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Policy Implications

Chapter 8

A. Introduction

The analysis and empirical evidence in the previous chapters have significant policy implications. The Report has sought to present the evidence in a comprehensive manner so that it can serve as a resource for policymakers and promote open policy dialogue both within the LDCs and between the LDCs and their development partners. Without seeking to pre-empt alternative locally-grounded interpretations, this final chapter draws some policy implications.

The basic message of this chapter is that there is a need for a paradigm shift in national and international policies to promote development and poverty reduction in the LDCs. The scaling-up of net ODA inflows into the LDCs since 2000, and promises of further increases in aid and enhanced complementary measures in the area of trade and debt relief, are potentially creating a major development opportunity. But the doubling and redoubling of external resources will not be effective if it is linked to the wrong development model. Unless external resources are geared to the development of the productive capacities of the LDCs, the recent growth spurts which many LDCs have experienced (see part I of this Report) will simply fizzle out and the past widespread pattern of growth collapses will reoccur. The paradigm shift which is required is one which places the development of productive capacities at the heart of national and international efforts to promote economic growth and reduce poverty in the LDCs.

There is a need for a paradigm shift in national and international policies to promote development and poverty reduction in the LDCs.

This chapter is divided into three sections. Section B sets out why the development of productive capacities is so important for poverty reduction, why current policies are not adequately addressing the challenge of developing productive capacities and what is the nature of the paradigm shift which is required. Section C focuses on the three key constraints on the development of productive capacities in the LDCs which have been identified in the previous three chapters of the Report — the infrastructure divide, institutional weaknesses and the demand constraint. The section identifies policy priorities and policy measures in each of these areas. Finally, section D briefly discusses the implications of the focus on the development of productive capacities for national and global governance.

The development of productive capacities should be placed at the heart of national and international efforts to promote economic growth and reduce poverty in the LDCs.

B. The paradigm shift: Its rationale and nature

1. The rationale for the paradigm shift

The need for the paradigm shift is based on the following two propositions:

- Substantial and sustained poverty reduction in the LDCs requires the development of their productive capacities so as to provide productive employment opportunities.
- National and international policies are not adequately addressing the challenge of developing productive capacities in the LDCs.

This section explains those propositions in turn.

(a) Productive capacities and poverty reduction in the LDCs

Substantial and sustained poverty reduction in the LDCs requires the development of their productive capacities because of the nature of poverty within the LDCs. It is not something which affects a minority of the population but rather is all-pervasive throughout society (see UNCTAD, 2002).

Mass poverty is rooted in low labour productivity and the underemployment of the labour force. Reducing poverty in this context requires the expansion of productive employment opportunities.

Generalized (or mass) poverty is rooted in low labour productivity and the underemployment of the labour force. Most persons have to earn a living using their raw labour, with rudimentary tools and equipment, little education and training, and poor physical infrastructure. They mainly work in household-based micro-enterprises rather than in firms, and the domestic financial systems and domestic knowledge systems which enable investment, technological learning and innovation are very weak. The economies of the LDCs are dominated by agriculture, which is subject to diminishing returns and the vagaries of the weather and climate; the extraction of mineral or oil resources which are non-renewable and will become exhausted; and petty services through which the poor compete with the poor to supply the basic needs of the poor. A few have also developed low-technology manufactures, mainly in clothing and garments, and also strong tourism sectors. Exports and imports constitute over half the GDP of the LDCs as a group. But there is a very limited range of products in which they are internationally competitive, and it is difficult for them to compete in their own markets even in simple products. Their export structure is dominated by primary commodities and, in spite of the recent boom in mineral and oil prices, most LDCs have experienced severe terms-of-trade losses since 1980. Food imports have been increasing significantly since the mid-1990s, particularly in African LDCs.

Reducing poverty in this context requires the expansion of productive employment opportunities. This in turn requires increased investment and technological learning to increase capital per worker, knowledge assets and productivity. It also requires structural change away from economic activities which are subject to diminishing returns, declining terms of trade and the vagaries of the natural environment towards economic activities which are likely to provide increasing returns and which offer increased opportunities for technological progress. One consequence of generalized poverty is that domestic markets are limited and stagnant, and thus incentives to invest and innovate are weak. But with the expansion of productive employment, the stimulus of domestic demand will strengthen. Investment and technological learning are also the basis of improved international competitiveness in tradable sectors, and the development of productive capacities is thus also essential for taking advantage of economic opportunities associated with demand in international markets. Poverty reduction can occur rapidly if policy can catalyse and sustain a virtuous circle in which the development of productive capacities and the growth of demand mutually reinforce each other.

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The need to focus on the development of productive capacities is particularly important now because the LDCs are at a critical moment of transition in which they face a double challenge.

In the past, the major mechanism through which the growing labour force has found employment was through the expansion of agricultural land. But this is becoming more and more circumscribed as there is a general tendency for agricultural land per agricultural worker to decline and more and more farmers are working on fragile land. Even in land-abundant LDCs, inequalities in land access mean that the poorest smallholders have little access to land. In these circumstances it is becoming increasingly difficult to productively absorb labour within agriculture. More and more people are seeking work outside agriculture, and urbanization is accelerating. However, productive absorption of labour outside agriculture is simply not happening in many LDCs. For the LDC group as whole, non-agricultural labour productivity declined between 1980–1983 and 2000–2003. Moreover, this declining trend is evident in four fifths of the LDCs for which data are available.

More people are seeking work outside agriculture, and urbanization is accelerating. However, productive absorption of labour outside agriculture is simply not happening in many LDCs.

For the LDCs as a group, the decade 2000–2010 is going to be the first decade in which the growth of the economically active population outside agriculture is predicted to be greater than the growth of the economically active population within agriculture. This transition will affect more than half the LDCs during the decade and even more in the decade 2010–2020. The past inability of most LDCs to generate productive non-farm jobs is thus a particularly serious problem. Real poverty reduction, which goes beyond palliative measures that alleviate the symptoms of suffering, will be impossible if this problem is not addressed now.

The challenge of generating productive employment to meet this urban transition is compounded by a second challenge – the challenge of globalization. As shown in earlier LDC Reports, very few LDCs have restrictive trade regimes at the present time and most have undertaken rapid and extensive trade liberalization. However, their existing production and trade structures offer very limited opportunities in a rapidly globalizing world driven by new knowledge-intensive products with demanding conditions of market entry. At the same time, the 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, R&D and management practice, which most LDC economies have lacked the resources to do. The relentless logic of cumulative causation threatens to push LDCs even further behind.

Generating productive employment to meet the urban transition is compounded by the challenge of globalization and an unprecedented degree of global competition.

