectors over the last few years. This mismatch between the change in the policy content of PRSPs and the lack of change in the composition of aid is a primary indicator of weak country ownership in the implementation of poverty reduction strategies. The low financing of productive sector development means that although PRSPs aspire to place poverty reduction and the achievement of the MDGs within a broad economic development framework, in practice they do not succeed. Moreover, the combination of policy conditionality geared to stabilization, liberalization and privatization, with donor financing oriented towards social sectors, ends up giving a specific strategic thrust to PRSPs. The evidence discussed earlier in this overview shows that this development model is unlikely to result in either sustained or inclusive development.

What can be done?

Increasing country ownership should be a major priority for improving development effectiveness in LDCs. This involves action on a range of fronts. One of the principal recommendations of the Report is that a first step towards improving country ownership could be to adopt aid management policies within LDCs. The Paris Declaration encourages countries to do this. Moreover, some LDCs, such as Mozambique, Rwanda, Uganda and the United Republic of Tanzania, are pioneers in this innovative practice.

Initial experience indicates that country-level aid management policies can provide a powerful bottom-up approach to better aid management. The improvements observed include: better data on aid inflows; increased levels of trust; increasing assertiveness on the part of the Government in expressing its preferences; greater rationalization and harmonization of processes and procedures among donors; increased predictability of aid, with donors making multi-year aid commitments; reduced transaction costs as donors support a joint assistance strategy; and increased mutual accountability, as performance indicators relate not only to government actions but also to donor actions in relation to aid disbursements. The introduction of jointly agreed monitoring indicators at the country level in relation to donor practices seems to be a particularly powerful way to reduce transaction costs and promote alignment and harmonization. However, it is important that country-level efforts to improve aid management do not crowd out thinking and action on the design of effective development strategies.

The purpose of a country-level aid management policy is to ensure that development assistance is of such a type, and is so deployed, as to maximize its contribution to the priorities set out in its development strategy. Together, a country-level aid management policy and country-owned development strategy can work as important instruments through which the terms of development partnership can be made more effective. The aid management policy can help to build trust and develop more balanced partnership, but in itself it will not be sufficient.

In the end, enhanced country ownership will depend on systemic measures as well as country-level action. Given the new focus of the second-generation PRSPs, it is necessary to rebuild State capacities for promoting growth and development. Renewed attention needs to be given to the nature of policy conditionality and the problem of aid predictability and volatility. It is also necessary to assess whether there are systemic biases against using aid in a catalytic way to develop productive sectors. Action to build local policy analysis capacity in LDCs and to generate alternative perspectives, especially from developing countries and LDCs, in the production of knowledge about development will also be important.



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