Against this background, it is essential that national and international action to reduce poverty in the LDCs focus on the development of their productive capacities and the concomitant expansion of productive employment opportunities. This is urgent in the current conjuncture in which on the one hand the LDCs are in an urban transition, with more and more people seeking work in non-agricultural activities, and on the other hand the LDCs must compete within the global economy.

b) The adequacy of current national and international policies

A paradigm shift is required because current national and international policies which seek to promote development and poverty reduction in the LDCs are not adequately addressing the challenge of developing their productive capacities.

Current national and international policies are not adequately addressing the challenge of developing their productive capacities.

Most of the LDCs have been engaged in economic reforms since the late 1980s. These were initially undertaken within the context of structural adjustment programmes and involved macroeconomic stabilization, liberalization and privatization in a package of measures widely referred to as the "Washington Consensus" (Williamson, 1990). Since 2000, they have been undertaken in the context of a second generation of economic reforms. These are generally being implemented through poverty reduction strategies which are undertaken within the context of the PRSP approach. As discussed in earlier Reports, the PRSP approach seeks to facilitate more context-specific and nationally-owned economic reforms, as well as to ensure greater donor coordination and alignment behind national strategies (see UNCTAD, 2002;

UNCTAD, 2004a). However, the poverty reduction strategies also implement the policy agenda of the second-generation reforms, which include a greater focus on poverty and human development outcomes and the social orientation of public expenditure, as well as an increased concern for institutions of governance and improving the administrative, legal and regulatory functions of the State. As part of this shift towards getting the institutions right, there is now increased emphasis on improving the investment climate. Recently too, there has been a much greater focus on infrastructure as part of the investment climate.

It is now widely agreed that the outcomes of the first-generation reforms were much less than expected. This, indeed, was the major rationale for the shift from first-generation to second-generation reforms. As the World Bank (2004a: 12) puts it, this shift "was not so much a planned strategy as a result of the disappointing supply response to first generation reforms". This disappointing response was found in LDCs as much as in other developing countries (UNCTAD, 2000).

The policy focus of reforms in the 1990s enabled better use of existing capacity but did not provide sufficient incentive for expanding that capacity.

There are disagreements over why the first-generation reforms failed. One view is that they were not properly implemented. But this view understates how much policy reform has actually taken place in developing countries. Within the LDCs, it has been considerable (UNCTAD, 2000). It is now becoming clear that the disappointing results of the first-generation reforms were rooted in design faults, rather than in weak implementation. Moreover, the fundamental weakness of these programmes was that they failed to develop productive capacities. They rarely led to increased capital accumulation and failed to address the complex issues in promoting technological learning and innovation. As the World Bank (2005a: 10) puts it, "The policy focus of reforms in the 1990s enabled better use of existing capacity but did not provide sufficient incentive for expanding that capacity". Griffin (2005: 9) has identified lack of investment as the "Achilles heel" of structural adjustment and globalization, whilst Lall (2004) argues that reforms were based on a faulty understanding of how technological learning and technology acquisition occur. Both of these authors show how the poor outcomes of the first-generation reforms were rooted in conceptual design faults with respect to how structural change, which ostensibly was the essence of structural adjustment programmes, could occur.

Second-generation reforms have recognized the problem of a weak investment response, and it is for this reason that much more emphasis is now being placed on improving the investment climate. This is certainly a move in the right direction from the perspective of the importance of developing productive capacities. However, what constitutes the investment climate can be understood in different ways. In broad terms, it is understood as "the set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs and expand" (World Bank, 2004b). But in practice, it is then defined in a narrower way in which "investment climate interventions" are firstly associated with institutions, governance and policies, and secondly, with deregulation, competition and the reduction of bureaucratic red tape. World Bank (2004b), for example, focuses on corruption, taxes, regulatory burdens and red tape, infrastructure and finance costs, labour market regulation, policy predictability and credibility, macroeconomic stability, rights to property, contract enforcement, expropriation, regulatory barriers to entry and exit, competition law and policy, functioning finance markets and infrastructure. World Bank (2004c: 4) uses the Heritage Foundation/Wall Street Journal Index of Economic Freedom to measure the quality of the investment climate, with higher scores on the index representing greater levels of government interference in the economy and a worse investment climate.

This approach to the investment climate has three weaknesses. Firstly, it focuses on *constraints* on investment but ignores the central role of effective demand as a *stimulus* for investment. Secondly, it prejudges the appropriate role of government in creating an appropriate investment climate. In the developing countries which have been most successful in promoting high rates of sustained economic growth, there has been a much more proactive approach to public action in which the animal spirits of investors have been animated through policies which create rents that are conditional on investment, technological progress or exporting (see UNCTAD, 1994, 1996; Amsden, 2004). Thirdly, the approach is concerned with establishing framework conditions for investment. But in an LDC context structural weaknesses mean that it is necessary also to address meso-level policy issues. These are related to the structure of production; persistent productivity gaps between agriculture and the rest of the economy, between formal sector and informal sector enterprises, between large and small firms, and between rich and poor farmers; and the nature of intersectoral linkages, inter-firm relationships and production complementarities. These weaknesses also mean that the development of enterprise capabilities at the micro-level is also essential. Indeed, a key finding of the Investment Climate Assessments undertaken within LDCs is that there is a high degree of firm heterogeneity in economic performance. Against this background, an approach which simply sets the overall incentives framework in place, although necessary, is insufficient.

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The recent adoption of poverty reduction as the central objective of national and international development policy has also served to complicate policymaking. As argued above, because of the essential links between production, employment and poverty, the divide between productive development and poverty reduction is certainly artificial. However, in practice the recent emphasis on poverty reduction has led to a strong focus on social sectors and related human development targets. These are certainly important, and they should constitute an essential element of a strategy to develop productive capacities. But whilst social sectors and human development targets have taken centre stage, production and employment issues have been neglected. Once this occurs, there is a danger that there will be a partial approach which addresses the symptoms of poverty rather than its causes. It has even been suggested that "Present policies run the risk of creating serious imbalances between efforts to create development and the palliative efforts of aid. What we may be creating is a system that could be described as 'welfare colonialism" (Reinert, 2005: 15).

Because of the essential links between production, employment and poverty, the divide between productive development and poverty reduction is certainly artificial.

Analysis of trends in the composition of aid commitments shows that there has been a significant decline in the share of ODA to LDCs which is committed to economic infrastructure and production-oriented sectors. The recent interest in "aid for trade" is a welcome reversal of this tendency, provided that it focuses, inter alia, on support to enhance supply capacities in tradables. But there are ongoing discussions about how this notion can be defined. Moreover, regardless of however it is defined, an approach to developing productive capacities which is simply trade-centric will not be enough for sustained and inclusive economic growth in the LDCs. As shown in the last LDC Report, export expansion has frequently not been associated with poverty reduction in the LDCs, partly because export activities develop as enclaves which are weakly linked to the rest of the economy and partly because they do not, in themselves, generate sufficient employment opportunities for the expanding labour supply.

Substantial and sustained poverty reduction in the LDCs will require "aid for the development of productive capacities", a part of which is "aid for trade".

It is important, too, that international support for the LDCs builds on domestic potentials. One consequence of the combination of a deficiency of domestic demand on the one hand, and weak capabilities, infrastructure and institutions for being internationally competitive on the other hand, is that productive resources and entrepreneurial capabilities are underutilized within the LDCs owing to lack of demand. There is surplus labour, latent entrepreneurship, untapped traditional knowledge and unsurveyed natural resources. International support for the LDCs needs to be founded on Albert Hirschmann's insight that "Development depends not so much on finding optimal combination for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized" (Hirschman, 1958: 5). Too often now, when aid is provided to develop productive capacities, it is envisaged as a "supply-side fix" to rectify perceived deficiencies, gaps and lacks, rather than serving to mobilize the creative forces and latent potentials of LDCs. The way in which technical cooperation currently works is a good example of this phenomenon (Fukudu-Parr, Lopes and Malik, 2002).

Policies should focus on promoting capital accumulation, technological progress and structural change in the LDCs and seek to start and sustain a virtuous circle in which the development of productive capacities and the growth of demand mutually reinforce each other.

2. The nature of the paradigm shift

The paradigm shift which is advocated here is one which places the development of productive capacities at the heart of national and international policies to promote economic growth and poverty reduction in the LDCs. In this approach, policies should focus on promoting capital accumulation, technological progress and structural change in the LDCs. They should seek to start and sustain a virtuous circle in which the development of productive capacities and the growth of demand mutually reinforce each other. This should be done in a way in which productive employment opportunities expand in order to ensure poverty reduction.

This paradigm shift is not something totally new. Such a policy orientation has been elaborated, for example, by ECLAC in a series of studies on productive development (box 23). Moreover, it is similar to the policy orientation of the Japanese approach to economic development (box 24), which has been so influential in spawning a variety of East Asian development models. But it would be a new policy orientation for the LDCs and their development partners, even though developing productive capacities is part and parcel of the Brussels Programme of Action for the LDCs.

The paradigm shift advocated here places production and employment at the heart of efforts to reduce poverty.

This approach is different from current policies in three major ways: it involves a different approach to poverty reduction, to productive capacities and to international trade.

(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 the productive base of a society. A society's capacity to consume is related to its capacity to produce. It also includes the essential role of employment expansion in poverty reduction.

Box 23. ECLAC´s approach to productive development

A *structuralist* strand of analysis has underpinned the approach of the Economic Commission for Latin America (ECLAC) since the 1950s, although a shift towards *neo-structuralism* has since around 1990 become the main thrust of the "ECLAC approach" to development. This is a holistic approach to productive development and is exemplified by its publication *Productive Development in Open Economies* (ECLAC, 2004).

The basic premise of the ECLAC approach is that the overall performance of the economy involves the interplay between macro-, meso- and microeconomic dynamics, the latter two referred to as *"structural" dynamics*. Because of the importance of these interactions, much emphasis in the ECLAC approach is put on understanding strategic complementarities between productive sectors. The existence of complementarities, according to ECLAC, is the basis for the system's competitiveness. The interaction between these levels also forms the basis for the delineation of a productive development strategy. It is additionally this interaction that is responsible for structural change which includes change in "productive and technological apparatuses, the configuration of factor and product markets, the availability of factors, the characteristics of entrepreneurial agents, and the way in which these markets and agents related to external circumstances" (ECLAC, 2000).

The recognition of *structural heterogeneity* is also critical to ECLAC´s approach. This heterogeneity derives from market failures, the underdevelopment of markets and asymmetries with regard to the varying ability of different economic agents to access information, factor markets and other assets. With increasing structural heterogeneity, the economy tends to exhibit deteriorating levels of aggregate productivity. If an economy is characterized by structural heterogeneity, there will be no spontaneous trend towards the full employment of productive resources (ECLAC, 2004). This is therefore the basis for concerted public action.

"Selective intervention" is needed owing to the recognition that although it is essential to have well-functioning markets, "getting the prices right" alone will not lead to economic growth that is socially equitable. "Selective intervention" is based on the justification of what is socially efficient for public policy to accomplish in areas in which it can have the greatest macroeconomic impact. A key feature of neo-structuralist thinking identifies the State as necessary for institutionalizing markets and encouraging *development from within;* this will not necessarily occur in a free-market environment.

In structurally heterogeneous economies, the application of apparently neutral policies has non-neutral outcomes. This is one of the main justifications for the reassessment of the role of public policy after the implementation of the neo-liberal policies. But the neo-structuralist approach represents a break with certain structuralist policies applied in the past, and therefore with the precepts underpinning these policies. This break represents an evolution in thinking towards recognizing the new dictates of the market economy, and that is evident in the incorporation of concepts of economic efficiency in current proposals, including an argumentation in favour of the "provision of incentives" but "on the basis of performance" (ECLAC, 2000: 233).

ECLAC´s 2004 Report entitled *Productive Development in Open Economies* provides an analysis of the main strategies available to the Latin American and Caribbean region to build, strengthen and modernize the region's productive apparatus. It includes the following three major strategies:

1) *An inclusion strategy*: intended to shift as many small productive units in the economy from the informal to the formal sector. Some mechanisms for this purpose include: the simplification of rules and administrative procedures, lower taxes with simplified declaration procedures, expanded access to credit for small investments, and basic training in management and technology skills.
2) *A modernization strategy*: based on selective measures directed at different production clusters or particular production chains. Criteria for selection could include the possibility of producing goods and services for exports, the possibility of introduction of higher levels of technology in the productive system, and so forth. It is suggested that support for modernizing production could include policies to improve access to information, credit, technology and marketing systems, and export activities enhanced by offering services for the provision of guidance on foreign markets by specialized public agencies, as well as by private sector business associations. Additionally, policies directed at training activities, the incorporation of improvements in production and technology, and procurement of new machinery and equipment should be adopted.
3) *A densification strategy,* which involves incorporating more knowledge into the national productive environment, to create a more interlinked web of productive, technological, entrepreneurial and labour relations. This simultaneously requires the necessary well-functioning institutions and public policy, and greater private sector involvement. This would include the implementation of programmes aimed at strengthening the links at the export base, public–private cooperation in particular areas of innovation, attracting higher-quality foreign investment for the creation of productive links and technological capacities, and strengthening services infrastructure to ease production bottlenecks.

Box 24. A Japanese approach to economic development

Like ECLAC (see box 23), various Japanese development economists have elaborated an approach to economic development which focuses on production development. Ohno (1998) summarizes the main features of the Japanese approach as follows:

- The highest priority should be given to the real economy, not financial targets.
- Real targets should be part of a long-term development strategy (not quarterly or monthly performance criteria) which would typically include "(i) setting long-term national goals (e.g. creating a certain number of jobs within five years, doubling income in ten years, building industries from scratch, achieving industrialization by 2020); and (ii) designing comprehensive and concrete annual steps towards these goals, identifying bottlenecks, appropriate budgetary resources and establishing implementing bodies' strategies. Working backwards from long-term goals thus determines action required today.
- Government plays an active role in promoting development.
- It is understood that fostering a market economy takes time.
- Strategies need to be country-specific.

Yanagihara (1998) distinguishes between the framework approach and the ingredients approach to development policy. As he puts it, "The 'framework' represents rules of the game according to which economic agents make decisions and take action in a given economy…In contrast, the 'ingredients' refer to tangible organizational units such as enterprises, official bureaus, and industrial projects and their aggregations such as industries, sectors and regions. They may, however, also relate to factors of production — land, labor, capital and technology — at different levels of aggregation and specificity. The ingredients approach conceives the economy as a collection of these components. It envisions economic development as the quantitative expansion and qualitative upgrading of the components, accompanied by shifts in composition" (pp. 70–71).

These approaches see development and structural adjustment policies in distinctly different ways. "In the 'framework approach' the central task of policy and institutional reforms is correcting distortions to the incentive scheme, defined by the policy environment and institutional arrangements. By contrast, in the 'ingredients approach' policies and institutions are viewed as tangible inputs, like conventional factors of production, that shape the process of economic change. They are the means to achieve a future vision of the economy, typically depicted in terms of a collection of industrial or regional economies". (p. 71)

In the "framework approach", "setting the framework right is considered a necessary, if not always sufficient, condition for successful development which will be manifested in improved macroeconomic indicators. By … [the] very essence of the approach, little consideration is given to what sort of real-sector economy will result once the framework is in place: that is left to the market to determine. Conversely in the ingredients approach the economic outcome in terms of sectoral composition or industrial organization occupies centre stage, while the mode of economic management remains flexible and uncommitted. Certain economic orientations, such as what sectors or activities ought to be given priority, come into play but they are derived from, and therefore subordinate to, the ultimate goal — or premeditated result — of economic development" (p. 71). This approach is "results-oriented, conceptualized in tangible rather than functional terms (building new factories versus enhancing the market mechanism in general). Development strategy aims to achieve economic expansion via accumulation of appropriate ingredients to increase productive capacity at the firm or project level" (p. 75).

In applying this approach in the context of very poor countries, a basic insight is that the market economy is underdeveloped and that markets have to be created (Ishikawa, 1998). Poverty reduction strategies should also focus on production and productivity rather than simply seeking to alleviate poverty directly (Ohno, 2002; Ishikawa, 2002).

Work within ILO on the employment nexus between growth and poverty has a similar emphasis (see box 13).

(b) The approach to productive capacities

From the foregoing discussion of the investment climate, it is clear that the development of productive capacities is not absent from the current policy approach. However, the paradigm shift advocated here involves a different approach to the development of productive capacities. This involves the following:

- Macroeconomic policies oriented to promoting growth, investment and employment;
- A multilevel approach which not only seeks to set the framework institutions and macroeconomic environment, but also includes policies to change meso-level production structures and institutions, as well as micro-level capabilities and incentives;
- An active approach to promoting entrepreneurship;
- A strategic approach to global integration.

Macroeconomic policies need to shift away from a focus on financial stabilization to promoting economic growth, investment and employment.

Macroeconomic policies are an essential part of developing productive capacities. But if the development of productive capacities is adopted as the central policy goal, macroeconomic policies need to shift away from a focus on financial stabilization to promoting economic growth, investment and employment. Ffrench-Davies (2005) has called such an approach "a macroeconomics-for-development". This "requires a clear and systematic distinction between what is merely an economic recovery as opposed to generating additional productive capacity. Distinguishing between creating *new* capacity and using *existing* capacity should be a guiding principle for monetary, exchange rate and fiscal policy, as well as regulation of capital flows" (p. 7). He goes on to argue that "To ensure a policy environment that stimulates growth, countries must strive to get the *real* macroeconomic fundamentals right. This implies a sustainable external deficit, a moderate stock of external liabilities with a low liquid share, and a reasonable matching of terms and currencies. It also means a crowding in of domestic savings, limited exchange-rate appreciation and an effective demand consistent with the production frontier, together with responsible fiscal policies and a manageable inflation rate" (p. 7).

Increasing productivity and employment for long-run sustainable growth requires a twin strategy of investing in dynamically growing sectors while at the same time building capacity in sectors where the majority of labour is employed.

The *multilevel approach* is based on the insight that the dynamics of production structures matter for economic growth and that within any given macroeconomic framework, there are very heterogeneous outcomes amongst enterprises involved in the same economic activities. Meso-policies are thus required in addition to macro-economic policies in order to promote structural change and dynamic linkages, and these should be complemented with policies to build micro-level enterprise capabilities. This is not a matter of "picking winners", as it is often disparagingly described. Within the LDCs, increasing productivity and employment for long-run sustainable growth requires a twin strategy of investing in dynamically growing sectors while at the same time building capacity in sectors where the majority of labour is employed. A strategy of investing only in dynamic sectors in attempts to "leapfrog" may not be enough to reduce poverty, mainly because the fastest-growing sectors may often not be where the majority of the poor are employed and may require skills and training that the poor do not possess. The challenge then is to broaden the impact of the dynamically growing sectors of the economy, while deepening their linkages with other sectors in the economy — sectors where the majority of the poor are underemployed. At the same time, it is paramount to ensure that the poor can be provided with skills and training for labour absorption in these growing areas of the economy.

The most effective approach would support and stimulate simultaneous investments in agriculture, industry and services along the value chain of the promising sectors, as well as promotion of exports, which would stimulate upgrading and increased local value-added of abundant natural resources. The focus should be on integrated development that would set off an interactive growth process that recognizes the important role of intersectoral dynamics in rural and non-rural activities, particularly in those activities that can catalyse and sustain economic growth through a dynamic interrelationship between the primary, secondary and tertiary sectors. Agricultural growth linkages, in which there is a virtuous circle in which demand stimulus from agricultural growth generates investment, entrepreneurship and employment in non-agricultural activities, particularly non-tradables, are likely to be relevant in many LDCs and at the heart of efforts to create a more inclusive process of development which supports sustainable poverty reduction.

The focus should be on integrated development that would set off an interactive growth process that recognizes the important role of intersectoral dynamics in rural and non-rural activities, particularly in those activities that can catalyse and sustain economic growth through a dynamic interrelationship between the primary, secondary and tertiary sectors.

Entrepreneurship is a critical component within the process of developing productive capacities. It is essentially the deliberate act of creating economic value by seizing new opportunities through risk taking and the mobilization of human, social, financial and physical capital. There are two features of entrepreneurship which are important for channelling this animating force into the development of productive capacities. Firstly, rents (or the extra profits associated with innovative activity) play an important role in animating entrepreneurship (Kahn and Jomo, 2000). Secondly, entrepreneurship need not always be oriented to positive economic outcomes. If entrepreneurship is understood to involve rent seeking it is necessary to distinguish between productive and unproductive variants. Unproductive or destructive entrepreneurial activities involve individuals or firms that are engaging in profit-seeking activities based on asymmetric information, establishing illegal barriers to entry or reinforcing a monopoly position. Such activities require unproductive use of resources in securing rents and can become very destructive by encouraging predatory types of firm behaviour. On the other hand, productive entrepreneurship can help to direct resources towards productive uses. A major policy challenge in LDCs today is how to convert rent-seeking unproductive entrepreneurship into productive entrepreneurship and how to use public action to create entrepreneurial rents which act as incentives for productive entrepreneurship and thus to channel entrepreneurship into the development of productive capacities.

A major policy challenge in LDCs today is how to convert rent-seeking unproductive entrepreneurship into productive entrepreneurship and how to use public action to create entrepreneurial rents which act as incentives for productive entrepreneurship.

The development of productive capacities is a strategy of "development from within", as Sunkel (1993) has put it,[1] in the sense that it seeks to mobilize and develop domestic productive resources and capabilities and to increase production linkages within the national economy. However, it is important not to confuse this with an inward-looking strategy. There are major opportunities for the development of productive capacities through global integration. Thus *policies of global integration* are an essential part of the policy orientation being advocated here.

However, policies for global integration should not be equated with trade and capital account liberalization. There is a broader range of options for strategic integration with the rest of the world which include, but are not limited to, a permissive state of full openness. As Westphal (2004) has put it with regard to trade integration, "Openness in efficacious terms does not preclude a significant degree of import protection, but only so long as protectionist measures do not unduly constrain a country's pursuit of its dynamic comparative advantage, as was true at least in the case of Taiwan [Province of China] and [the Republic of Korea]." Bradford (2005) notes that there is a role for targeted capital controls and intermediate exchange rate regimes in providing the macroeconomic policy space to prioritize economic growth.

What is best will vary between countries. But what is being advocated here is a strategic approach to global integration in which the speed and degree of liberalization in different types of economic interaction areas take account of the goal of developing productive capacities. In many LDCs, the regional dimension of global integration is likely to be important. Moreover, policies need to be adopted to maximize the opportunities and minimize the risks of global integration.

In this regard, three major opportunities can be underlined. Firstly, the external market, as a vent for surplus, can provide an outlet for domestic productive capacities that would otherwise remain underutilized, and can trigger a virtuous circle of higher demand, greater investment and increased productivity growth. Secondly, much of the effort in developing productive capacities should be concentrated on strengthening the role and size of domestic enterprises. However, foreign firms (through FDI and other channels) can be a beneficial factor in this process if domestic policy works to ensure that foreign enterprises crowd in rather than crowd out domestic enterprises, and if there are dynamic linkages between them promoting learning and investment. Thirdly, promoting the acquisition of imported technologies, technological learning and the diffusion of best practice amongst firms can provide important opportunities for accelerating economic growth through technological catch-up.

The paradigm shift entails starting at the development end, rather than the trade end, of the relationship between trade and development.

(c) The approach to international trade

The paradigm shift advocated here also involves a different approach to international trade. Since the early 1980s, there has been a strong tendency for ideas from international trade theory to dominate the 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 in the 1990s through arguments to the effect 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 replace national development as the major policy objective of Governments.

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.

As argued in the last LDC Report on trade and poverty, "International trade can play a powerful role in reducing poverty in the least developed countries as well as in other developing countries. But 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" (UNCTAD, 2004a: 67). The policy approach advocated here thus first focuses 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 the beneficial effects of trade.

C. Some policy options and policy measures

National and international policies to develop productive capacities in the LDCs should prioritize the relaxing of key constraints on capital accumulation, technological progress and structural change.

National and international policies to develop productive capacities in the LDCs should prioritize the relaxing of key constraints on capital accumulation, technological progress and structural change. The idea that public policy in developing countries should focus on relaxing key constraints on economic growth has been recently elaborated by Hausmann, Rodrik and Velasco (2005). They argue that economic reforms should be growth strategies and propose that the latter should be formulated "by identifying the most binding constraints on economic activity, and hence the set of policies that, once targeted on these constraints at any point in time, is likely to provide the biggest bang for the reform buck" (p. 2). The approach proposed here — to focus on relaxing key constraints on capital accumulation, technological progress and structural change — is analogous.

As Hausmann, Rodrik and Velasco argue, one of the advantages of such policy diagnostics is that it gets away from a one-size-fits-all approach to economic reform and identifies binding constraints in particular country contexts. It is important that in putting productive capacities at the heart of national and international policies to promote economic growth and poverty reduction in the LDCs, a context-specific approach be followed. However, in order to illustrate what the paradigm shift might mean in practice, this section focuses on the three key constraints which were identified in the previous three chapters of the Report and seeks to summarize briefly some of the key policy priorities and policy measures to relax these constraints. The three constraints are:

It is important that in putting productive capacities at the heart of national and international policies to promote economic growth and poverty reduction in the LDCs, a context-specific approach should be followed.

- The infrastructure divide;
- Institutional weaknesses — firms, financial systems and knowledge systems;
- The demand constraint.

The main message which follows from this discussion is that the paradigm shift does not entail wholesale changes in the subjects which policymakers are seeking to address. However, some policy issues which have been ignored or neglected assume more importance than previously, and some old policy issues are treated in a different way. Moreover, the focus on the development of productive capacities is likely to raise questions with regard to national and global governance, which is an issue which will be dealt with in the final section of this chapter.

1. Closing the infrastructure divide

Closing the physical infrastructure divide between LDCs and other developing countries is one of the quantitative targets of the Brussels Programme of Action for the LDCs. The evidence of this Report suggests that it is an important objective as the LDCs have the poorest transport, telecommunication and energy infrastructure in the world. Although possibilities for private financing of physical infrastructure should not be neglected, the past record shows that this source alone cannot meet infrastructure needs. There is thus a need for increased public investment and a reversal of the downward trend in aid for economic infrastructure which a number of LDCs, particularly in Africa, have experienced in the period 1990–2003. In the field of physical infrastructure there is a strong complementarity between private and public investment. This complementarity can serve as an important source of growth and an important influence on the composition and distribution of gains from growth. Public investment can be a key factor in raising the levels of productivity in order to generate a net surplus as a key source of accumulation in all sectors of the economy (UN Millennium Project, 2005).

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Improved physical infrastructure can play an important role in reducing the costs and the amount of time with which exporters have to contend in international trade transactions. However, infrastructure investment should focus not only on investment in trade-related infrastructure. There is rather a need for a joined-up approach to infrastructure development which includes (i) rural infrastructure and district-level links between rural areas and small towns; (ii) large-scale national infrastructure (such as trunk roads, transmission lines and port facilities); and (iii) cross-border regional infrastructure. Increased public investment in the first is important for agricultural productivity growth and the development of a market economy in rural areas, as well as the creation of rural non-farm employment. Increased public investment in the second is important for diversification and structural change, as well as international trade integration. Increased public investment in the third is important for regional integration.

Particular efforts should be made to promote electrification and to close the electricity divide between LDCs and other developing countries. Most modern technologies require electricity, and the current low levels of access to electricity increase costs for firms, reducing their available funds for investment, and are a basic source of the technological incongruence between the LDCs and the rest of the world which is hampering the acquisition of technologies. This Report also shows that access to electricity affects the composition of exports in developing countries, and that differences in the degree of diversification into manufactures exports are partly related to the degree of electrification.

Particular efforts should be made to promote electrification and to close the electricity divide between LDCs and other developing countries.

2. Addressing institutional weaknesses: Firms, financial systems and knowledge systems

The major thrust of current efforts to get institutions right is focused on good governance. With the paradigm shift advocated here, there needs to be a much greater focus on the nature of the domestic private sector and the financial systems and knowledge systems within which it is embedded. Productive capacities are developed and put to work at the level of the firm and the farm. But this does not happen in isolation from the wider institutional context and the systems of local production and consumption within which they are embedded.

A major problem in many LDCs is that there is a "missing middle" in the enterprise structure, with a multitude of informal sector micro-enterprises coexisting with a few large firms, and there are formal sector SMEs, particularly medium-sized firms, that are weakly developed. In addition, these SMEs face numerous obstacles to expansion. The current PRSP strategies recognize this and focus on providing support for SME development and small scale entrepreneurship. Also: "Most PSD [private sector development] work has focused on providing effective support to the development of small scale entrepreneurs, [and] micro-finance schemes" (World Bank, 2001: 12). SMEs are certainly important as they tend to use local inputs and thus are the agents that

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link local primary and manufacturing activities. They also provide employment to the local population. But an exclusive focus on SMEs is based on a static view of the development process. From a dynamic efficiency perspective, large-size firms are in a better position to generate the resources to realize higher rates of capital formation, innovation, economies of scale and the accompanying learning effects. Such firms are also in a far better position to diversify into higher-value-added activities (Kozul-Wright, 1995). One major reason why SMEs do not grow is that there is an inadequate demand for their products. Fostering linkages between large firms and SMEs is an important demand-side measure to complement the supply-side measures for SME development. Moreover, such inter-firm linkages can also facilitate knowledge transfers, technology transfer and technological upgrading. This suggests the need for an alternative policy framework based on supporting firm growth and expansion, the promotion of linkages between SMEs and large firms, the development of subcontracting relations, and the promotion of clustering and spatial agglomeration.

Fostering linkages between large firms and SMEs is an important demand-side measure to complement the supply-side measures for SME development.

The development of productive capacities depends on the ability of an economy to create enterprises with a high propensity to invest, learn and innovate. A major focus of investment climate reforms is on reducing obstacles to entry, lowering costs of credit, and encouraging competition and market efficiency. But the available evidence suggests that firm entry is not the major problem, and markets are very competitive and can prune out inefficient firms. However, that "churning" process may be so strong that it may not permit new entrants to acquire the required technological capabilities to grow. Greater attention thus needs to given to constraints on firm growth. Attention should also be given to dealing with the anti-competitive conduct of oligopolistic processors and exporters (some of which are vertically integrated with TNCs), which prevents diversification and the development of new processing industries.

Without access to capital by the private sector, the potential for development of productive capacities cannot be realized.

The working of financial systems and knowledge systems is closely related to the issue of enterprise development. Financial markets are weak and subject to major market failures. Increasingly, in a more liberal policy environment, foreign financial institutions have come to dominate, but the narrow client base has not expanded and remains concentrated on either the Government or large domestic and foreign firms. Overcoming bottlenecks in financing for the private sector should be a critical priority for policymakers in the LDCs. Without access to capital by the private sector, the potential for development of productive capacities cannot be realized.

The importance of improving the financial systems in the LDCs is indeed widely recognized. However, new sources of financing urgently need to be identified and lessons may be drawn from the more successful cases in countries with deeper financial systems that are more responsive to the needs of the private sector. Experience suggests that a bank-based system is important at low levels of development. Possible financial instruments include, the following:

- Loan guarantee schemes between the public and the private sector to facilitate access to bank credit for SMEs and large enterprises investing in technical change;
- Public development banks, particularly to create long-term financing;
- Value-chain lending in which lending to enterprises along a value chain is coordinated;
- Innovative market-based financial instruments.

Knowledge systems are as important as financial systems in the development of productive capacities.

Knowledge systems are as important as financial systems in the development of productive capacities. Thus improving domestic knowledge systems should complement efforts to improve domestic financial systems. This involves not only setting up special bodies oriented to creating knowledge which could be applied in production (such as research centres), but also creating bridging institutions with users and promoting linkages amongst users. For most LDCs the three most important sources for building their domestic knowledge base are education, foreign technology imports (through foreign licensing, FDI, turnkey plants and capital goods imports) and the mobility of experienced technical personnel. These are more important than seeking to increase levels of R&D. Investing in all levels of education is particularly important given the currently low levels of schooling which are found in most LDCs. This makes technology absorption difficult and slows down the technology catch-up process.

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LDCs need to develop well-designed and coherent national technology learning strategies to increase access to technology and to improve the effectiveness of imported technology, as well as to benefit from linking to global knowledge. There are major opportunities for blending modern and traditional knowledge, particularly in areas of health and agriculture.

3. The demand constraint

The greatest shifts in policy priorities arise when the demand constraint is brought into the analysis of the development of productive capacities. In the analysis in this Report, two mechanisms through which the development of productive capacities is either limited or stimulated by demand-side factors have been emphasized: the balance-of-payments constraint on the other components of domestic demand, — namely private consumption, investment and government consumption expenditure; and the linkages between agricultural growth and the expansion of non-tradables.

The greatest shifts in policy priorities arise when the demand constraint is brought into the analysis of the development of productive capacities.

With regard to the balance-of-payments constraint, it is clear that most LDCs have persistent trade deficits which have been financed by capital inflows and transfers. When these are insufficient to finance the deficits, or when they are volatile, the other components of demand have to be limited. Moreover, current growth rates are highly dependent on the level of capital inflows and transfers, which for most countries come in the form of ODA inflows. Policy needs to be explicitly geared to relax the balance-of-payments constraint on economic growth in order to decrease dependence on external sources of finance, particularly aid. This can be achieved by supply-side reforms which increase the income elasticity of demand for exports (by increasing the share of more dynamic products in the export structure) and reduce the income demand elasticity (through facilitating efficient import substitution and rationalizing import costs).

Upgrading of the export structure is particularly important in the LDCs because it is difficult to generate sufficiently fast export growth to finance the imports they need in order to develop their productive capacities, given the current pattern of trade integration with the global economy. The current LDC growth trajectories, based on export specialization of raw, unprocessed commodities, have evolved in line with the theoretical principles of static comparative advantage. The concentration on production and export of primary commodities and extractive industries largely oriented towards external markets has essentially failed in LDCs to contribute effectively to catching up, and has not provided the road out of persistent poverty. Instead, too often, such growth trajectories have led to enclave economies, dualistic economic structures, a poor poverty reduction record, and an increase in macroeconomic instability.

Upgrading of the export structure is particularly important in the LDCs... The policy measures to achieve export upgrading should not be limited to the trade regime but should also include a new kind of industrial policy.

Box 25. Industrial policy for the 21st century

Traditional activist industrial policy aimed at shifting the structure of production towards promising sectors was applied in most developing countries in the 1950s and 1960s through the strategy of import substitution, which called for (a) subsidies to targeted industries, and (b) the nurturing of infant industries through high tariffs on, and non-tariff barriers to, imported products in order to increase the domestic demand for locally produced products. With a view to expanding their industrial bases and developing strategic sectors, the strategy of "picking winners" was widely used. Interventions included targeting and subsidizing credit to selected industries, and protecting domestic import substitutes through trade and tariff policies. Public investment was directed towards the selected "winners", and public development banks supported the development of the selected firms or sectors through sectoral or vertical industrial policy. The State helped the "winners" to export by setting export targets, and getting "prices wrong" (Amsden, 2004) in order to promote the development of domestic enterprises.

These policies often gave rise to rent-seeking by special interest groups. State-owned enterprises were not subject to performance criteria or effective monitoring in line with development goals, and this often led to rampant rent-seeking and unproductive entrepreneurship (Baumol, 1990). The situation was made worse by the debt crisis, and, too often, industrial policy became the hostage of special interest groups and wasted scarce resources.

Beginning in the 1980s, these policies were dismantled in the context of structural adjustment programmes. However, with the disappointing results of these programmes there has recently been a revival of interest in industrial policies with a new approach (Oyelaran-Oyeyinka, 2005, Kuznetsov and Sabel, 2005; Cimoli, Dosi and Nelson, 2006).

The new model of industrial policy is based on a mixed, market-based model with private entrepreneurship and government working closely together in order to create strategic complementarities between public and private sector investment. The key role assigned to Governments relates to performing a strategic and coordinating role in the productive sphere that goes "beyond simply ensuring property rights, contract enforcement and macroeconomic stability" (Rodrik, 2004b: 2). The new industrial policy essentially perceives the State as a facilitator of learning and a provider of a regulatory framework that can accommodate a system of ensured private IPRs, attract FDI through fiscal incentives and indirect subsidies, and improve market governance by removing bottlenecks and correcting market failures. The role of the State is to provide a system of market-based political governance, based on the principles of a sound macroeconomic climate, in order to promote a pro-business investment climate. The new industrial policy focuses on innovation, and emphasizes the role of non-market institutions in the process of discovery. The private sector is perceived as the main agent of change (Kuznetsov and Sabel, 2005).

The new industrial policy is conceptualized as a discovery process, in which non-market institutions such as intellectual property rights, are critical in shaping industrial dynamics. The relevant institutions and cost structures are not given but need to be discovered. There are significant risks involved. This implies the need for a partnership and synergies with the public sector to socialize risks. The State generates and coordinates private investment through market-based incentives aimed at reducing risks and sharing benefits.

The policy measures to achieve export upgrading should not be limited to the trade regime but should also include a new kind of industrial policy. Such a policy is not like the old industrial policy but should draw lessons from policy innovations in developed countries which seek to develop new kinds of public–private partnerships (box 25). It may encompass proactive measures to promote agriculture and services as well as manufacturing industries.[2] The policy needs to seek out new areas of comparative advantage, or to "acquire" comparative advantage, whereby goods with a high income elasticity of demand in the world markets are produced. There is potentially a role for selective protection in LDCs based on arguments linked to addressing market failures, capturing externalities or welfare-enhancing policies, and in the case of international distortions. Given some unfortunate experiences in implementing trade reforms (see World Bank, 2006; Laird and Fernández de Cordoba, 2006, forthcoming), this implies that, in countries which have not yet undertaken extensive trade liberalization, there is a case for caution and a gradual approach. For those countries which have undertaken trade liberalization, this is not a call for a blanket reversal of this policy; rather, it is a call for a pragmatic analysis of policy options. This could include special safeguards against food import surges.

The policy needs to seek out new areas of comparative advantage, or to "acquire" comparative advantage, whereby goods with a high income elasticity of demand in the world markets are produced.

Policymakers should be cautious in relying on the effects of national currency devaluation as a policy for balance-of-payments adjustment. From a theoretical point of view, it is not clear that a one-off currency depreciation can put an economy on a higher growth path consistent with balance-of-payments equilibrium. Devaluation will not work from the demand side if the price elasticities of demand for imports and exports are low; and devaluation will not work from the supply side if devaluation is inflationary and raises costs in the traded goods sector, which reduce foreign exchange earnings per unit of domestic inputs. Currency devaluation can be highly inflationary and have effects that could erode an initial competitive advantage. The limited role for real exchange rate adjustment reinforces the need for a structural approach to balance-of-payments difficulties focusing on the income elasticities of demand for imports and exports, rather than on price elasticities working through relative price changes. However, equally, government needs to ensure that real exchange rates do not appreciate.

The most effective strategy is not simply to focus on the development of productive capacities within the tradable sectors, but also to develop productive capacities within non-tradable activities and to intensify the dynamic linkages between those activities.

Policy analysis of the balance-of-payments constraint shows the importance of exports for growth processes within the LDCs. However, inclusive development and poverty reduction require a development strategy which also pays attention to the dynamics of domestic demand as well as external markets. This is particularly important since the domestic components of demand are the major demand-side source of economic growth in most LDCs. From this perspective, the most effective strategy is not simply to focus on the development of productive capacities within the tradable sectors, but also to develop productive capacities within non-tradable activities and to intensify the dynamic linkages between those activities. It is in the non-tradable sectors that labour can be more effectively absorbed.

Because the majority of the population in most of the LDCs are employed in agriculture, the dynamics of domestic demand are strongly influenced by what happens in agriculture. In this regard, an important poverty reduction mechanism that has been identified is the backward linkage effects of agricultural growth on the development of non-tradable industries and services in rural areas and small towns. These linkage effects mainly work through consumer demand for these products. They can create a virtuous circle in which demand stimulus from agricultural growth generates investment, entrepreneurship and employment in non-agricultural activities, particularly non-tradables, and growth of these non-agricultural activities in turn enables and stimulates investment in agriculture. Policy needs to facilitate such dynamic inter-sectoral linkages. This is likely to be relevant in many LDCs and at the heart of efforts to create a more inclusive process of development which supports sustainable poverty reduction.

The formulation and the implementation of policies to promote capital accumulation, technological progress and structural change require government–business cooperation within the framework of a pragmatic developmental State.

D. Governance issues

Placing the development of productive capacities at the heart of national and international policies to promote economic growth and reduce poverty in the LDCs has implications for both national and global governance.

1. National governance

The formulation and the implementation of policies to promote capital accumulation, technological progress and structural change require government–business cooperation within the framework of a pragmatic developmental State. The policies should be implemented as far as possible through private initiative rather than public ownership and through the market mechanism rather than administrative controls. But the Government should play a key role in animating the animal spirits of the private sector and harnessing the aggressive pursuit of profits, which is the motor driving the system, to the realization of national development and poverty reduction goals. It should play a creative role in developing markets, and also in "allowing private agents to satisfy individually or collectively certain goals unattainable through market forces alone" (Moreau, 2004: 848). Often this can be achieved through improving coordination between economic agents to take account of production and investment complementarities.

Honest, impartial and competent administrative, judicial and law enforcement systems are crucial not only for upholding the rule of law, protecting property rights and ensuring personal security but also for building an atmosphere of trust in public institutions.

Promoting the development of productive capacities will require the enhancement of State capacities rather than State minimalism. Honest, impartial and competent administrative, judicial and law enforcement systems are crucial not only for upholding the rule of law, protecting property rights and ensuring personal security but also for building an atmosphere of trust in public institutions. The developmental State also requires the creation of civil service capacities and of agencies capable of drawing up coherent development programmes and implementing specific policies so that they serve the broader national interest and are not captured by sectional or individual interests.

It may be argued that in the LDCs the State capacities required in order to develop productive capacities simply do not exist.[3] There is an objective basis for this argument. In many LDCs, the cutbacks in State administrative services since the early 1980s have been particularly severe, as the data in chapter 3 indicate. In addition, government effectiveness has suffered from an internal brain drain from government offices to bilateral and multilateral aid agencies setting up parallel projects. There are also instances of inadequate governance which arise from rapacious leadership. In some countries, predatory behaviour associated with the exploitation of natural resources has interacted with civil conflict and instability to create growth collapses. Finally, it is clear that lack of financial resources is a key source of inadequate governance (UN Millennium Project, 2005). Good governance requires an adequately paid civil service, judiciary and police force; adequate communication and information technology; equipment and training for a reliable police force; and modern technological capabilities for customs authorities to secure borders. But in poor countries the magnitude of financial resources which can be mobilized domestically for good governance is severely constrained by the weak productive base of the economy and the consequent low revenue base.

Although State capacities are weak, this does not mean that the State is irrevocably incapable.

However, although State capacities are weak, this does not mean that the State is irrevocably incapable. The government capacities required in order to formulate and implement a strategy to develop productive capacities and expand productive employment opportunities are no more exacting than those required for formulating and implementing a poverty reduction strategy. Indeed, there are probably more working models to turn to with regard to the former than the latter.

It is important to see good governance not in static terms but rather in dynamic terms as a learning process.

With the publication of comprehensive sets of governance indicators which benchmark countries globally, it appears that there is now an objective basis for measuring governance. But the methodology which is used makes it difficult to see how an individual country is changing over time and governance is measured in relative terms (i.e. governance standards in relation to other countries) rather than absolute terms. There is a close relationship between higher governance scores and GDP per capita. As a result, most LDCs will always be towards the bottom 40 per cent of countries, those with bad governance.

In the end it is important to see good governance not in static terms but rather in dynamic terms as a learning process. For this to happen, Governments need the flexibility to experiment, to make mistakes and to make incremental improvements. It is through this process that learning will take place and good governance will develop. Such processes of trial and error and institutional and policy experimentation have characterized all previous examples of successful development. Through such processes Governments have discovered what actually works in their particular context.

2. Global governance

Developing productive capacities requires not only good national governance but also good global governance. With globalization, various international institutions matter for capital accumulation, technological progress and structural changes within countries. Critically important are the international regimes governing private capital flows and aid, technology transfer and intellectual property rights, and international migration, both globally and regionally. The nature of these international regimes has an important role to play in enhancing the opportunities for globalization and reducing its risks. They are generally characterized by asymmetries which constrain and enable different countries to a different extent. Improving these regimes is an important policy pressure point to promote the development of productive capacities within LDCs.

Developing productive capacities requires not only good national governance but also good global governance.

As shown in the first part of this Report, since 2000 there has been a major scaling up of international financial support for LDCs provided by their development partners, as well as increased debt relief and international initiatives to support trade expansion. But these positive developments need to be linked more closely to national policies to develop productive capacities if they are to be effective in creating a more self-sustaining growth process and reducing aid dependence. Moreover, any conditions attached to aid must not hamper a Government's efforts to discover the best ways to develop productive capacities and its ability to experiment to find the best approach in its local context.

Making productive capacities the focus of national and international policies to promote economic growth and poverty reduction in the LDCs requires policy innovation with regard to international support measures for LDCs.

Making productive capacities the focus of national and international policies to promote economic growth and poverty reduction in the LDCs also requires policy innovation with regard to international support measures for LDCs. Examples could be: a broad approach to "aid for trade" which links it not simply to physical infrastructure but also private sector development and the promotion of linkages, as well as the development of domestic financial systems and domestic knowledge systems; measures to deepen market access with supply-side support, for example through special incentives for encouraging FDI (Cline, 2004), particularly a type of FDI which has positive spillover effects for domestic enterprise; the activation of the provision in the TRIPS Agreement to support technology transfer to LDCs; a rethinking of the role of technical cooperation and the way in which ODA supports domestic knowledge systems; or new approaches to use aid for private sector development and to strengthen the domestic financial systems in LDCs. These are indicative suggestions. Devising new international support measures which can promote the development of productive capacities in the LDCs is an important frontier for development policy analysis which should be explored in the future.

Notes

1. Sunkel (1993) describes "development from within" as a "creative domestic effort to shape productive structure" (p. 46), writing that "The heart of development lies in the supply side: quality, flexibility, the efficient combination and utilization of productive resources, the adoption of technological developments, an innovative spirit, creativity, the capacity for organization and social discipline, private and public austerity, an emphasis on savings, and the development of skills to compete internationally. In short, independent efforts undertaken from within to achieve self-sustained growth" (pp. 8–9).
2. As part of the preparations for this Report, a small ad hoc expert meeting was held in Geneva on 3 and 4 October 2005 on the subject of "New productive development policies for LDCs". The experts participating were Anthony Bartzokas (UNU-INTECH), Mario Cimoli (ECLAC) and Andrew Dorward (Imperial College, London).
3. In Africa, for example, Mkandawire (2001) has identified a series of "impossibility theses" that are often put forward to argue that the State cannot play a developmental role.

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